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What's in a Name? Reputation and Monitoring in the Audit Market

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Currently, audit reports issued in the USA do not reveal the name of the lead partner at the audit firm who conducted the audit. In December 2015, PCAOB (Public Company Accounting Oversight Board) approved a new rule which mandates that the lead partner's name be disclosed in audit reports. This rule was approved by the Securities and Exchange Commission (SEC) in May 2016 and will come into effect after January 2017[3]. In this paper, we analyse partner incentives under the two regimes (with and without disclosure of partner names) and explore the possible impact of the new rule on audit quality. This paper highlights an important tussle between monitoring and reputation incentives in a partnership under two different information structures - a collective reputation environment and an individual reputation environment. Thus, our paper contains a more general message but we set it in the audit market environment for two reasons - a) To analyse the impact of the proposed rule and b) To develop a rich model which incorporates many details particular to the audit industry in the hope that this model can be used for analyzing several questions related to the audit market.

We show that when there are similar incentives to monitor in the two regimes, an engagement partner has greater incentive to produce higher quality audit reports under the disclosure regime (as compared to the non-disclosure regime). However, an unintended consequence of this regime change is that the incentives to monitor a fellow partner are lower under the disclosure regime, which in turn can lead to lower audit quality. The intuition is as follows. While identification of the partner makes his reputation (and therefore future payoffs) more sensitive to his actions, the incentives to monitor a fellow partner reduce with identification because bad actions taken by one partner no longer affect the reputation of other partners (since reputation is not collectively shared with others under partner identification). This creates a tradeoff which makes the impact of the new rule on audit quality uncertain. We argue that this unintended consequence can be mitigated through a realignment of incentives inside the audit firm or external monitoring from regulators or through increased audit fees.

We discuss three different solutions to the monitoring problem. One potential solution is to increase audit fees which in turn leads to increased revenue for the firm. For a given sharing rule, an increased

[1] This is a working paper. Please do not quote or distribute without the authors' permission (email: somdutta.basu@gmail.com). Most of the research in this paper was conducted while Somdutta Basu was a fellow at the Public Company Accounting Oversight Board (PCAOB) and Suraj Shekhar was a graduate student at the Pennsylvania State University. Somdutta Basu is currently a research at EconOne and Suraj Shekhar is currently a post-doctoral research fellow at the African Institute of Financial Markets and Risk Management (AIFMRM), University of Cape Town. The PCAOB, as a matter of policy disclaims responsibility for any views of the authors and do not necessarily reflect the views of Board, individual Board members, or staff of the PCAOB.

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[3] Securities and Exchange Commission (Release No. 34-77787; File No. PCAOB-2016-01) May 9, 2016 Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards.

audit fee can provide incentives for both the engagement partner and the monitor partner. The proposed solution is also supported by the empirical findings of Carcello and Li (2013) where the authors report the joint occurrence of higher quality of audits and higher audit fees after audit partners were mandated to sign the audit report in the UK.

Our paper contributes to the literature by providing a theoretical model on how partner identification interacts with profit sharing rules and sanctions inside the accounting firms and affects incentives of partners. To the best of our knowledge this paper is the first to model the three relational aspects unique to the audit market (the leadership of the accounting firm to audit partner relationship, the partner-partner relationship via monitoring, and the partner's interaction with the client) to explore the consequences of a disclosure of partner names.