

Auditor Professional Skepticism: An Examination of Audit Partners and Accounting Estimates

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March 2024

Acknowledgments: We appreciate the helpful comments from Joe Brazel, Jeff Burks, Jackie Hammersley, Miguel Minutti-Meza, Michael Mowchan, Allison Nicoletti, Marcy Shepardson, Sarah Stein, Jim Wahlen and workshop participants at the University of Miami Winter Warm-Up Conference, Conference on Financial Economics and Accounting (Indiana University), Summer Audit Brownbag Series, ISB Accounting Research Conference, Hawaii Accounting Research Conference, Arizona State University, Texas A&M University, and the University of Notre Dame. The views expressed herein do not necessarily represent the views of the St. Louis Fed or the Federal Reserve System. All errors are our own.

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ABSTRACT: This paper examines whether an audit partner's professional skepticism varies within an individual audit partner/client relationship. Using confidential data on audit partner identity in the banking industry, we find that banks systematically report higher loan loss reserves at the beginning of audit partner/client relationships relative to the later years, consistent with declining partner professional skepticism during a partner/client relationship. We find that the higher skepticism in the early years of a partner/client engagement is limited to the first time a partner is matched with a client. While initial skepticism is greater for higher-risk clients, the decline in skepticism is also greater for these clients. Finally, we find that declining partner skepticism is offset when partner's experience a regulatory downgrade of another client, consistent with partner's responding to increased risk salience. Our results provide evidence that partners' skepticism changes during their relationship with a given client. The findings are informative to regulatory discussions on the effects of partner tenure on professional skepticism.

JEL Classifications: E58, J33

Keywords: professional skepticism; auditing estimates; audit partner effects; banking

I. INTRODUCTION

Audit partners' professional skepticism is central to conducting a high-quality audit (Nolder and Kadous 2018). Insufficient professional skepticism is consistently cited by regulators as a primary cause of audit failures, Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) enforcement actions, and auditor litigation (e.g., Beasley, Carcello, and Hermanson 2001; Brazel, Jackson, Schaefer, and Stewart 2016; Kraussman and Messier 2015; Messier, Kozloski and Kochetova-Kozloski 2010; PCAOB 2012). Despite the centrality of professional skepticism in the formation of regulatory policy, there is limited archival evidence that effectively isolates audit partners' professional skepticism. Such focused examination is important because, "in order to enact measures to improve skepticism, there must be a better understanding of the concepts that underlie it and the factors at different structural levels that influence it" (Glover and Prawitt 2014, 2). In this study, we examine whether and how partners' professional skepticism varies during an audit partner/client relationship.

The archival literature closest to addressing professional skepticism examines auditor rotation. The implicit assumption underlying auditor rotation studies is that impaired auditor independence due to long tenure is a threat to professional skepticism. These studies rely upon comparison of the final year of an outgoing partners' tenure with a client to the first year of the incoming partner (Laurion, Lawrence, and Ryans 2017; Kuang, Li, Sherwood, and Whited 2020; Krishnan and Zhang 2019; Lennox, Wu, and Zhang 2014; Chi, Huang, Liao, and Xie 2009; Carey and Simnett 2006). While these studies have yielded interesting insights about partner rotation, due to data limitations they are unable to speak directly to regulators' core concern of partners' changing professional skepticism because 1) auditor/client matching is not a random

process (Dodgson, Agoglia, Bennett, and Cohen 2020); and 2) partners' professional skepticism is a function of a partner's individual characteristics (Bowlin, Hobson, and Piercey 2015; Quadackers, Groot, and Wright 2014; Nolder and Kadous 2018). Without controlling for both partner-client matching and partner characteristics, it is difficult to determine whether differences in observed audit outcomes are due to changes in partner professional skepticism *during* a partner/client relationship or are a result of differences *across* audit partners and/or the endogenous matching process when rotation occurs. This distinction is critical because one of the primary arguments for audit partner rotation is to address regulators' concerns over declining professional skepticism.

Consistent with the view of audit regulators, we assume a presumptive doubt view of professional skepticism, meaning higher levels of skepticism are associated with increased auditor scrutiny as auditors must collect more audit evidence in order to conclude that accounts are reasonably stated (Nelson 2009; Glover and Prawitt 2014). Prior literature in the banking industry has demonstrated that higher levels of auditor scrutiny are associated with a higher allowance for loan loss estimate (ALL), suggesting that the level of the ALL estimate is a reasonable proxy for the extent of audit partner professional skepticism (Stuber and Hogan 2021; Ege, Nicoletti, and Stuber 2023). Thus, we utilize the level of the ALL in the banking industry as a proxy for auditor partner skepticism where higher (lower) levels of professional skepticism manifests in higher (lower) levels of the allowance for loan losses.¹

A key advantage of the banking setting is that the availability of confidential data on partner identity data allow us to construct a panel data set of audit partner/client relationships between 2005 and 2019. Data availability allows for identification of both the timing of partner

¹ We validate the ALL as a reasonable proxy for professional skepticism in Section VI.

changes, as well as individual partner tenure for 2010 to 2019. The extended time series allow us to utilize an enhanced fixed effect structure to control for individual partner characteristics and endogenous partner/client matching. Specifically, we utilize an empirical model that includes partner \times engagement fixed effects, which hold constant audit partner and client characteristics to isolate the change in skepticism within a single partner/client relationship. By isolating within-engagement changes in partner behavior we are able to provide insight into the primary concern of regulators: the effect of tenure on individual partners' professional skepticism.

We find evidence that the level of the ALL decreases significantly as the length of the partner/client relationship increase. Specifically, we find that the ALL as a fraction of beginning-of-period loans is 2.13 (2.99) percent higher during the initial year (initial two years) of an audit partner/client engagement relative to later years, consistent with partner skepticism declining during the partner/client relationship. This finding supports the concern of regulators over the potential for declining skepticism over an audit partner's tenure with a given client.

Reputational concerns and accountability pressure may differentially affect audit partners' professional skepticism and these pressures vary with the nature of the client engagement (Nelson, Elliott, and Tarpley 2002; DeZoort, Harrison, and Taylor 2006; Nolder and Kadous 2018). Thus, we next consider whether changes in audit partners' professional skepticism vary with three measures of potential partner reputation risk based on client characteristics: 1) public vs private status of the bank, 2) bank size, and 3) bank complexity. Public clients are subject to greater scrutiny such as increased legal liability and potential inspection by the Public Accounting Oversight Board (PCAOB), which may increase partner reputation risk. Similarly, clients that are larger and clients that are more complex are likely to carry greater partner reputation risk relative to smaller and less complex clients, thus increasing

partner skepticism. While the initial skepticism is higher on these clients, we find that these higher risk clients are also those where the partner exhibits a greater *decline* in skepticism relative to lower risk clients. Together the results suggest that the concerns regarding declining partner skepticism with increasing length of the partner/client relationship is particularly acute among the riskiest clients.

Auditors' professional skepticism is influenced by situational determinants and knowledge (Nelson 2009; Nolder and Kadous 2018), thus a natural question is whether partner-specific experiences moderate the relation between the length of the partner/client relationship and partners' professional skepticism. One such experience specific to the banking setting is the potential for a regulatory downgrade of a bank client. Banks are subject to high levels of regulatory oversight through regular examinations and examinations culminate in ratings of bank health and performance (Gopalan, Imdieke, Schroeder, and Stuber 2023). A bank downgrade following a regulatory examination is a negative signal of bank health on various dimensions, thus a downgrade of a bank client may increase the salience of client risk for a bank partner. Such an increased salience of risk may result in higher professional skepticism across a partner's entire portfolio of bank clients, offsetting the on average decline in skepticism that occurs absent a client downgrade. Utilizing confidential data on bank holding company regulatory ratings, we find that partners' experience of a downgrade in in the financial component of bank holding company regulatory ratings offsets the documented decline in professional skepticism over a partner/client relationship. These results are consistent with partners changing their behavior as a result of knowledge gained from clients' regulatory downgrades such that their professional skepticism does not decline across tenure with other clients. This finding is particularly interesting as it offers

some insight into the process of partner learning and a potential mechanism, other than rotation, that may mitigate concerns related to declining partner skepticism.

