THE EVOLUTION OF PERFORMANCE MEASUREMENT, CAREER DEVELOPMENT, AND COMPENSATION FOR AUDIT PARTNERS IN THE CONTEXT OF PUBLIC SCRUTINY

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ABSTRACT

We examine how audit firms changed their *policies* regarding audit partner performance measurement, career development, and compensation during a period of heightened public scrutiny of audit quality (2007 to 2017). We theorize how implementing policy changes requires a delicate transition in the organizational design and internal processes of the firms and may not effectively translate into their day-to-day *practices*. Our access to proprietary performance management policies and individual partner performance and compensation data from the eight largest Dutch audit firms allows us to gain an in-depth understanding of the evolution of performance management for audit partners. We find that most of the policy changes have real consequences. For example, audit quality becomes more consequential to career development, while profit sharing becomes better linked to quality and long-term performance. We conclude that audit firms appear effectively responsive to public scrutiny, increasingly aligning partner incentives with societal expectations of audit quality.

Keywords: audit partners; performance management; career development; compensation; public scrutiny; audit quality.

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I. INTRODUCTION

In this paper, we examine how audit firms adapt their performance measurement, career development, and compensation policies for audit partners in the context of public concerns about audit quality. Because auditors have a responsibility to third parties and society, audit firms are likely to be heavily influenced by the normative expectations of their external environment. Public concern, generally exercised through regulatory scrutiny, has increasingly focused on improving the quality of a firm's audits. A significant concern raised in the public debate has been whether systems of performance management, including mechanisms for performance evaluation, career development, and compensation, provide audit partners with sufficient incentives to prioritize audit quality in their activities (e.g., IOSCO 2009; AFM 2011; CMA 2019; PCAOB 2019; Commonwealth of Australia 2020). This increased public scrutiny may have prompted many audit firms to respond to these concerns by revisiting their internal policies to provide incentivizes to improve audit quality.

While firms can consider a range of *policy* changes with regard to audit partner performance management, implementation of such policies can require a difficult and delicate transition in the organizational design and internal processes of a firm and may not effectively translate into the day-to-day *practices* of the firm. First, implementing such systems in practice may turn out to be much more complicated than expected because of the delicate balance across the various dimensions of the organizational design of a firm, i.e., people, architecture, routines, and culture (Milgrom and Roberts 1990; Holmstrom and Milgrom 1994; Roberts 2004). The changes in performance management policies need to work in concert with the various other dimensions of the firm's organizational design to be effectively implemented. Second, the overall organizational design may differ among firms depending on their idiosyncratic strategy, clients, and knowledge base (Simons 2010). Failure to consider the collective arrangement and internal consistency of these interconnected dimensions may lead to less effective implementation than desired or expected (Brickley, Smith, and Zimmerman 1995; Roberts 2004). Hence, the effectiveness of a performance management system in practice depends in part on "how well it works in the environment in which it is operating" (Roberts 2004, 19). Third, these forces are particularly salient in an audit partnership because a partnership has a unique governance structure (partners are both principals and agents) making partner performance management and incentives central to effective operations (Huddart and Liang 2003, 2005; Lennox and Wu 2018). Resistance from individual partners may make it hard to implement changes in the performance management system given the need for consensus among the individual partners who are subject to the system and have to bear the "cost" of change (Schaefer 1998). Changes in a performance management system within which a partner may currently operate comfortably may require acculturation and a "leap of faith" by individual partners, the absence of which may undermine the effectiveness of the changes in practice.

Audit firms may be less sensitive to internal pressures because of the need to maintain their reputation and credibility in the eyes of the public. While each firm has relative autonomy to develop its own policy changes in the context of increased public scrutiny, the regulator does not require audit firms to report on how they *execute* such new policies. Accordingly, it is not known if the execution of new policies related to performance management is as effective as hoped for or claimed. Researchers have had little opportunity to directly access detailed performance and compensation policy documents or individual audit partner data over an extended period to gauge how audit firms respond in the context of public scrutiny. The few studies that exist focus on specific elements of performance management rather than adopting a comprehensive perspective of performance management systems in audit firms. For example, some research has analyzed specific performance measures within audit partner compensation schemes (Trompeter 1994; Coram and Robinson 2017) or audit partner equity ownership, profit sharing, and compensation (Burrows and Black 1998; Carcello, Hermanson, and Huss 2000; Liu and Simunic 2005; Knechel, Niemi, and Zerni 2013; Coram and Robinson 2017; Ernstberger, Koch, Schreiber, and Trompeter 2020; Lennox, Wang, and Wu 2020; Dekeyser, Gaeremynck, Knechel, and Willekens 2021).[1] Likewise, Lennox, Wang, and Wu (2023) specifically focus on how an audit partner's past performance influences whether a partner is selected to serve on a firm's national leadership team.

The purpose of this study, therefore, is to examine the extent to which *policy* changes in audit partner incentives affect the day-to-day *practices* of the firms by studying the comprehensive set of elements constituting an audit firm's performance management system. Specifically, in this study we (1) examine how audit firms changed their *policies* related to audit partner performance measurement, career development, and compensation in the context of heightened public scrutiny on audit quality over a period of time and (2) test whether these policy changes are associated with real consequences in individual partner career development and compensation in *practice*.

For this purpose, we obtain proprietary data from the eight largest audit firms in the Netherlands where the regulatory debate about audit quality has been particularly intense (AFM 2010; House of Representatives 2014a, 2014b; NBA 2014; MCA 2016). This debate is similar to discussions in other countries (e.g., IOSCO 2009; CMA 2019; PCAOB 2019; Commonwealth of Australia 2020) and ultimately culminated in Article 18b to the Dutch Audit Firms Supervision Act, requiring that "the remuneration system of the audit firm, including its profit-sharing system, should contain appropriate performance incentives to ensure the quality

[1] A major limitation of prior research is that the few available studies rely on publicly available data from auditor tax returns, accounting regulators, and firm transparency reports (Knechel et al. 2013; DeFond and Zhang 2014; Lennox and Wu 2018; Lennox et al. 2020; Ernstberger et al. 2020; Vandenhaute, Hardies, and Breesch 2020; Dekeyser et al. 2021; Knechel, Mao, Qi, and Zhuang 2021). Other studies are based on surveys or interviews (Trompeter 1994; Burrows and Black 1998; Coram and Robinson 2017).

of statutory audits" (Ministry of Finance 2016). This legislation allows firms significant autonomy in structuring their performance management systems, while external regulators retain the authority to enforce policy changes and require audit firms to report their policy choices. However, since regulators do not mandate reporting on the *execution* of these policies, potentially it is not known if implementation of new policies has been effective in practice. At this point, information about changes to the performance management systems is only known from anecdotes, firm public relations efforts, and firm transparency reports. Our access to proprietary archival performance management policies and individual partner performance and compensation data allows us to gain an in-depth understanding of the evolution of performance management for audit partners.