We next consider the effects of audit partner rotation rules which allow partners to rotate back onto the same client after a cooling off period of 5 years (i.e., “boomerang partners”). We consider whether boomerang partners assess the ALL differently in their later engagements relative to their initial engagement with the same client. Our analyses reveal that the higher skepticism in the early years of a partner/client engagement is limited to the first time a partner is matched with a client. The results suggest that partners’ level of skepticism on the second time on the client engagement is comparable to the ending level of the first time on the client engagement. This finding is consistent with the concept that partner professional skepticism is highest during the initial years of their first encounter with a client during our sample period.

Although higher professional skepticism is generally assumed to result in more effective audits, it is also possible that audit partners may be overly skeptical (Brazel, Leiby, and Schaefer 2022; Nelson, 2009; Stuber and Hogan, 2021; Westermann, Cohen, and Trompeter 2019). Therefore, we next consider whether higher ALL in the initial years of audit partner/client engagements are associated with higher estimate *quality*. Utilizing two measures of ALL quality, we find that higher ALL associated with the initial years of the partner/client relationship are indicative of higher estimate quality. Collectively, the results are consistent with audit quality benefits of higher professional skepticism in the initial years of a partner/client relationship.

This paper contributes to several streams of the accounting literature. First, we contribute to the literature on audit partner professional skepticism. We extend the behavioral literature on professional skepticism (e.g., Brazel et al. 2016; Bowlin et al. 2015; Cohen, Dalton, and Harp 2017) by providing large-scale archival evidence on changes in audit partners’ professional

skepticism during their relationship with a client. Our results are consistent with declining partner skepticism during a partner's tenure with a given client, with this decline being strongest for those clients where the initial skepticism would likely be the highest.

Second, we contribute to the literature on accounting estimates by providing insight into how auditors affect critical accounting estimates that are subject to judgment and discretion. Although prior literature examines how external parties affect bank financial reporting and the ALL level and quality (Bushman and Williams 2012; Costello, Granja, and Weber 2019; Gopalan 2022; Nicoletti 2018; Stuber and Hogan 2021), this literature does not provide insight into the effect of the partner on the ALL or how the partner's effect varies within a partner/client relationship. By using the setting of audit partner/client relationships in the banking industry, we isolate the impact of audit partners, over and above other forces, in shaping the quality of financial reporting.

Finally, we contribute to the literature on audit partner rotation. While prior studies have examined the effects of changing audit partners, we examine the mechanism that motivates the mandatory rotation policy. Understanding how audit partners affect accounting estimates during the tenure with a specific client is fundamental to informing the regulatory discussion regarding the costs and benefits of audit partner rotation with regards to improving professional skepticism. We use an extended time series of partner identity to overcome limitations of prior literature by mitigating concerns related to endogenous partner/client matching and differences in individual characteristics. We provide consistent evidence of significant variation in partners' professional skepticism throughout their relationship with a given client. Further, our longer time series allows our study to be one of the first to examine the effects of boomerang partners.

II. BACKGROUND AND THEORETICAL FRAMEWORK

Professional Skepticism and Audit Partners

Auditors have a responsibility to plan and perform an audit with professional skepticism. Professional skepticism requires an auditor to maintain a questioning mind and thoroughly investigate all evidence presented by the client (AU 206.07; AS 1015.07). Despite professional skepticism's importance, it is difficult to define and measure due to the lack of precision in professional standards' discussion of professional skepticism (Hurttt, Brown-Liburud, Earley, and Krishnamoorthy 2013; Nolder and Kadous 2018; Nelson 2009). Generally, views on skepticism fall into two broad categories: neutral and presumptive doubt (Quadackers et al. 2014). Under the neutral perspective, the auditor "neither assumes the management is dishonest nor assumes unquestioned honesty" in evaluating audit evidence (AU 230.09). In contrast, the presumptive doubt view likens skepticism to suspicion where the auditor assumes some level of doubt regarding the assertions of management (Nelson 2009; Glover and Prawitt 2014; Shaub 1996). Prior literature suggests that the presumptive doubt perspective is consistent with the approach of audit regulators and better predicts auditors' judgements (Quadackers et al. 2014; Nelson 2009), thus we adopt a presumptive doubt view of skepticism for the purposes of this study. Under this view, the amount of evidence that an auditor requires to justify their audit opinion is increasing with the level of professional skepticism (Brazel et al. 2016; Nelson 2009).

Insufficient professional skepticism is often cited by regulators as a primary cause of audit failures, Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) enforcement actions, and auditor litigation (e.g., Beasley et al. 2001; Brazel et al. 2016; Kraussman and Messier 2015; Messier et al.2010; PCAOB 2012). However, why and where insufficient skepticism persists is not well understood.

Theoretical frameworks of professional skepticism, indicate that both individual determinants and social and society determinants affect audit partners' professional skepticism (Nolder and Kadous 2018). Further, skeptical judgements leading to observable skeptical actions are influenced by partners traits, knowledge, incentives and individual audit experience and training (Nolder and Kadous 2018). Experimental literature suggests auditors are penalized for insufficient skepticism, but that the evaluation of skeptical behavior is influenced by whether or not the auditor identifies a misstatement, consistent with challenges in observability of skepticism (Brazel et al. 2016). Further, the extent of audit partners' skepticism can be significantly influenced by the cost of skeptical actions and the nature of the reward structure in place (Brazel et al. 2022). Partners' perspectives on skepticism (i.e., neutral vs presumptive doubt) affect their career outcomes, with higher presumptive doubt approaches being associated with both higher audit quality (Cohen et al. 2017).

Regulatory concerns regarding audit partners' professional skepticism have motivated much of the archival research on examining audit partner rotation. The rotation literature examines variation in audit outcomes when changing from one partner to a *different* partner. Individual partner identity in the U.S. is unavailable prior to the implementation of Form AP in 2017, thus prior studies have attempted to infer partner tenure and mandatory rotation from a public disclosure (Laurion et al. 2017; Kuang et al. 2020; Krishnan and Zhang 2019) or rely on international data (Lennox et al. 2014; Chi et al. 2009; Carey and Simnett 2006). Generally, on the relation between rotation on audit quality are mixed, with some studies providing some evidence of a benefit of "fresh eyes" by a new audit partner rotating on to a client (Laurion et al. 2017), while others find little to no evidence of a significant effect of audit partner rotation (Kuang et al. 2020; Gipper, Hail, and Leuz 2021). While these studies provide important insights

regarding the overall effect of the policy, audit partner rotation is not a discrete event and partner/client matching is not random (Dodgson et al. 2020), making it challenging to precisely identify the mechanism underlying empirical findings. These challenges limit the conclusions that can be drawn related to audit partners' professional skepticism.

Hypothesis Development

Prior literature suggests that the likelihood of partners agreeing to client-preferred accounting treatment (i.e., exhibiting lower professional skepticism) increases with the extent of client identification, where identification is defined as feeling a close association with the client (Bamber and Iyer 2007). Regulatory interest in limiting the length of the partner/client relationship is based on concerns that client identification represents a threat to auditor independence and is positively related to the length of the relationship. The reduced independence is predicted to result in a decrease in partner skepticism as the length of the relationship increases.

However, there are several reasons that such an effect may not exist. First, non-partner members of the engagement team perform most of the substantive audit work, and the engagement team does not typically change when the audit partner changes. The continuity of experience on the engagement team could mitigate any individual partner's effect on accounting estimates (Gipper et al. 2021; Hoopes, Merkley, and Schroeder 2018). Second, Knechel Vanstraelen, and Zerni (2015) find that aggressive and conservative audit reporting persists for individual audit partners over time. Given that professional skepticism is affected by auditor-specific traits (Bowlin et al. 2015; Nolder and Kadous 2018; Nelson 2009), it is possible that the level of partner skepticism similarly remains constant over a partner/client relationship. Based on competing predictions of the effect of the length of an audit partner/client relationship on professional skepticism, we state our hypothesis in null form.

Hypothesis: There is no change in auditor partner skepticism during a partner/client relationship.

III. RESEARCH DESIGN

Allowance for Loan Loss Estimate

We use the ALL estimate as our proxy for professional skepticism. The ALL is typically the largest estimate on a bank's balance sheet and is subject to a high level of management discretion (Beatty and Liao 2014). Prior literature has found that bank management exercises discretion in the ALL to manage earnings and capital (Ahmed, Takeda, and Thomas 1999; Beatty and Liao 2014; Beatty, Ke, and Petroni 2002). This presents a challenge for auditors, as the inputs to key estimates are highly subjective and challenging to verify, and prior research suggests that auditor effectiveness may be limited in some cases (Stuber and Hogan 2021).

The ALL is a reasonable proxy for professional skepticism for several reasons. First, prior literature provides consistent evidence that auditors have a significant effect on the ALL (Stuber and Hogan 2021; Nicoletti 2018; Altamuro and Beatty 2010; Ege et al. 2023). Second, under the presumptive doubt approach, higher levels of professional skepticism result in an increase in audit procedures performed (e.g., an increase in auditor scrutiny) (Nelson 2009). Given the direction of risk related to income, audit procedures are generally designed to constrain income-increasing accruals (Barron, Pratt, and Stice 2001; Becker, Defond, Jiambalvo, and Subramanyam 1998; Nelson et al. 2002), thus increased auditor scrutiny leads to a higher ALL, on average (Stuber and Hogan 2021; Ege et al. 2023). Therefore, high (low) professional skepticism should manifest in a higher (lower) ALL. In addition to the theoretical support for the reasonableness of our proxy, we also conduct additional analyses to empirically validate our use of the ALL as a proxy for professional skepticism in Section VI.

Primary Analysis

Our primary analysis relies on the ALL as a proxy for professional skepticism and examines how the ALL varies across a partner/client relationship. A higher (lower) ALL indicates more (less) professional skepticism estimate. We examine H1 by estimating the following equation:

$$ALL_{ipt} = \beta_0 + \beta_1 Relationship\ Stage_{ipt} + \gamma Controls_{ipt} + \alpha_{pe} + \alpha_t + \epsilon_i \quad (1)$$

We define ALL_{ipt} as the ALL scaled by the beginning of period total loans. We measure $Relationship\ Stage_{ipt}$ in two ways. First, we construct the variable $Initial\ Year_{ipt}$, which is equal to one when the relationship is in its first year, and zero otherwise. Second, we create the indicator variable $Beginning_{ipt}$, which is equal to one when the relationship is in the first or second year, and zero otherwise. The coefficient on the $Relationship\ Stage_{ipt}$ variables captures the difference in ALL in the early years of the relationship relative to the later years. A positive (negative) coefficient on the $Relationship\ Stage_{ipt}$ variables indicates higher (lower) estimates of the ALL in the early stages of the partner/client relationship relative to the later years of the relationship. We include the bank-level control variables assets $Size_{ipt}$, $Equity_{ipt}$, non-performing loans (NPL_{ipt}) and ROA_{ipt} to mitigate concerns that our results may be driven by the size or performance of the bank unrelated to the relationship between tenure and bank outcomes. Given that the ALL is directly affected by loan portfolio composition, we also include controls for the proportion of the portfolio comprised of commercial & industrial ($C\&I_{ipt}$), mortgage ($Mortgage_{ipt}$), consumer ($Consumer_{ipt}$), and commercial real estate (CRE_{ipt}) loans. Standard errors are clustered at the bank level.

One potential concern is that unobservable differences in bank characteristics, audit partner characteristics, audit firm characteristics, and/or changing macroeconomic conditions during our sample period might impact our results. To mitigate this concern, we incorporate two classes of

fixed effects to control for unobserved heterogeneity in our sample.

First, we know that the selection of an auditor and the assignment of an audit partner to a client is endogenously determined. To control for any unobservable factors that contribute towards the pairing of an audit partner and a client, we include partner \times engagement fixed effects.² Additionally, the inclusion of the partner \times engagement fixed effects controls for time-invariant bank, partner, and audit firm characteristics that may affect our inferences. The second class of fixed effect is a year fixed effect that allows us to examine variation within a given year. The inclusion of these fixed effects allows us to isolate within partner/client relationship changes in the ALL_{ipt} after netting out time-specific shocks. Figure 1 provides an illustration how the partner \times engagement fixed effects isolate within partner/client relationship variation. We also include year fixed effects to control to time-varying changes that affect all sample bank-years.

IV. SAMPLE SELECTION AND RESULTS

Sample Selection

We construct a panel data set consisting of both publicly available and proprietary data. All regulated bank holding companies are required to file FR Y-9C reports containing financial information. These reports are useful for market investors who wish to gather information on publicly traded banks (Badertscher, Burks, and Easton 2018), as well as for examiners who use regulatory reports to determine whether reported bank performance meets or exceeds implicit or explicit risk thresholds (Gopalan 2022; Costello et al. 2019). From the publicly available regulatory report data, we collect information on bank size, performance, and asset quality. Our second data source consists of confidential data that identify the audit partner on all bank audits between 2005 and 2019. These data are obtained from the Federal Reserve Bank of St. Louis and

² Bank fixed effects are not separately included, as these fixed effects are subsumed by engagement fixed effects.

allow us to identify the year in which the audit partner changes for a given client and the tenure of the audit partner/client relationship. We begin our sample period in 2010 because five years of lagged partner identity data are necessary to accurately calculate partner tenure. We require that all bank-year observations have non-missing total assets at time t . We merge audit partner/client relationship data from bank holding company regulatory filings with bank-year FR Y-9C data, resulting in a final sample of 6,325 bank-year observations from 2010 to 2019.³

Table 2 presents summary statistics for all bank-year observations in our sample. Twenty-percent of sample bank-years are initial audit years, while 45 percent are classified as *Beginning*. The average bank in our sample has \$26 billion in total assets, while loans comprise 69.3 percent of assets (untabulated). Sample banks are profitable, with a mean ROA of 0.8 percent. The mean ALL is 1.596 percent of loans. Forty-seven percent of sample bank-years are public, and 19.7 percent are identified as complex institutions. Eighteen-percent of our bank-years are audited by a partner that had a client experience a regulatory downgrade and 9 percent of bank-years are audited by a boomerang partner.

Results: Allowance for loan losses level

In our first analysis, we examine whether a bank's ALL levels change across the audit partner/client relationship by estimating equation (1) using the outcome variable ALL scaled by beginning of period total loans (ALL_{ipt}). Table 3 shows that the coefficients on both *Initial Year* _{ipt} and *Beginning* _{ipt} are positive and statistically significant at the one percent level. In terms of economic significance, the coefficients in column (1) (column (2)) suggest that the ALL is 2.13 (2.99) percent higher in the first year (first two years) of the relationship relative to all subsequent

³ We end our sample period in 2019 to avoid concerns related to the confounding effects of the COVID-19 pandemic on the 2020 financial statements.

years.⁴ The result provides evidence supporting a higher ALL at the beginning of the audit partner's tenure relative to the later years.

V. ADDITIONAL ANALYSES

Client Risk Characteristics

The results presented in Section IV provide evidence that, on average, banks report higher ALLs in the earlier years of the audit partner/client relationship, consistent with the partner exhibiting higher skepticism in the initial years of the relationship, relative to later years. This naturally leads to the question of whether any declines in audit partner skepticism are limited to lower-risk clients, i.e., do audit partners maintain their initial skepticism on clients that pose a greater reputational risk to the partner. To examine this question, we modify equation (1) as follows:

$$ALL_{ipt} = \beta_0 + \beta_1 Relationship\ Stage_{ipt} + \beta_2 Client\ Reputational\ Risk_{ipt} + \beta_3 Relationship\ Stage \times Client\ Reputational\ Risk_{ipt} + \gamma Controls_{ipt} + \alpha_{ipe} + \alpha_t + \varepsilon_{it} \quad (2)$$

We utilize the three measures of *Client Reputational Risk*: 1) public vs private status of the bank ($Public_{ipt}$), 2) bank size ($Size_{ipt}$), and 3) bank complexity ($Complexity_{ipt}$). We define $Public_{ipt}$ as an indicator variable equal to 1 if a bank is publicly traded, zero otherwise. We define $Large_{ipt}$ as an indicator equal to one if a bank has assets greater than the sample median for a given year, zero otherwise. Finally, we define $Complex_{ipt}$ as an indicator equal to one if a bank self-identifies as a complex financial institution based on variable RSSD9057 in the FRY-9C report, and zero otherwise. All other variables are defined consistent with equation (1). For this analysis, similar to our primary tests, we are interested in whether partner skepticism *within* a given engagement varies

⁴ The dependent variable *ALL Loans* is multiplied by 100 in Table 3 to ease interpretation; therefore, the economic significance for coefficient of 0.034 in Table 3 is calculated as $\frac{0.00034}{.016} = 0.0213$.

differently based on client risk. To examine this question, we estimate equation (2) with partner \times engagement fixed effects.