We first describe the types of *policy* changes the eight audit firms made to their formal system of audit partner (1) performance measurement, (2) career development, and (3) compensation (hereinafter referred to as "performance management systems", see DeNisi and Murphy 2017) at three points in time during a period of particularly heightened public scrutiny of audit quality (2007, 2012, and 2017).[2] We find that the firms had discernible policy differences at the start of our sample period (2007) and maintain some meaningful firm-specific policies at the end of the period (2017). Of critical importance though, is that all firms changed their *formal* policies to clearly elevate the attention given to audit quality when evaluating audit partner performance. For example, firms that did not have a quantifiable system to evaluate audit quality for an individual partner introduced metrics for this purpose, while many firms increased the weight placed on audit quality metrics in performance evaluations. Additionally, firms increased the granularity of performance measures. Poor performance, especially low audit quality, became increasingly consequential in determining partner career development

[2] "Audit partner" refers to equity partners who also sign-off on audit opinions, as opposed to non-equity partners who have no equity stake in the firm (Knechel et al. 2013; Lennox and Wu 2018).

and compensation, particularly with monetary penalties introduced in firm policies for failing to meet audit quality goals.

Second, to empirically test whether the policy changes of audit firms had a real impact on audit partners, we examine the consequences of performance evaluations on subsequent decision-making for career development (i.e., individual partner promotions or demotions and job retention) and compensation (i.e., profit sharing and penalties) using proprietary records of individual audit partners. Our results indicate that the changes observed in formal performance management policies had an empirically observable effect on partner evaluations and compensation, consistent with public concern and regulatory scrutiny. Specifically, we find that audit partner performance measures have become more consequential for career-related decisions. For example, audit quality has become increasingly important relative to other performance dimensions, reflected in a higher likelihood that a partner with subpar audit quality would be demoted or dismissed from the firm. We also observe that the immediate translation of performance into profit sharing has decreased over time, suggesting that partners are increasingly rewarded for long-term performance.

Taken together, our findings contribute to the ongoing debate about regulation in the audit profession. We find that changes in firm policies made in the context of public scrutiny have real and discernible consequences for audit partner career development and compensation. Despite a potentially delicate and complicated transition in an organization's design and internal processes, audit firms are able to effectively adopt policy changes which strengthens the alignment of audit quality incentives among audit firms, audit partners, regulators, capital markets, and society. This study also contributes to the performance management literature broadly, and the growing literature on audit partner compensation more specifically. By considering typical elements in a performance management system, we show how performance measurement informs a firm's decisions in relation to audit partner career development and compensation (Gibbons and Murphy 1992; Gibbons and Kaplan 2015). Furthermore, we document how audit firms shift their focus from evaluating past performance to setting expectations for future performance (Bol and Leiby 2018) by increasing the emphasis on performance in career development (promotions and demotions), while deemphasizing short-term performance metrics in awarding compensation.

II. PUBLIC SCRUTINY AND POLICY DEVELOPMENT

Over the past two decades, many countries have made an intense effort to spur the audit profession to enhance audit quality by raising concerns about the way audit partners are evaluated and incentivized within their firm. In this section, we consider the nature of the public concern and regulatory scrutiny in the Netherlands and describe how eight Dutch audit firms adjusted their audit partner performance, career development, and compensation policies in the context of this increased public scrutiny. We then hypothesize (Section III) and test (Section IV) whether formal *policy* changes are associated with changes in day-to-day performance management *practices* of audit partners.

Public Concern and Regulatory Scrutiny

In response to auditing scandals in the early 2000s, many countries undertook extensive legislative and regulatory initiatives designed to safeguard and improve audit quality. The most notable efforts are embodied in the Sarbanes-Oxley Act in the US (U.S. Congress 2002) and the 8th Company Law Directive extension on statutory audits in the EU (European Commission 2006). A significant concern has been whether systems of performance management, including mechanisms for career development and compensation, provide audit partners with sufficient incentives to conduct high-quality audits (IOSCO 2009; AFM 2011; CMA 2019; PCAOB

2019; CTA 2020). The debate in the Netherlands is typical of many other countries.[3] In the wake of the 2008 global financial crisis, auditor inspections by the Dutch *Authority for the Financial Markets* (AFM) led to a focus on the quality incentives incorporated in performance management systems for audit partners, including disciplinary actions and sanctions in cases of low audit quality (AFM 2010, 2011).[4] Although early inspections were exploratory and not focused on enforcement, the AFM advocated for more stringent and uniform legislation on this topic. Accordingly, the AFM expects audit firms' performance management policies to "support the standards and values of the audit firm, as well as the quality objectives it aims for" (2014, 10) and to include "more consistent, explicit, and consequential consideration of quality aspects in the performance evaluation and compensation of audit partners" (2011, 40).

The continued severity and persistence of AFM audit inspection findings triggered further public debate, culminating in a motion in the Dutch House of Representatives to have the Minister of Finance require the Dutch auditing profession to develop a plan to improve partner incentives (House of Representatives 2014a). Representatives proclaimed that "the partner model as it currently operates is no longer sustainable (...) because audit partners own and share in the profits of the audit firm", calling it "unprecedented and unacceptable" (House of Representatives 2014b). The profession was called upon to "come up with a revision of [business] models to reduce, limit, and contain potentially conflicting incentives with respect to audit quality." In response, the Dutch Institute of Chartered Accountants (NBA) accelerated the development of numerous improvement measures, amongst which was the development of a "remuneration and performance assessment policy with the right quality incentives for audit partners" (NBA 2014). In addition, the NBA established the Monitoring Committee

[3] In the Netherlands, the audit profession has developed into a mature institution and has been subject to regulatory oversight by the Dutch Authority for the Financial Markets (AFM) since 2006. Similar to the oversight role of the PCAOB in the United States, AFM's oversight on audit firms focuses on quality management and audit file quality (i.e., process quality). Individual auditors are subject to enforcement actions through a disciplinary court.
[4] The term "sanction" is mentioned as an example of remedial action but is not prescribed and remains undefined.

Accountancy (MCA) in 2015 to report to the Minister of Finance on the implementation of improvement measures. The MCA intensified the public debate by referring to the partner compensation model as one of the "wicked problems" in the structure of audit firms and suggesting that profit sharing amongst partners, especially across service lines, may conflict with a focus on audit quality (MCA 2016).