Table 4 presents the results of this analysis. We find an insignificant coefficient on the *Initial Year*_{ipt} and *Beginning*_{ipt} across all three panels, suggesting that there is no evidence of a change in partner skepticism during the relationship with lower reputational risk clients. The lack of a change in skepticism for these clients may be because initial partner skepticism is lower for these clients and the partners simply retain this lower level of skepticism. In Panel A we find positive and significant coefficients on *Initial Year* \times *Public*_{ipt} and *Beginning* \times *Public*_{ipt}. These results suggest that there is a significant decline in skepticism during a partner/client engagement when the client is publicly traded, relative to privately traded clients. Similarly, in panel B, we observe a positive coefficient on *Initial Year* \times *Large*_{ipt} and *Beginning* \times *Large*_{ipt} and in panel C we observe a positive coefficient on *Initial Year* \times *Complex*_{ipt} and *Beginning*_t \times *Complex*_{ipt}.⁵ Overall, the results suggest that while partners might initially increase skepticism for higher-risk clients, they fail to maintain this higher level of skepticism throughout the duration of the relationship.

Regulatory Downgrades

We next consider whether events that may heighten a partner's awareness of risk may mitigate the decline in skepticism within a partner/client relationship. Prior literature suggests that partners learn from prior experiences, and the experiences affect their behavior on other client events (Bonner 1990; Chi, Myers, Omer, and Xie 2017; Lisic, Pittman, Seidel, and Zimmerman 2022), thus it is possible that an event that increases the salience of a partner's risk exposure may

⁵ We find the coefficient on *Public*, *Large*, and *Complex* is insignificant across all three panels; however, we hesitate to draw strong conclusion from the insignificance of the coefficient, given the inclusion of bank fixed effects subsumes nearly all of the variation the main effect of these variables.

affect the extent of partner skepticism.

Bank regulators conduct periodic examinations of banks, and the outcome of these examinations is a regulatory rating. For bank holding companies, the ratings are called RFI/C(D) ratings. Among the specific ratings, the “C” comprises a composite assessment and the “D” component refers to the composite rating of the lead subsidiary bank. Among the component ratings specifically focused on the consolidated holding company, the RFI components encompass the consolidated bank holding company’s risk management practices (“R” component), financial condition (“F” component) and the potential impact of non-depository entities of a holding company on the depository subsidiaries (“I” component).⁶ Auditors are required to review the most recent regulatory reports as part of audit procedures, meaning auditors are aware of any changes to bank ratings. A downgrade in the “F” component is most salient to financial reporting issues of concern to the auditor. Given the importance of bank regulatory ratings to both bank management and as a signal of risk to the auditors, we examine whether a downgrade in the regulatory rating of a client in a partner’s client portfolio affects the extent of skepticism across other clients. Specifically, we examine whether the decline in partner skepticism within a client/partner relationship varies with the extent of partner awareness of risk.

Using confidential data on consolidated holding company examinations from National Information Center (NIC), a confidential data repository maintained by federal banking regulators, we identify banks that experience a downgrade in the “F” component of the RFI rating during the regulatory exam. We then estimate equation (1), adding the interaction $Downgrade \times Relationship Stage_{ipt}$. We define $Downgrade_{ipt}$ as an indicator equal to one if the audit partner has a client

⁶ In addition to traditional depository subsidiaries, bank holding companies often have non-depository subsidiaries such as trusts. Bank regulators are primarily concerned with the safety and soundness of depository institutions, thus the I component specifically considers the risk exposure of the depository subsidiaries due to the non-depository.

experience a downgrade in the F component in the prior year, zero otherwise. All other variables and fixed effects are consistent with equation (1).

Table 5 shows a positive and significant coefficient on *Initial Year*_{ipt} and *Beginning*_{ipt}, consistent with our primary results, evidencing a decline in partner skepticism during a partner/client relationship. In columns (1) and (2) we also observe a negative and significant coefficient on the interaction between *Downgrade*_{ipt} and both *Relationship Stage*_{ipt} variables. These results indicate that the partners with a heightened awareness of client risk due to a client regulatory downgrade exhibiting significantly less decline in professional skepticism during the partner/client relationship.

Overall, our findings suggest that the declining partner skepticism during a partner/client relationship is offset when the partner experiences an event that increases partner awareness of potential reputational risk. This finding is particularly interesting as it offers some insight into the process of partner learning and a potential mechanism, other than rotation, that may mitigate concerns related to declining partner skepticism.

Boomerang Partners

In our primary analysis, we consider each instance of an audit partner/client pairing as a separate relationship when examining whether there is a time-varying partner effect. While audit partners generally rotate off client engagements after 5 years, the partner may rotate back onto the same client after a cooling-off period. We identify these partners as boomerang partners. It is possible that the effect of the partner in the initial years of a repeat engagement with a given client differ relative to the effect of the partner in their earlier engagement pairing with a client.

To examine the potential differential effect of partner tenure in subsequent engagements with a given client, we create an indicator variable *Boomerang*_{ipt} which is equal to one when a

partner is not in their initial term with a client (i.e., a boomerang partner) and zero otherwise.⁷ We then modify equation (1) by adding an interaction between *Relationship Stage* and *Boomerang*. In Table 6 we find negative and statistically significant coefficients on *Beginning* \times *Boomerang_{ipt}* interaction in column (2) and a negative and statistically insignificant coefficient on the interaction between *Initial Year* \times *Boomerang_{ipt}* in column (1). Most importantly, an f-test of the joint significant between the main effects of the *Relationship Stage_{ipt}* variables and the interactions of *Relationship Stage* \times *Boomerang_{ipt}* is not statistically different from zero, consistent with declines in partner skepticism during a client relationship being attenuated when a partner is not in the initial pairing of the client.

The most likely reason for the lack of decline in professional skepticism is due to a lower initial skepticism when the partner is not in her initial engagement with the client. Stated differently, we expect that the skepticism in the initial years of the non-initial pairing with a client is comparable to the skepticism in the latter years of the partners' initial pairing of the client. We validate this by comparing the mean ALL level for a sample of only boomerang client engagements. Consistent with our expectation, we find that the mean value of ALL for the first two years of a partners initial pairing with a client is 6.23 percent higher relative to the mean value of ALL for the first two years of the non-initial pairing. This difference is statistically different, with a p-value of 0.027. Further, we find no significant difference between the mean value of the ALL for the last two years of the initial pairing relative to the first two years of the non-initial pairing of a partner with a given client. Thus, the lack of evidence of declining skepticism in a partners' non-initial pairing with a client is due to the partner maintaining an overall lower level of

⁷ We acknowledge that it is possible that some relationships in our sample may be identified as initial engagements when in fact it is not the partner's initial engagement with the client. However, our measure of *Boomerang* does capture non-initial terms with a client and to the extent that we have misclassified certain relationships incorrectly as *Boomerang*=0, it would bias against our findings.

skepticism in subsequent engagements with the same client.

Overall, the findings in Table 6 are consistent with partners exercising high professional skepticism in the initial engagement with a client during our sample period, but skepticism waning in subsequent engagements as the partner becomes more comfortable with the client. The result also mitigates concerns that our primary results are driven by the partner change itself, rather than by an effect of the tenure of a partner with a particular client.

ALL Quality

The results in Table 3 indicate that audit partners exhibit higher professional skepticism in earlier years of the relationship with their client relative to later years. However, the amount of professional skepticism employed requires a balance between effectiveness and efficiency (Nelson 2009). While an auditor requires a certain amount of evidence to reduce the chance that they fail to detect a material misstatement (e.g., audit effectiveness), if an auditor is too skeptical, the audit will be inefficient and potentially cause client dissatisfaction. If estimate quality is higher in earlier years of the relationship, it would suggest that higher ALL estimates documented in Table 3 may be indicative of greater audit effectiveness. Furthermore, it may suggest that higher skepticism is appropriate. However, if estimate quality is either not different or worse in earlier years of the relationship, audit partners may be *overly* skeptical in the early years of the relationship, potentially resulting in an inefficient audit. Thus, while the results in Table 3 have important implications for bank lending and bank risk assessment, it remains unclear whether the level of the ALL represents improved estimate quality (audit effectiveness) or a decline in audit efficiency.

For these reasons, we next examine whether there is evidence of differential ALL quality in the early years of partner/client relationship relative to the later years. We use two methods to assess the quality of the ALL estimate. First, we use the following equation based on Altamuro

and Beatty (2010) to examine whether the validity of the loan loss provision varies with audit partner tenure:

$$CO_{ipt+1} = \alpha + \beta_1 Relationship\ Stage_{ipt} + \beta_2 LLP_t + \beta_3 Relationship\ Stage \times LLP_{ipt} + \gamma Controls_{ipt} + \alpha_{ipe} + \alpha_t + \varepsilon_{it} \quad (4)$$

where CO_{ipt+1} is equal to charge-offs in year $t+1$ scaled by beginning total assets.

The validity of the LLP is measured by the strength of the relationship between the LLP in time t and charge-offs in time $t+1$; thus, a positive (negative) coefficient on LLP suggests higher (lower) LLP validity. In this study, we are interested in how the audit partner relationship stage affects the relationship between the LLP and subsequent charge-offs. Thus, we interact both of our measures of $Relationship\ Stage_{ipt}$ with LLP_{ipt} . A positive (negative) coefficient on β_3 indicates that the validity of the LLP is higher (lower) in the initial years of the relationship compared to later years of audit partner tenure and suggests a more (less) effective audit.

We present the results of our tests of LLP validity in Table 7, panel A. We find the coefficients on $LLP_{ip} \times Initial\ Year_t$ and $LLP_{ipt} \times Beginning_t$ related to the future charge-offs are positive and significant at the 5 percent level. These results provide evidence that the validity of the LLP is higher in the earlier years of the relationship compared to the later years of the relationship, indicating a higher quality ALL.

As a second measure of quality, we examine the error in the ALL ($ALL\ Error_{ipt}$) defined as the absolute deviation from the ratio of loan charge-offs in $t+1$ to the ALL in t from 1 (Gopalan et al., 2023; Stuber and Hogan, 2021).⁸ To analyze how $ALL\ Error$ varies with audit partner tenure, we estimate the following equation:

⁸ We follow prior literature and regulatory guidance in considering one year to be the appropriate time period for examining subsequent charge-offs (Altamuro and Beatty, 2010; Bushman and Williams, 2012; Gopalan et al., 2023; Nicoletti, 2018; OCC, 2012; Stuber and Hogan, 2021).

$$ALL\ Error_{ipt} = \beta_0 + \beta_1 Relationship\ Stage_{ipt} + \gamma Controls_{ipt} + \alpha_{pe} + \alpha_t + \epsilon_i \quad (5)$$

where *Relationship Stage*, controls, and fixed effects are consistent with equation (1). A positive (negative) coefficient on β_j indicates a higher (lower) error in the early stages of a relationship relative to the later stages, consistent with lower (higher) quality in the early stage.

Table 7, panel B, column (1) shows the coefficient on *Initial Year*_{ipt} is negative and significant, consistent with lower *ALL Error*_{ipt} and a higher quality audit in the initial year of the audit relative to the later years. The coefficient on *Beginning* in column (2) is negative, but insignificant. These results suggest that the effect of a partner on the *ALL Error*, is concentrated in the initial year of the audit.

Overall, the results of our analyses of LLP validity and *ALL Error*_{ipt} are consistent with the higher skepticism in the earlier years of the relationship resulting in a higher-quality audit relative to the later years of the relationship.

Changes in underlying bank risk

If the change in the ALL represents a change in actual risk, then our results do not suggest a change in partner effect on estimate quality because the change in reported risk represents the change in the underlying economics of the bank. We conduct analyses to assess the possibility that the actual bank risk is directly affected by the stage of the partner/client relationship rather than reported bank risk. Specifically, we examine the effect of the relationship stage on loans that are 30+ days past due. If individual audit partners affect the underlying risk-taking activities of their clients, we would expect to see changes in past due loans, which are leading indicators of bank deterioration and are not subject to management discretion. Additionally, the audit evidence required to evaluate loans that are 30+ days past due requires less judgment than the audit evidence

required to evaluate the quality of an estimate such as the ALL, given that past-due classification is mechanical based on days since the last loan payment.

In Table 8, we present the results of estimating equation (1) using *Past Due 30_{ipt}* as the dependent variable, where *Past Due 30_{ipt}* is the amount of loans 30 or more days past due, scaled by total loans. We find no evidence of significant association between loans that are 30+ days past due and the stage of the partner/client relationship, mitigating concerns that the results of our primary analyses can be explained by changes in actual bank risk-taking.

Validation

Finally, we validate our assumption that the level of the ALL varies predictably with levels of auditor skepticism. Reputational concerns and accountability pressure differentially affect audit partners' professional skepticism (Nelson et al. 2002; DeZoort et al. 2006). We expect that partners' professional skepticism will be higher in the first years of an engagement for clients that present greater reputation risk relative to the first years of an engagement for lower-risk clients. Thus, if higher levels of *ALL_{ipt}* are indicative of higher professional skepticism, we expect to observe an incrementally stronger positive relation between our measures of reputational risk and *ALL_{ipt}* in the early years of a partners' relationship with a higher risk client. Critically, this test differs from our main analysis as we are interested in differences in partner skepticism *across* clients rather than within a client relationship. Due to this difference, we relax the fixed effect structure relative to equation (1).

Our research question relates to the changing behavior of a partner within a given partner/client relationship, thus equation (1) includes partner \times engagement fixed effects. However, the predictions related to measure validity are cross-sectional in that we are comparing the ALL level in the early years of engagement on public, large, and complex clients relative to

private, smaller, and less complex clients. To test this prediction, equation (2) includes bank fixed effects, partner fixed effects, and year fixed effects. This structure allows us to control for time-invariant bank characteristics while allowing cross sectional-comparison. The inclusion of partner fixed effects facilitates a within-partner analysis allowing us to examine how the behavior of the same partner differs across client type.

Table 9 presents the results of these analyses. As predicted, we observe a positive and significant coefficient on the interactions between $Public_{ipt}$, $Large_{ipt}$, and $Complex_{ipt}$ and indicators for *Initial Year* and *Beginning*. Overall, the results are consistent with our expectation that partners' higher professional skepticism on higher risk clients will manifest in higher levels of ALL_{ipt} . The findings provide support of the validity of our use of ALL_{ipt} as a proxy for partner skepticism.

We find negative and marginally significant coefficients on $Beginning_{ipt}$ and $Initial Year_{ipt}$, which would suggest that on lower-risk clients, professional skepticism is lower in the early stages of the relationship for the lower reputational risk clients. However, as previously mentioned, this analysis relies on a more relaxed fixed effect structure, which make the results subject to endogeneity concerns related to auditor-client matching. Our results of the within-engagement analyses in Table 9, show no such evidence of increasing skepticism in the lower-risk clients. These differing coefficients highlight both the challenge in drawing meaningful inferences from cross sectional comparisons of clients and the importance of controlling for auditor-client matching.

VI. CONCLUSION

In this study, we utilize a key estimate in the banking industry to examine how partners' professional skepticism changes during the audit partner/client relationship. Using a novel panel

data set of audit partner/client relationships within the banking industry, we find that banks systematically report a higher ALL at the start of an audit partner engagement relationship than in later years, consistent with declining audit partner professional skepticism during a partner/client relationship.

In additional analyses, we find that while initial partner skepticism is positively related to client risk, the decline in partners' professional skepticism is also more significant in public, large, and complex clients. An examination of boomerang partners reveals that the higher skepticism in the early years of a partner/client engagement is limited to the first time a partner is matched with a client, consistent with partners maintaining a lower level of skepticism on subsequent engagements with the same client. In considering partner-specific experiences, we find that the relation between partner/client relationship and professional skepticism is moderated by partners' experiences. Specifically, we find that declining partner skepticism is offset when partner's experience a regulatory downgrade of another client, consistent with partner's responding to increased risk salience. Finally, we find some evidence that the ALL estimate is of higher quality, on average, at the start of audit partner engagement relationships relative to later years.