The public debate ultimately culminated in legislative initiatives with the addition of Article 18b to the Dutch Audit Firms Supervision Act. Article 18b requires that "the remuneration system of the audit firm, including its profit-sharing system, should contain appropriate performance incentives to ensure the quality of statutory audits" (Ministry of Finance 2016). With the passage of this law, the Minister of Finance underlined the importance "that audit firms identify whether and where their remuneration policies may create undue incentives (...) which may lead audit partners, in the course of their work, to be guided primarily by their own (financial) interests rather than putting audit quality first" (House of Representatives 2016a). In further parliamentary debate, the Minister of Finance elaborated:

> *"Although financial incentives by themselves may not ensure high audit quality, I find it of great importance that perverse incentives in the remuneration model are to be avoided and that auditors focus on the public interest of the statutory audit and thus keep the quality of the statutory audit permanently high. ... Performance incentives in remuneration policies should enhance, and not undermine, audit quality. ... If an individual auditor's appraisal and compensation are strongly influenced by the quality of his work, this provides good incentives such that the compensation policies can support a quality-oriented culture."* (House of Representatives 2016b)

While the resulting legislation is principles-based, audit firms are expected to design performance management systems that incorporate appropriate incentives for audit partners so that "quality should have both positive and negative consequences for compensation or profit sharing" (House of Representatives 2016b). Little is known about the actual effect of this public scrutiny over time, other than what can be gleaned from anecdotes, firm public relations efforts, and audit firms' annual transparency reports.

Performance Management Policy Development

DeNisi and Murphy (2017, 421) describe performance management as "activities, policies, procedures, and interventions designed to help employees to improve their performance" and note that "[t]hese programs begin with performance appraisals but also include feedback, goal setting, and training, as well as reward systems." In this section, we examine how large Dutch audit firms changed their official performance management *policies* for audit partners amid a period of heightened public scrutiny. This is particularly salient as firms have significant autonomy and discretion in how to implement their performance management systems, given the principles-based nature of the legislative directive and the ambiguous and broad focus of public concern (DiMaggio and Powell 1983).

Performance appraisals are the formal process to evaluate employees, typically by a supervisor who assesses the employee's performance given a set of performance metrics (DeNisi and Murphy 2017). However, Bol and Leiby (2018) argue that assessing performance is a distinctively different activity from assessing promotion prospects as performance in the current role is not necessarily associated with success in a future role, i.e., responsibilities and necessary competencies may differ substantially after promotion (Baker, Jensen, and Murphy 1988; Gibbs 1995). This distinction highlights the dual purpose of performance appraisals: they are fundamental in deciding on career development—reflecting expectations about a partner's future performance—while simultaneously determining compensation for the partner's past performance (Bol and Leiby 2018). In the following qualitative analysis, we first examine changes in the measurement of audit partner performance. Next, we discuss changes in how these measurements are used for (1) assessment of audit partner competence and career development and (2) determination of audit partner compensation.

Data Gathering

Our examination is based on in-depth analyses of firm policy documents from the eight largest audit firms in the Netherlands for three separate sample years: 2007, 2012, and 2017.[5] The initial year, 2007, is the earliest year for which we could obtain complete documents and data and reflects the legacy performance management systems prior to a period of increased public concern and regulatory scrutiny. The ending year, 2017, follows a particularly active period of regulatory scrutiny of audit quality in the Netherlands. The year 2012 provides an intermediate point from which we can assess the evolution of firm policies over time.[6] We received full and original policies, plans, and procedures related to partner performance management systems from the firms for the three years. All data was gathered through the *Foundation for Auditing Research* and is subject to a strict confidentiality agreement.[7] All descriptions that follow are based on the original policy documents. Audit firms are identified by a unique letter (A to H) throughout the discussion. Table 1 provides a summary of the changes in firm policy documentation of their performance management systems for our sample years, supplemented with examples of original policy language illustrating these changes.

Audit Partner Performance Measurement

A key component for incentivizing audit partners is the set of performance measures used in the firm's formal performance management system. In 2007, as detailed in Table 1

[5] These eight firms are the Big 4 (Deloitte, EY, KPMG, and PwC) and mid-tier firms (Baker Tilly, BDO, Grant Thornton, and Mazars), which are responsible for most of the audit engagements in the Netherlands. The Big 4 conduct roughly 90% of all statutory audits of Public Interest Entities (PIEs) and almost 50% of all statutory audits of non-PIEs, and receive approximately 76% of all audit revenue in the Netherlands (AFM 2014). The other four firms account for approximately 10% of PIE audits and 15% of non-PIE audits. Dutch policies for performance management and compensation largely align with their global affiliations. Similar to other audit firms internationally (Lennox and Li 2012), audit partnerships in the Netherlands are typically organized as limited liability companies (LLCs). We observe that the legal organizational form of Dutch firms does not influence an audit firm's performance management system (e.g., all audit partners share in firm profits), audit partner ownership (e.g., all audit partners are required to contribute to the firm's capital structure, the amount ranging from €175,000 to €500,000 for different firms), or internal governance (e.g., one partner, one vote in the firms' decision-making process). Moreover, all but one firm switched to the LLC organizational form prior to 2007.

[6] Audit firm policies tend to be "sticky" from year to year. We pick the mid-point of our sample period because we could not identify the specific years in which individual firms may have amended their policies. As a result, our mid-point may lag the actual changes made by specific firms.

[7] Data confidentiality and anonymity ensure that information cannot be traced back to an individual audit firm. Any presumed resemblance to a specific firm is purely coincidental.

Panels A and B, six of the eight firms in our sample used a system of annual goal setting, performance measurement, and performance rating to evaluate individual audit partners. By 2012, all eight firms had adopted this approach.[8] These performance measurement systems utilize performance targets along different dimensions of partner activity conducted within the strategic context of the audit firm. For example, one firm's policy states:

> *"Each partner incorporates the strategic vision laid down in the firm's strategy plan into his/her personal (annual) goals and gives his/her commitment by aligning his/her goals with this plan." (Firm F, 2017).*[9]

Five firms use four categories of performance, one uses three, and two use six. In general, the four common dimensions for rating an auditor are *Clients*, *People*, *Firm*, and *Quality* (see Table 1 Panel A). *Client* performance is generally described as "client service and delivery" (Firm A, 2012) and "market leadership and growth" (Firm G, 2007), which may include client satisfaction, relationship management, market or industry leadership, contributing to the firm's reputation, and business and client portfolio development. *People* performance relates to personnel development, team building, and development of colleagues (e.g., "connecting with people through meaningful career conversations, helping people gain experiences they need to develop and thrive, and focus on team development", Firm H, 2017). *Firm* performance reflects a dedication to operational excellence, financial performance, product development and innovation, engagement productivity, and collaboration across service lines and industry groups.

A notable change that we observe from 2007 to 2017 is the increased presence and salience of performance measures related to audit quality (Table 1 Panel A). From a

[8] While a detailed discussion of the annual performance measurement and evaluation cycle for audit partners is outside the focus of this study, the process is broadly geared towards assessing performance over the past year and goalsetting for the next, based on both a partner's self-assessed performance and the evaluation of that performance by "reviewing partners" during an annual performance review meeting. A partner's evaluation is further reviewed by an appraisal (calibration) committee which has the final say over performance ratings.
[9] Some policy statements we received were in English, while others were in Dutch and translated to English. Direct quotes have been anonymized for firm specific language to safeguard firm confidentiality.

reputational perspective, the dimension of *Quality* is key to establishing public confidence in an audit firm.[10] In 2007 and 2012, quality was usually defined in relatively generic terms like "eminence and quality" (Firm H) or "quality and effective risk management" (Firm D) and typically focused on formal compliance with auditing standards and methodology, independence rules, codes of ethics, risk management, and training. By 2017, all firms had developed more refined definitions of audit quality and related performance measures. For example, two firms introduced a "quality dashboard" with at least ten metrics to assess the audit performance of individual partners (Firms D and F). The metrics include internal and external quality reviews and remediation (i.e., the way a partner responds to review findings), tone at the top, acting in the public interest, compliance, university or educational outreach, consultation on important audit matters, and attendance at or delivery of technical training. The related metrics use both qualitative and quantitative input from different sources and can differ in precision and subjectivity. For example, quality reviews, contributions to audit quality initiatives, and roles in professional bodies are directly measurable, while tone at the top, professional skepticism, and acting in the public interest are more subjective.

Another major shift is the increased granularity of performance ratings, and the weight placed on *Quality* relative to the other dimensions of performance to arrive at an overall performance rating. As illustrated in Table 1 Panel B, a granular system of numerical ratings of performance (i.e., 1 to 5) for specific performance dimensions was implemented by only two firms prior to 2007 (A, D), while two firms did not have any formal performance measurement system at that time (B, E). Two firms adopted a granular approach prior to 2012 (F, G), and one firm adopted it by 2017 (Firm C). The other three firms also evaluate various sub-dimensions of performance but with one doing so in qualitative terms (B) and two using

[10] For example, one firm stated: "Our efforts to provide high quality service need to be supported by strong and effective risk management policies and procedures (…) in order to maximize long-term revenues and safeguard the image of the firm." (Firm D, 2007).

only an overall numerical performance rating (E, H). No specific weights were placed on any of the four performance measures in 2007.[11] By 2017, two firms increased the weight on *Quality* performance to 40% (C) and 50% (F). In two firms (D, F), achieving a minimum level of *Quality* performance became a prerequisite for an overall rating of high performance, regardless of the performance on other dimensions. In sum, we find evidence that audit firms substantially modified their performance measurement systems from 2007 to 2017 to be more granular and extensive, particularly regarding *Quality*.

Audit Partner Career Development

A firm's performance management system often focuses on partner career development and is generally based on a firm-specific competence framework which reflects different career levels, roles, and responsibilities. The "career level" at which a partner is perceived to operate by the firm is generally denoted by their "*Competence Class*".[12] A "Competence Class" is not based solely on longevity and experience but increasingly reflects performance considerations as part of the assessment of an auditor's role within the firm. As illustrated in Table 1 Panel C, different firms use different nomenclatures for classes of competence, with up to nine competence categories, each of which may include up to five sub-levels. A *Competence Class* reflects the level of complexity and responsibility expected for the partner as defined by the skills, competencies, and experience relevant to the partner's position in the firm.[13] Firms generally assign their partners to a competence class and sub-class at the beginning of each year, or once every two to three years, as part of their performance assessment. A step-up in competence class can be considered a "promotion" and reflects growth in the individual's competencies. In some firms, step-ups may be automatic in the first few years after partner

[11] Suggesting, implicitly, that the four categories were considered of equal importance.
[12] Two firms do not categorize their partners based on competence classes as such classes are not needed for the equal profit-sharing systems (discussed next) in these firms.
[13] For example, junior partners are responsible for the audit of small and medium-sized engagement, generally lower risk, while senior partners would be assigned the most challenging and strategically important clients.

admission, assuming overall satisfactory performance. After the initial period, however, an increase in a partner's competence rating would be based on substantiated development over multiple years and continuous development of higher-level skills needed for more challenging roles and responsibilities.

A partner's competence rating is not dependent on *current* performance alone but reflects previous multi-year historical performance and expected future performance. One firm's policy states that the competence classification communicates that:

> *"Decisions with regard to competence class are not based on short-term performance but on the mid-long perspective of the firm and the partnership to support a healthy balance between achieving short- and long-term goals." (Firm C, 2017).*

Over our sample period, we observe that the policies not only have become more detailed in describing the expected performance for each competence level, but they have also provided clearer guidelines for demoting audit partners to a lower competence class for subpar performance. In extreme cases, a partner may shift out of the audit function or be asked to resign from the firm. A partner may be given a grace period to remediate performance deficiencies but there is an increasing and non-trivial probability that underperforming partners will be sanctioned or dismissed by the firm as illustrated by one firm's policy:

> *"Demotion is possible in case of performance issues for two years in a row and resignation in case of quality issues for two years in a row." (Firm F, 2017).*

These policies imply that an audit partner's performance evaluation can have significant consequences for the individual's career. In sum, firm policies for audit partner career development have become more specific over time and provide clearer criteria and more firm control over promotions and demotions, with potentially significant consequences for a partner's career development.

Audit Partner Compensation

Audit partner compensation generally consists of two components: (1) a share in the firm's profit based on the firm's allocation scheme and (2) a penalty in cases where quality is unusually low.