Our study makes several contributions to the literature. First, we contribute to the literature on audit partner professional skepticism by providing evidence consistent with declining partner skepticism during a partner's tenure with a given client, and with this decline being strongest for those clients where the initial skepticism would likely be the highest. We also contribute to the literature on accounting estimates by providing insight into how auditors affect critical accounting estimates that are subject to judgment and discretion. Finally, we contribute to the literature on audit partner rotation by isolating the mechanism that motivates the mandatory rotation policy: professional skepticism. Together, our study provides important insights for audit firms as they

seek to attain appropriate levels of professional skepticism as well as to regulators as they design policies intended to mitigate concerns related to potential declining skepticism during a partner/client relationship.

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APPENDIX A
Variable Definitions

Dependent variables	
<i>ALL</i>	Loan loss reserve scaled by beginning-of-period total assets (BHCK3123 _t)/(BHCK2170 _{t-1})
<i>ALL</i>	Loan loss reserve scaled by beginning-of-period total loans
<i>CO_{t+1}</i>	Annual loan charge-offs scaled by beginning-of-period total assets (RIAD4635 _{t+1})/(BHCK2170 _t)
<i>LLP</i>	Annual loan loss provisions scaled by beginning-of-period total assets (RIAD4230 _t)/(BHCK2170 _{t-1})
<i>ALL Error</i>	Absolute value of 1 minus charge-offs in t+1 divided by loan loss reserve in t. $ABS[1-(RIAD4635_{t+1})/(BHCK3123_t)]$
<i>Past Due 30</i>	The ratio of loans 30-89 days past due to lagged assets (BHCK1406 _t /BHCK2170 _{t-1} for bank-years after 2017, BHCK5524 _t /BHCK _{t-1} for bank-years up to 2017)
Independent variables	
<i>Initial Year</i>	An indicator variable equal to 1 if it represents the first year of the audit partner/client relationship, 0 otherwise
<i>Beginning</i>	An indicator variable equal to 1 if it represents either of the first two years of the audit partner/client relationship, 0 otherwise
<i>Boomerang</i>	An indicator variable equal to 1 if an audit partner is engaging with a bank for at least the second time, 0 otherwise
<i>Public</i>	An indicator variable equal to 1 if the client is a publicly traded bank, 0 otherwise
<i>Size</i>	Natural log of beginning-of-period total assets (BHCK2170 _{t-1})
<i>Equity</i>	Equity scaled by beginning-of-period total assets (BHCK3120 _t)/(BHCK2170 _{t-1})
<i>NPL</i>	Non-accrual loans scaled by beginning-of-period total assets (BHCK1403 _t)/(BHCK2170 _{t-1})
<i>ROA</i>	Net income scaled by beginning-of-period total assets (RIAD4340 _t)/(BHCK2170 _{t-1})
<i>C&I</i>	Commercial and Industrial Loans scaled by total loans (BHCK1763+BHCK1764)/BHCK2122
<i>Consumer</i>	Consumer loans to total loans BHDM1975/BHCK2122
<i>CRE</i>	Commercial Real Estate loans scaled by total loans (BHDM1460 + BHCKF160+BHCKF161+BHCKF158+BHCKF159)/BHCK2122
<i>Mortgage</i>	Home Mortgage Loans scaled by Total Loans (BHDM1791 + BHDM5367 + BHDM5368)/BHCK2122

FIGURE 1
Hypothetical Diagram of Audit Partner × Client × Engagement Fixed Effect

This figure presents a diagram of how we identify audit partner/client relationships. For each BHC-year observation in our sample, the variable TEXTC704 provides the identity of the audit partner. As a result, for any given year, we observe separate engagements for the same audit partner. Furthermore, given our time series, we observe whether one audit partner engages with the bank at multiple time periods. Every separate engagement is a separate fixed effect in our empirical specification. For example, for Bank A, we include a separate fixed effect for Partner 1 when he/she audits Bank A from 2010 – 2011 and 2017 – 2019

	Bank A	Bank B	Bank C
2010	Partner 1 Year 4	Partner 3 Year 1	Partner 1 Year 1
2011	Partner 1 Year 5	Partner 3 Year 2	Partner 1 Year 2
2012	Partner 2 Year 1	Partner 3 Year 3	Partner 1 Year 3
2013	Partner 2 Year 2	Partner 3 Year 4	Partner 3 Year 1
2014	Partner 2 Year 3	Partner 3 Year 5	Partner 3 Year 2
2015	Partner 2 Year 4	Partner 4 Year 1	Partner 3 Year 3
2016	Partner 2 Year 5	Partner 4 Year 2	Partner 3 Year 4
2017	Partner 1 Year 1	Partner 4 Year 3	Partner 3 Year 5
2018	Partner 1 Year 2	Partner 4 Year 4	Partner 5 Year 1
2019	Partner 1 Year 3	Partner 4 Year 5	Partner 5 Year 2

TABLE 1
Sample selection

	<u>Bank-year observations</u>
Bank Holding Company year Observations from 2005 - 2019	13,251
Less: Observations before 2010	(5,457)
Less: Observations with missing lagged assets	(1,321)
Less: Observations with missing data needed for control variables	(148)
Final Sample for analysis	<u>6,325</u>

TABLE 2
Descriptive Statistics

Variable	N	Mean	Std. Dev.	p25	Median	p75
<i>Initial Year_{ipt}</i>	6,325	0.200	-	-	-	-
<i>Beginning_{ipt}</i>	6,325	0.450	-	-	-	-
<i>ALL_{ipt}</i>	6,325	1.596	0.868	1.052	1.386	1.919
<i>Size_{ipt-1}</i>	6,325	14.603	1.453	13.604	14.150	15.147
<i>NPL_{ipt-1}</i>	6,325	0.012	0.014	0.003	0.007	0.014
<i>Equity_{ipt}</i>	6,325	0.111	0.041	0.090	0.106	0.127
<i>ROA_{ipt}</i>	6,325	0.008	0.009	0.006	0.009	0.012
<i>Boomerang_{ipt}</i>	6,325	0.089	0.285	-	-	-
<i>Downgrade_{pt}</i>	6,325	0.179	0.383	-	-	-
<i>Complex_{ipt}</i>	6,325	0.197	0.397	-	-	-
<i>Large_{ipt}</i>	6,325	0.211	0.408	-	-	-
<i>Public_{ipt}</i>	6,325	0.474	0.499	-	-	1.000
<i>Past Due 30_{ipt}</i>	6,325	0.636	0.779	0.178	0.391	0.766
<i>LLP_{ipt}</i>	6,325	0.339	0.553	0.058	0.162	0.371
<i>CO_{ipt+1}</i>	5,541	0.542	0.751	0.118	0.280	0.604

This table provides summary statistics for variables used in our analyses. *ALL*, *NPL*, *ROA*, *LLP*, and *CO* are all multiplied by 100 to ease interpretation

TABLE 3
Loan Loss Reserve and Stage of Partner/Client Relationship

VARIABLES	<i>ALL_{ipt}</i>	
	(1)	(2)
<i>Initial Year_{ipt}</i>	0.034** (2.41)	
<i>Beginning_{ipt}</i>		0.048*** (2.91)
<i>Size_{ipt-1}</i>	-0.129* (-1.85)	-0.124* (-1.80)
<i>NPL_{ipt-1}</i>	14.03*** (7.27)	13.98*** (7.24)
<i>Equity_{ipt}</i>	-3.688*** (-8.35)	-3.679*** (-8.29)
<i>ROA_{ipt}</i>	-8.580*** (-5.64)	-8.468*** (-5.57)
<i>C&I_{ipt}</i>	0.602* (1.90)	0.617* (1.94)
<i>Mortgage_{ipt}</i>	0.843* (1.74)	0.824* (1.70)
<i>Consumer_{ipt}</i>	1.064 (1.26)	1.056 (1.26)
<i>CRE_{ipt}</i>	1.872*** (3.47)	1.875*** (3.51)
Partner × Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	6,325	6,325
Adjusted R ²	0.886	0.886

*, **, *** Represent statistical significance at the 10 percent, 5 percent and 1 percent levels respectively. This table presents the results of estimating equation (1). T-statistics are presented in parentheses and standard errors are clustered at the bank level.