Profit sharing: All firms start with the premise that an audit partner's profit share is based on the number of "units" held by the individual partner. The value of a single unit is calculated by dividing the firm's profit pool (i.e., the net income of the firm aggregated across service lines) by the total number of units distributed among the partners.[14] Different firms may use slightly different approaches to calculating profit shares, and changes to a firm's profit-sharing policies are nuanced (Table 1 Panel D). Four firms in our sample applied a form of *equal profit sharing* throughout the decade, i.e., all partners share equally in the firm's profit regardless of competence level, seniority, or any other personal attributes. Two firms (Firms B and E) apply such a system in its purest form, i.e., the firm's profit is simply divided by the number of partners. We refer to this form as "fixed equal profit sharing" in Table 1. Two other firms (A, G) apply equal sharing in principle but only award a fraction of a full share in the first few years of partnership, increasing each year until eventually reaching a full share. We refer to this second form as "stepwise equal profit sharing". Compensation in these firms does not structurally depend on either current or past performance.

Two firms (C, H) apply *equal profit sharing within competence classes*. Individual partners within each competence class are assigned the same number of "units", i.e., units are equal across all partners in the same competence class, with partners in higher competence classes receiving more units. Profits are shared equally across individual partners within each class. This set-up did not change much during our sample period, although Firm C decreased the ratio of units assigned to the highest and lowest competence classes by about 28% between 2007 and 2017. Under this system, a partner's profit share is unaffected by the partner's current

[14] Seven of the firms in our sample aggregate the profit pool for audit partners across audit, tax, and consultancy, while one separates tax revenues. Most of the firms adjust for short-term volatility in profitability across different service lines each year. This adjustment offsets swings in profitability of individual lines of business due to business cycles. For example, audit revenues tend to be consistent over time, while consulting revenues can oscillate with the business cycle and economic conditions (Paterson and Valencia 2011).

or past performance except when it influences the partner's assigned competence class.

One firm (Firm F) used a hybrid profit-sharing system – *performance-based profit sharing within competence classes* – for the entire sample period. In this approach, some units within a competence class are shared equally across partners, while additional "performance units" are assigned to – or taken away from – individual partners based on recent performance. This means that the performance component of profit shares for individual audit partners within the same competence class can vary up and down from year to year. After 2012, this firm both decreased the ratio of such "performance units" assigned to the lowest and highest competence class by about 40% and reduced the number of units tied to superior performance within a competence class by about 20%. The firm did not change its ability to take away units for poor performance, thereby skewing the short-term performance component of profit shares downward. Finally, the last firm (Firm D) used a similar hybrid system until 2012 but moved to equal profit sharing within competence classes prior to 2017. The firm's rationale was that partners develop their careers for reasons beyond immediate pay alone and they believed this approach would foster a longer-term focus amongst their partners.

In summary, half of the firms in our sample used an equal profit-sharing approach throughout our sample period, meaning that earnings were not directly influenced by performance, while four had some form of variable profit-sharing system at some point. However, even for these firms, profit shares were essentially "flattened" (i.e., less of a difference between highs and lows) and a partner's profit share increasingly became based on *historical* performance over multiple years, rather than recent performance, with greater emphasis on audit quality.

Penalties: The most important development across all firms since 2007 has been the introduction or an increase in penalties for low audit quality (see Table 1 Panel E). Only one firm had a quality penalty in 2007 (F), but all eight firms had implemented such penalties by

2017. Audit quality penalties may be implemented in two ways. First, a cash penalty may be imposed due to a substandard audit which varies across the six firms with such penalties. Second, a profit share penalty may reduce the number of units that count towards an individual partner's share of firm profits. In either case, this approach reflects an exception to strict equal sharing because it is generally imposed after initial profit shares are assigned.

A final development is the introduction of claw-back provisions for audit partners who produce low quality. These did not exist in 2007 but as of 2017, claw-back provisions are a standard policy in all but one firm.[15] Basically, a claw-back system involves deferring the payment of some compensation, or delayed repayment of a partner's capital contribution upon retirement, to cover costs arising from poor audit quality that later comes to light. The "claw-back reserve" often equals a partner's average one-year profit share and is used to cover costs (e.g., fines, penalties, claims) associated with poor audit quality attributable to that partner.

In conclusion, firms started out with different legacy systems and philosophies of firm performance management. Some of the variation across firms has narrowed over the years. Of most importance is the focus on granular measurement of performance and audit quality, as well as firms imposing financial penalties for low audit quality. These important changes manifest in policies related to performance measurement, career development, and compensation of audit partners. This is true even in firms that share profits equally among their partners. That is, poor performance, especially low audit quality, has become more influential in determining audit partner career development and compensation.

III. HYPOTHESIS DEVELOPMENT

In the previous section, we discussed the changes audit firms have made to their formal

[15] The one audit firm that does not have a claw-back provision argues that because they use equal profit sharing, their audit partners are less sensitive to moral hazard. They also feel that other mechanisms are in place to recover losses arising from audit quality issues from their partners.

policies for audit partner performance management. However, implementation of such policies can require a difficult transition in the organizational design and internal processes of a firm. In this section, we discuss and hypothesize how these formal policy changes affect the day-to-day *practices* of the firms.

Roberts (2004) argues that firm structures are comprised of four interrelated dimensions: people, architecture, routines, and culture (hereinafter: PARC).[16] The dimension of architecture, including its elements such as performance measures, incentives, and rewards, is specifically relevant to our study. The collective arrangement and internal consistency of these interconnected dimensions set the conditions which allow a firm to function effectively (Holmstrom and Milgrom 1994). General organizational-design research has shown that a change in one dimension of a firm's operating structure can impact the operations of the entire firm (e.g., Milgrom and Roberts 1990), so a potential change in one individual dimension needs to be evaluated against its consequences for other dimensions (Brickley et al. 1995; Roberts 2004). Failure to consider such interactions may lead to less effective implementation than desired or expected. Furthermore, the overall design and conceptualization across these dimensions may differ among firms depending on their idiosyncratic strategy, clients, and knowledge base (Simons 2010). Accordingly, Roberts argues (2004, 19): "There is no uniquely best strategy, and there is no one best way to organize."

While all large organizations need performance management systems to operate effectively, implementing such systems in practice may turn out to be much more difficult than

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[16] Roberts (2004) describes the four dimensions of PARC as follows: *People* is understood as "the set of people who are part of the organization", including their talents and skills, personal preferences, beliefs, and objectives, attitudes towards work, risk, and rewards, as well as their position towards and in the organization. *Architecture* features the organizational and management structure and reporting lines, performance measurement, and incentive systems to align actions with organizational objectives. *Routines* refer to "managerial processes, policies, and procedures, official and unofficial, formal and informal" to gather and transmit information, make decisions, allocate resources, monitor performance, and control activities. *Culture* is described as "the fundamental shared values of the people in the firm" regarding why the firm exists, what they are collectively and individually doing, and to what end.

expected because of the delicate balance across the four interrelated PARC dimensions. For example, an empirical study by Abernethy et al. (2023) finds that firms across different industries implement different approaches linking pay to performance depending on the overall work climate. Specifically, in companies where managers are mostly out for themselves (PARC dimensions of *people* and *culture*), firms tend to place greater weight on aggregate performance measures (two elements within the PARC dimension of *architecture*). In contrast, in a work climate where managers care more about others, firms place lower weights on aggregate performance measures. For these different firms, various positions of the PARC elements work in concert. Hence, the effectiveness of a performance management system in practice is in part defined "in terms of how well it works in the environment in which it is operating" (Roberts 2004, 19).