TABLE 4
Partner Skepticism and Client Risk Characteristics

Panel A: Public Clients

VARIABLES	<i>ALL_{ipt}</i>	
	(1)	(2)
<i>Public_{ipt}</i>	0.048 (0.70)	0.0243 (0.35)
<i>Initial Year_{ipt}</i>	-0.008 (-0.41)	
<i>Public × Initial Year_{ipt}</i>	0.080*** (3.50)	
<i>Beginning_{ipt}</i>		0.001 (0.04)
<i>Public × Beginning_{ipt}</i>		0.091*** (3.90)
<i>Size_{ipt-1}</i>	-0.127* (-1.87)	-0.116* (-1.70)
<i>NPL_{ipt-1}</i>	13.97*** (7.26)	13.80*** (7.19)
<i>Equity_{ipt}</i>	-3.676*** (-8.30)	-3.652*** (-8.18)
<i>ROA_{ipt}</i>	-8.528*** (-5.61)	-8.478*** (-5.61)
<i>C&I_{ipt}</i>	0.592* (1.86)	0.599* (1.86)
<i>Mortgage_{ipt}</i>	0.815* (1.68)	0.781 (1.61)
<i>Consumer_{ipt}</i>	1.074 (1.27)	1.029 (1.21)
<i>CRE_{ipt}</i>	1.857*** (3.43)	1.820*** (3.40)
Partner × Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	6,325	6,325
Adjusted R ²	0.886	0.886

TABLE 4 (continued)

Panel B: Large Clients

VARIABLES	<i>ALL_{ipt}</i>	
	(1)	(2)
<i>Large_{ipt}</i>	-0.115** (-2.17)	-0.159*** (-2.94)
<i>Initial Year_{ipt}</i>	0.007 (0.46)	
<i>Large</i> × <i>Initial Year_{ipt}</i>	0.112*** (4.14)	
<i>Beginning_{ipt}</i>		0.0129 (0.77)
<i>Large</i> × <i>Beginning_{ipt}</i>		0.148*** (5.39)
<i>Size_{ipt-1}</i>	-0.121* (-1.79)	-0.115* (-1.71)
<i>NPL_{ipt-1}</i>	14.15*** (7.37)	14.18*** (7.39)
<i>Equity_{ipt}</i>	-3.699*** (-8.42)	-3.725*** (-8.42)
<i>ROA_{ipt}</i>	-8.614*** (-5.66)	-8.487*** (-5.57)
<i>C&I_{ipt}</i>	0.609* (1.90)	0.637* (1.96)
<i>Mortgage_{ipt}</i>	0.842* (1.74)	0.798* (1.67)
<i>Consumer_{ipt}</i>	1.061 (1.26)	1.013 (1.22)
<i>CRE_{ipt}</i>	1.852*** (3.38)	1.815*** (3.41)
Partner × Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	6,325	6,325
Adjusted R ²	0.886	0.887

TABLE 4 (continued)

Panel C: Complex Clients

VARIABLES	<i>ALL_{ipt}</i>	
	(1)	(2)
<i>Complex_{ipt}</i>	-0.0121 (-0.27)	-0.0394 (-0.84)
<i>Initial Year_{ipt}</i>	0.0131 (0.86)	
<i>Complex × Initial Year_{ipt}</i>	0.100*** (3.65)	
<i>Beginning_{ipt}</i>		0.0236 (1.37)
<i>Complex × Beginning_{ipt}</i>		0.125*** (4.34)
<i>Size_{ipt-1}</i>	-0.134* (-1.93)	-0.133* (-1.94)
<i>NPL_{ipt-1}</i>	14.12*** (7.31)	14.12*** (7.31)
<i>Equity_{ipt}</i>	-3.705*** (-8.38)	-3.714*** (-8.37)
<i>ROA_{ipt}</i>	-8.592*** (-5.65)	-8.502*** (-5.59)
<i>C&I_{ipt}</i>	0.617* (1.95)	0.658** (2.07)
<i>Mortgage_{ipt}</i>	0.857* (1.77)	0.855* (1.77)
<i>Consumer_{ipt}</i>	1.078 (1.29)	1.100 (1.33)
<i>CRE_{ipt}</i>	1.871*** (3.47)	1.891*** (3.52)
Partner × Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	6,325	6,325
Adjusted R ²	0.886	0.886

*, **, *** Represent statistical significance at the 10 percent, 5 percent and 1 percent levels respectively. This table presents the results of estimating equation (2), with the client reputational risk variables of *Public*, *Large*, and *Complex* in panels A, B, and C, respectively. T-statistics are presented in parentheses and standard errors are clustered at the bank level.

TABLE 5
Partner Experience with Client Regulatory Downgrade

VARIABLES	<i>ALL_{ipt}</i>	
	(1)	(2)
<i>Downgrade_{pt}</i>	0.006 (0.50)	0.005 (0.38)
<i>Initial Year_{ipt}</i>	0.051*** (3.36)	
<i>Beginning_{ipt}</i>		0.054*** (3.24)
<i>Downgrade_{ipt} × Initial Year</i>	-0.097*** (-2.95)	
<i>Downgrade_{ipt} × Beginning</i>		-0.039* (-1.68)
<i>Size_{ipt-1}</i>	-0.129* (-1.87)	-0.124* (-1.80)
<i>NPL_{ipt-1}</i>	14.08*** (7.34)	14.01*** (7.27)
<i>Equity_{ipt}</i>	-3.696*** (-8.42)	-3.677*** (-8.30)
<i>ROA_{ipt}</i>	-8.497*** (-5.58)	-8.436*** (-5.55)
<i>C&I_{ipt}</i>	0.594* (1.88)	0.620* (1.95)
<i>Mortgage_{ipt}</i>	0.851* (1.75)	0.826* (1.70)
<i>Consumer_{ipt}</i>	1.061 (1.26)	1.056 (1.26)
<i>CRE_{ipt}</i>	1.859*** (3.44)	1.871*** (3.50)
<i>Initial Year_{ipt} + Downgrade × Initial Year_{ipt}</i>	-0.046	
p-value	0.127	
<i>Beginning_{ipt} + Downgrade × Beginning_{ipt}</i>		0.015
p-value		0.560

TABLE 5 (continued)

Partner \times Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	6,325	6,325
adj. R-sq	0.886	0.886

*, **, *** Represent statistical significance at the 10 percent, 5 percent and 1 percent levels respectively.
This table presents the results of estimating equation (1), with interactions added between *Downgrade* and the *Relationship Stage* variables. T-statistics are presented in parentheses and standard errors are clustered at the bank level.

TABLE 6
Professional Skepticism and Boomerang Partners

VARIABLES	<i>ALL_{ipt}</i>	
	(1)	(2)
<i>Initial Year_{ipt}</i>	0.037** (2.53)	
<i>Beginning_{ipt}</i>		0.052*** (3.04)
<i>Boomerang</i> × <i>Initial Year_{ipt}</i>	-0.030 (-1.16)	
<i>Boomerang</i> × <i>Beginning_{ipt}</i>		-0.040* (-1.69)
<i>Size_{ipt-1}</i>	-0.128* (-1.84)	-0.124* (-1.80)
<i>NPL_{ipt-1}</i>	14.01*** (7.26)	13.97*** (7.24)
<i>Equity_{ipt}</i>	-3.692*** (-8.37)	-3.686*** (-8.31)
<i>ROA_{ipt}</i>	-8.584*** (-5.64)	-8.460*** (-5.57)
<i>C&I_{ipt}</i>	0.607* (1.91)	0.622* (1.95)
<i>Mortgage_{ipt}</i>	0.842* (1.73)	0.818* (1.69)
<i>Consumer_{ipt}</i>	1.070 (1.27)	1.061 (1.26)
<i>CRE_{ipt}</i>	1.874*** (3.47)	1.874*** (3.51)
<i>Initial Year_{ipt}</i> + <i>Boomerang</i> × <i>Initial Year_{ipt}</i>	0.007	
p-value	0.786	
<i>Beginning_{ipt}</i> + <i>Boomerang</i> × <i>Beginning_{ipt}</i>		0.012
p-value		0.621

Table 6 (continued)

Partner × Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	6,325	6,325
Adjusted R ²	0.885	0.886

*,**,*** Represent statistical significance at the 10 percent, 5 percent and 1 percent levels respectively.
This table presents the results of estimating equation (3). T-statistics are presented in parentheses and standard errors are clustered at the bank level.

TABLE 7
Quality of the Allowance for Loan Losses

Panel A: LLP Validity

VARIABLES	<i>CO</i> _{<i>ipt+1</i>}	
	(1)	(2)
<i>Initial Year</i> _{<i>ipt</i>}	0.000 (0.56)	
<i>Beginning</i> _{<i>ipt</i>}		-0.000 (-0.17)
<i>LLP</i> _{<i>ipt</i>}	0.088*** (2.96)	0.071** (2.18)
<i>LLP</i> × <i>Initial Year</i> _{<i>ipt</i>}	0.083** (2.53)	
<i>LLP</i> × <i>Beginning</i> _{<i>ipt</i>}		0.065** (2.22)
<i>Size</i> _{<i>ipt-1</i>}	0.004*** (6.88)	0.004*** (7.11)
<i>NPL</i> _{<i>ipt-1</i>}	0.162*** (11.34)	0.162*** (11.32)
<i>Equity</i> _{<i>ipt</i>}	-0.0023 (-0.68)	-0.001 (-0.42)
<i>ROA</i> _{<i>ipt</i>}	0.0139 (1.17)	0.0140 (1.19)
<i>C&I</i> _{<i>ipt</i>}	0.005** (2.21)	0.006** (2.25)
<i>Mortgage</i> _{<i>ipt</i>}	0.001 (0.47)	0.001 (0.52)
<i>Consumer</i> _{<i>ipt</i>}	0.011** (2.30)	0.011** (2.30)
<i>CRE</i> _{<i>ipt</i>}	0.007*** (2.91)	0.007*** (2.92)
Partner × Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	5,274	5,274
Adjusted R ²	0.807	0.806

TABLE 7 (continued)

Panel B: ALL Error

VARIABLES	<i>ALL Error_{ipt}</i>	
	(1)	(2)
<i>Initial Year_{ipt}</i>	-0.0108* (-1.75)	
<i>Beginning_{ipt}</i>		-0.00481 (-0.76)
<i>Size_{ipt-1}</i>	-0.105*** (-4.35)	-0.106*** (-4.37)
<i>NPL_{ipt-1}</i>	-4.782*** (-8.93)	-4.786*** (-8.92)
<i>Equity_{ipt}</i>	-0.0246 (-0.17)	-0.0333 (-0.24)
<i>ROA_{ipt}</i>	-0.150 (-0.29)	-0.157 (-0.30)
<i>C&I_{ipt}</i>	-0.386** (-2.34)	-0.387** (-2.35)
<i>Mortgage_{ipt}</i>	-0.214 (-1.64)	-0.212 (-1.63)
<i>Consumer_{ipt}</i>	-0.291 (-1.38)	-0.288 (-1.36)
<i>CRE_{ipt}</i>	-0.330** (-2.49)	-0.334** (-2.52)
Partner × Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	5,260	5,260
Adjusted R ²	0.682	0.682

*, **, *** Represent statistical significance at the 10 percent, 5 percent and 1 percent levels respectively. Panels A and B present the results of estimating equations (4) and (5), respectively. T-statistics are presented in parentheses and standard errors are clustered at the bank level.

TABLE 8
Asset Quality

VARIABLES	<i>Past Due 30_{ipt}</i>	
	(1)	(2)
<i>Initial Year_{ipt}</i>	0.0021 (0.17)	
<i>Beginning_{ipt}</i>		0.006 (0.39)
<i>Size_{ipt-1}</i>	-0.007 (-0.12)	-0.007 (-0.11)
<i>Equity_{ipt}</i>	2.055*** (6.18)	2.054*** (6.19)
<i>ROA_{ipt}</i>	-2.874** (-2.55)	-2.857** (-2.54)
<i>C&I_{ipt}</i>	0.027 (0.11)	0.029 (0.11)
<i>Mortgage_{ipt}</i>	0.305 (1.30)	0.303 (1.29)
<i>Consumer_{ipt}</i>	0.215 (0.53)	0.214 (0.53)
<i>CRE_{ipt}</i>	0.075 (0.28)	0.075 (0.28)
Partner × Engagement FE	Yes	Yes
Year FE	Yes	Yes
N	6,325	6,325
Adjusted R ²	0.749	0.749

*, **, *** Represent statistical significance at the 10 percent, 5 percent and 1 percent levels respectively.

This table presents the results of estimating equation (1) using *Past Due 30_{ipt}* as the dependent variable. T-statistics are presented in parentheses and standard errors are clustered at the bank level.

TABLE 9
Measure Validation

VARIABLES	<i>ALL_{ipt}</i>					
	(1)	(2)	(3)	(4)	(5)	(6)
<i>Initial Year_{ipt}</i>	-0.030*		-0.021		-0.016	
	(-1.90)		(-1.63)		(-1.31)	
<i>Beginning_{ipt}</i>		-0.031*		-0.029**		-0.023*
		(-1.93)		(-2.31)		(-1.84)
<i>Public_{ipt}</i>	0.025	0.014				
	(0.37)	(0.21)				
<i>Public × Initial Year_{ipt}</i>	0.053**					
	(2.54)					
<i>Public × Beginning_{ipt}</i>		0.050**				
		(2.32)				
<i>Large_{ipt}</i>			-0.029	-0.060		
			(-0.61)	(-1.25)		
<i>Large × Initial Year_{it}</i>			0.077***			
			(2.80)			
<i>Large × Beginning_{it}</i>				0.106***		
				(3.91)		
<i>Complex</i>					0.0143	-0.0143
					(0.32)	(-0.31)
<i>Complex × Initial Year_{it}</i>					0.0670**	
					(2.44)	
<i>Complex × Beginning_{it}</i>						0.0912***
						(3.36)
<i>Size_{it-1}</i>	-0.124**	-0.122**	-0.120**	-0.120**	-0.122**	-0.123**
	(-2.21)	(-2.18)	(-2.08)	(-2.07)	(-2.10)	(-2.12)
<i>NPL_{it-1}</i>	16.25***	16.19***	16.28***	16.30***	16.27***	16.29***
	(10.00)	(9.98)	(9.98)	(9.99)	(9.97)	(9.97)
<i>Equity_{it}</i>	-	-	-	-	-	-
	3.754***	3.753***	3.794***	3.820***	3.754***	-3.754***
	(-8.57)	(-8.55)	(-8.67)	(-8.70)	(-8.57)	(-8.57)
<i>ROA_{it}</i>	-	-	-	-	-	-
	11.03***	11.08***	11.05***	11.05***	11.07***	-11.12***
	(-7.19)	(-7.23)	(-7.18)	(-7.18)	(-7.21)	(-7.22)
<i>C&I_{it}</i>	0.217	0.211	0.220	0.225	0.235	0.236
	(0.71)	(0.69)	(0.72)	(0.73)	(0.77)	(0.77)

TABLE 9 (continued)

<i>Mortgage_{it}</i>	0.437 (1.14)	0.426 (1.11)	0.438 (1.14)	0.427 (1.12)	0.459 (1.20)	0.463 (1.21)
<i>Consumer_{it}</i>	0.949 (1.34)	0.927 (1.31)	0.939 (1.34)	0.917 (1.32)	0.944 (1.35)	0.955 (1.37)
<i>CRE_{it}</i>	1.640*** (3.84)	1.621*** (3.79)	1.640*** (3.81)	1.625*** (3.84)	1.656*** (3.88)	1.661*** (3.88)
Bank FE	Yes	Yes	Yes	Yes	Yes	Yes
Partner FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
N	6,896	6,896	6,896	6,896	6,896	6,896
Adjusted R ²	0.863	0.863	0.863	0.864	0.863	0.863

*, **, *** Represent statistical significance at the 10 percent, 5 percent and 1 percent levels respectively.

This table presents the results of estimating equation (2) with bank, partner, and year fixed effects. T-statistics are presented in parentheses and standard errors are clustered at the bank level.