In the context of auditing, Antle and Nalebuff (1991) show how changes in individual elements of an audit firm's incentives may alter partner behavior in ways that could undermine firm quality and profitability. Policy changes motivated by external pressure might cause auditors to become more conservative to such an extent that financial statements become less informative (Barth 2018). Conversely, audit partners may become too aggressive in areas not affected by the new policies to placate clients who perceive the changes to have created excess conservatism. The issue is particularly salient to audit firms given the need to coordinate audit planning and execution with clients (Knechel, Thomas, and Driskill 2020).

These forces are particularly salient when an audit firm attempts to implement policy changes with regard to performance management. This is especially critical when public concern regarding audit partner incentives relates to the essence of an audit firm partnership to create and organize service opportunities for professionals with different specializations (Garicano and Santos 2004). One way to enhance firm performance is to appoint partners who are likely to behave to the firm's norms (Levin and Tadelis 2005). However, partnerships can also create unusual agency problems since a partner is simultaneously an owner of the firm (principal) and someone who "works" for the firm by servicing clients (agent) (Huddart and Liang 2003, 2005). Consequently, implementation policy changes requires consensus among individual equity partners (Hart and Moore 1990; Carreras 1996) and new policies cannot be imposed by fiat of senior leadership. This dual role makes it critical that the incentive system in a partnership properly balance potentially competing roles. Otherwise, policy changes may not have the expected effect on performance management of individual partners, and may even work against the best interest of the firm or society.

At the same time, individual partners are subject to the system and have to bear the "cost" of change, some of whom may object because they feel that there is inadequate justification or practical development for the changes to be effective. For example, public scrutiny could readily result in internal tension, political maneuvering, and proactive resistance resulting from competing logics related to the policy changes (Pache and Santos 2010).[17] Furthermore, changes to the norms in a performance management system within which a partner may currently operate comfortably, would require individual partners to adjust their own behavior, stimulating a process of acculturation by individual partners that may or may not be successful. For example, the increase in the salience of audit quality, possibly at the expense of client or employee satisfaction, challenges how the firm monitors audit work and how an individual auditor internalizes firm norms (Kandel and Lazear 1992). Schaefer (1998) demonstrates that the "cost" of a change *to individuals* cannot exceed the individually perceived benefits when the firm expects full compliance. This is critical to our setting as changes in performance management for audit partners may affect their future career prospects and potential for compensation. Consequently, overcoming inertia surrounding significant

[17] Organizational inertia applies to all organizations, but a partnership may have less power to execute change through a top-down "decree" than a more hierarchical organization (Hart and Moore 1990).

policy changes may require a “leap of faith” by individual partners, the absence of which may undermine the effectiveness of the changes in practice.

These arguments suggest that it is not clear whether new *norms* for behavior will effectively emerge from new *policies*. However, prior research has shown that regulatory focus has an impact on audit firm reputation (Nagy 2014) and that audit firms prefer to avoid public criticism about the quality of their audits (Johnson, Keune, and Winchel 2019). In order to protect their reputation, audit firms may need to demonstrate that their incentive system encourages audit partners to deliver high-quality audits. At the same time, the new legislation issued by the Dutch government is principles-based, so each firm has the autonomy to develop its own approach for synchronizing its organizational elements with the new regulation. Furthermore, since the regulator does not require audit firms to report on how they *execute* the new policies, it is not known if the policy changes were effectively implemented in the face of internal resistance and inertia. Accordingly, the execution of new policies related to performance management may not be as effective as hoped for or claimed. This leads to our hypothesis, stated in the null form:

> **Hypothesis:** *The formal changes in audit firm policies for audit partner performance measurement, career development, and compensation, made in the context of public scrutiny, will have no effect in practice on how audit firms decide on career development and compensation of individual audit partners.*

IV. EMPIRICAL ANALYSES

We test our hypothesis on whether the performance management policy changes described above translate into changes in practice using three tests that examine the relationship between partner performance and (1) promotions and demotions, (2) job retention, and (3) compensation.

Measures

We measure partner-level variables using proprietary data obtained from the audit firms. All variables are defined in Appendix A. Our analysis is based on three measures of individual performance: (1) *Performance_Overall*, the firm's measure of partner overall performance calculated as the weighted average of the four sub-categories of performance described in Section II (Quality, Client, People, and Firm);[18] (2) *Quality* isolates the audit quality performance measure used by the firms; and (3) *Other_Performance* is the average of Client, People, and Firm. A five-point scale is the most commonly used across the firms to measure performance, so we normalize all performance measures to a five-point scale.[19] A higher rating indicates better performance. Where performance is described in qualitative terms, we transform the data to a numerical value by assigning a numerical rank from the lowest to the highest qualitative evaluation level attainable (again normalized to a scale of five). Two firms use more than four categories in their evaluations, so we first map the ratings to Quality, Client, People and Firm and then normalize the ratings.

For the analysis of career development and compensation, we normalize partner competence classes (*Competence*) to a five-point scale to adjust for heterogeneity in competence framework across firms and years. Ultimately, a higher competence class indicates a higher rank with greater responsibility and role complexity. Promotions are indicated by an upward shift in competence class, while demotions are marked by a downward shift. *Competence_5Year* is each partner's competence class five years in the future (i.e., 2012/2017 for the analysis of 2007/2012). *Exit_Involuntary* is an indicator variable that equals one if a partner is involuntarily forced to move to a non-audit role or resign from the firm during the sample period. We measure partner profit share (*Profit_Share*) as all income paid to a partner relative to the total compensation paid to all partners in the sample for that firm and year.[20]

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[18] The weights vary across firms and year based on the stated formal firm policies.
[19] We normalize the evaluation results by calculating the percentage of each partner's performance rating relative to the maximum possible rating per firm policy, multiplied by five.
[20] Ideally, a firm's entire profit pool should be used to calculate partner profit share percentages. However, as this

Sample Data

Table 2 Panel A outlines the sample selection process and composition across years and firms.[21] We initially identified all audit partners in the Dutch Big 8 audit firms for each year (2007, 2012, and 2017). This yielded 585, 530, and 466 partners for 2007, 2012, and 2017, respectively, representing a pool of 900 unique partners. We excluded partners who would reach mandatory retirement age before 2017 (age 62-65 depending on firm) and individuals who only entered the partnership in 2017, yielding 644 unique partners. Due to audit firm concerns about the confidentiality of highly sensitive proprietary data, they agreed to provide data for one-third of the average number of partners over the three sample years. To ensure a representative sample, we applied a systematic sampling procedure. We started with a list of anonymized partner personnel numbers and birth dates per firm, which we ordered by birth date to generate an equal distribution across all available partners (e.g., both junior and senior partners). We randomly selected the 1st, 2nd, or 3rd partner in the list to start our systematic sample and then applied the computed sampling interval to select one-third of the average number of partners over the sample period, yielding a final sample of 190 unique partners.

We then worked with the firms to determine the availability of data needed to test our hypothesis. In some cases, partner data was not available because it did not exist or was infeasible to collect. Two mid-tier firms (Firms B and E) did not have systematic data on partner performance evaluations (needed to measure *Performance_Overall*, *Quality*, and *Other_Performance* in all three of our empirical tests) and competence classes (needed to measure *Competence* and *Competence_5Year*), nor did these firms provide supplementary

information was not available, we use the total partner remuneration paid per firm-year within the sample as a proxy for the profit to be allocated. Untabulated analyses show robust results when the absolute compensation [*ln(Total_Pay)*] is tested, controlling for the size of the profit pool in the sample [*ln(Pay_Pool)*].

[21] Data was collected with institutional approval of the Ethics Committee.

information on why partners left the firm (needed to measure *Exit_Involuntary*).[22] Due to this missing data, we drop 16 partners from those two firms (26 partner-year observations) from our empirical tests, yielding a final sample of 174 unique partners and 369 partner-year observations from six audit firms.[23]

Table 2 Panel B details the sample construction for each of our three empirical tests. First, given that *Competence_5Year* is defined as *Competence* five years in the future, it is only available for partners who are employed in at least two consecutive sample years. Accordingly, we lose 172 partner-year observations, leaving 197 observations for our analysis of the relationship between partner performance and promotions/demotions. Second, missing partner-year data on *Performance_Overall* reduces the sample to 308 partner-year observations for our analyses of the relationship between overall partner performance and job retention and compensation, and 152 for our analysis of promotions/demotions. Lastly, additional exclusions occur when we consider the complete availability of all of the specific components of performance at the individual partner level, yielding samples of 57 observations for the analysis of promotions/demotions and 137 observations for the analyses of job retention and compensation in relation to *Quality* and *Other_Performance* separately.

Descriptive Statistics

Table 3 reports the descriptive statistics for the variables in our empirical analyses. The median values suggest that a typical audit partner in our sample is a 48-year-old male, holding a 4% share in firm profit, which equates to approximately €375,000 per year (untabulated). Competence class levels range from 0.17 to 5.00 on a five-point scale. The value of

[22] The lack of availability of performance evaluations and competence classes for these two firms can largely be explained by the strict equal profit-sharing system wherein performance evaluations do not affect formalized career development or profit shares. Consequently, any changes in performance measurement would not have had an effect on changes in promotions, demotions, or compensation.

[23] To gauge if our net sample is representative of the population of audit partners under study, we compared the absolute levels of profit shares per partner in our sample to publicly available disclosures of average profit shares per partner in 2017. Our sample results (untabulated) vary from the averages in the disclosures by 1.2% up to 8.7%. This comparison provides further support for the representativeness of our sample.

Competence_5year reflects performance five years in the future and allows us to track changes in competence class over the period 2007–2012 and 2012–2017. About one-third of audit partners left their positions during the 2007-2017 period, with about half being involuntary. A more detailed breakdown of the descriptive statistics is discussed in subsequent sections.

Table 4 presents the pairwise correlation matrix of the variables in our empirical analyses. Notably, *Competence* does not correlate with any of the performance variables. *Performance_Overall*, which encapsulates all performance aspects, is highly correlated with each sub-category of performance (*Quality, Clients, People,* and *Firm*). Interestingly, *Quality* is not correlated with the other three, suggesting its unique role in performance evaluation.

Empirical Analyses

To test our hypothesis, we first explore the relationship between partner performance and career development in terms of (1) promotions and demotions and (2) job retention.[24] We then (3) investigate the association between partner performance and compensation. We test for changes over time by comparing 2007 and 2012 to 2017 using *Post*, an indicator variable that takes a value of one for the later period (zero otherwise). We consider *Performance_Overall*, and *Quality* and *Other_Performance* separately. To minimize estimation bias, we interact *Post* with all variables in the model, including our control variables (deHaan, Moon, Shipman, Swanquist, and Whited 2023). *Control* is a vector of current-year partner attributes including current-year competence class (*Competence*), age (*Age*), gender (*Male*), and workload (*Engage_Score*). We include firm and year fixed effects in all models unless otherwise specified. To control for unobserved partner-specific factors, we treat each partner as an individual cluster, allowing intercepts to vary across partners (Cameron and

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[24] We report findings based on six firms without differentiating between the Big 4 and non-Big 4 firms. The Big 4 results are qualitatively the same as the pooled sample. Sample size limitations preclude us from conducting separate tests for the non-Big 4 firms, or to compare Big 4 to the non-Big 4 in different time periods.

Trivedi 2009).[25] We do not include partner fixed effects because we are interested in explaining between-partner variations and our partner-year panel is unbalanced and short. Robust standard errors are clustered at the partner level to adjust for heteroskedasticity and serial correlation (Angrist and Pischke 2008).

Partner Performance and Promotions and Demotions

We first examine promotions and demotions. Table 5 Panel A illustrates the number of partners who are promoted, demoted, or stay at the same level during the sample period.[26] We observe 72 partners over the entire sample period of whom 63.89% were promoted and 19.44% were demoted. From 2007 to 2012, 36.26% of the partners received promotions, while 45.05% were demoted, a trend that can likely be attributed to the aftermath of the 2008 global financial crisis. From 2012 to 2017, the promotion rate was 64.15%, with a demotion rate of 25.47%. Across both intervals, there were 101 promotions (51.27%), 68 demotions (34.52%), and 28 instances where competence classes remained unchanged (14.21%).

To formally examine how partner performance is associated with future promotions and demotions, we first estimate equation (1). Subsequently, we test our hypothesis on the changes over time by estimating equation (2).

$$Competence\_5Year_{i,t} = \alpha_0 + \beta' Performance_{i,t} + \gamma' Control_{i,t} + \varepsilon_{i,t} \tag{1}$$

$$Competence\_5Year_{i,t} = \alpha_0 + \beta' Performance_{i,t} + \gamma' Control_{i,t} + \alpha_1 Post_t + \delta' Post_t \times Performance_{i,t} + \varphi' Post_t \times Control_{i,t} + \varepsilon_{i,t} \tag{2}$$

Performance is either *Performance_Overall* or *Quality* separated from *Other_Performance*.

Table 5 Panel B shows the descriptive statistics five years before a promotion or demotion for the subsample of partners used to estimate equations (1) and (2). We also compare promoted to demoted partners. The general characteristics of this sub-sample do not

[25] We also estimate mixed models for multi-year data allowing both intercepts and coefficients to vary across individual partners. The results are not significantly different, as confirmed by likelihood ratio tests.
[26] Individual partners may also be promoted or demoted in the intervening years.

differ from the full sample. Compared to the promoted partners, partners who are demoted are two years older (*Age*, 1.94, $p<0.05$) and have marginally higher competence levels (*Competence*, 0.46, $p<0.05$). Competence levels become significantly lower for demoted partners afterwards (*Competence_5Year*, -1.35, $p<0.01$), showing that competence reassignment can have a real career impact. Demoted partners receive higher ratings for three specific performance metrics (*Other_Performance*, 0.43, $p<0.01$; *Clients*, 0.28, $p<0.10$; *People*, 0.44, $p<0.01$; and *Firm*, 0.59, $p<0.01$), but not *Quality* (0.05, ns).

Table 5 Panel C presents the regression results. Columns (1) and (3) report the coefficients for equation (1) and reflect subsequent promotions and demotions in relation to *Performance_Overall* and *Quality* separated from *Other_Performance*, respectively. Results show that, across the entire sample period (2007 – 2017), *Performance_Overall* is positively associated with a partner's competence class five years into the future (0.163, $p<0.05$). We find the same association for *Quality* (0.176, $p<0.05$) but not for *Other_Performance* (-0.079, ns). We also note that *Competence*, for which we control throughout our analyses, exhibits a positive and significant association with *Competence_5Year* across all columns.[27]

Next, we isolate the relationship between partner performance and promotions and demotions in the two periods, i.e., 2012 to 2017 and 2007 to 2012, by using the *Post* interaction term in columns (2) and (4). The coefficient for *Performance_Overall* in column (2) represents the association in the earlier period (0.160, ns) and *Post x Performance_Overall* reflects the incremental change in this association in the later period (0.129, ns). Neither coefficient is significant, indicating no observable change over time in the role of overall performance in relation to future promotions. Separating *Quality* from *Other_Performance* in column (4), we do not find a change in the role of *Quality* (0.064, ns). However, we do find a significant

[27] We also ran alternative tests where competence classes are rank ordered into deciles or quintiles within each firm and year. This reduces the effect of unique firm policies on our analysis. Results are qualitatively the same.

decline in the role of *Other_Performance* (*Post x Other_Performance*, 0.744, p<0.01), which is positively associated with future promotions in the earlier period (0.575, p<0.01), but not in the later period. In other words, the role *Other_Performance* plays in promotions is significantly diminished in the later period. Subsequent tests (untabulated) focused on the later period (2012-2017) confirm that *Quality* is positively associated with future partner promotions (0.190, p<0.05), whereas *Other_Performance* is not (-0.049, ns).[28]

Taken together, these results suggest that audit quality has become increasingly important relative to other performance dimensions for partner promotions and demotions over time. This shift aligns with the policy refinements in audit partner performance management previously discussed, particularly regarding the importance of audit quality, which has resulted in impactful changes in the promotions and demotions of audit partners.

Partner Performance and Job Retention

Next, we investigate whether partner performance explains the departure of audit partners from their firm and whether this association has changed over time. Table 6 Panel A details the sample distribution of partner departures and whether the departures were voluntary or involuntary. Of the 174 unique partners in our sample, 56 (32.18%) left their audit position or firm between 2007 and 2017 for reasons other than normal retirement. Some left voluntarily to pursue an alternative career opportunity, and some were dismissed from the firm. Roughly

[28] In economic terms, one-standard-deviation improvement in *Quality* in 2012 (0.90 on a scale of five), corresponds to a 0.17 upward shift in competence class by 2017 (untabulated). One potential concern may be that the higher promotion rate in 2012–2017 (64.15%, Table 5 Panel A) is due to the high level of demotions that correspond to the global financial crisis rather than policy changes. Our main analysis shows a declining association between *Other_Performance* and *Competence_5Year* over time and untabulated analysis shows that *Performance_Overall* is increasingly related to promotions and demotions, when examined separately, in the later period. Furthermore, untabulated analysis shows that of the 41 partners that were demoted in 2007–2012, 26 were subsequently promoted in 2012–2017 (out of 68 promoted partners in that period), while 15 were further demoted, remained at the same level, or departed from the firm. This means that 42 of the 68 promotions in the later period are not related to demotions in the earlier period, i.e., promotions in the later period exceed what was needed to simply "replace" those who were demoted in 2007–2012. In a similar vein, of the 33 promoted partners in 2007–2012, 10 were demoted in 2012–2017, while 23 were further promoted, remained at the same level, or departed from the firm. Lastly, the number of involuntary departures relative to voluntary departures is higher in the later period (17/36, Table 6 Panel A) than in the earlier period (8/20). This pattern suggests promotions and demotions consistent with the firm's performance management practices and corroborates our main results.

14% (25) of the partners were asked to leave their audit position or firm during the sample period. For 19 of these involuntary departures, the firm indicated that these were due to poor audit quality (untabulated).[29] Both the total number of departures and the ratio of involuntary departures were higher in 2012-2017 (17/36, 47.2%) than in 2007–2012 (8/20, 40.0%), suggesting more rigorous performance management in the later period.

We examine the association between partner performance and retention across the entire sample period using equation (3) and the changes over time using equation (4).

$$Exit\_Involuntary_i = \alpha_0 + \beta' Performance_{i,t} + \gamma' Control_{i,t} + \varepsilon_{i,t} \quad (3)$$

$$Exit\_Involuntary_i = \alpha_0 + \beta' Performance_{i,t} + \gamma' Control_{i,t} + \alpha_1 Post_t + \delta' Post_t \times Performance_{i,t} + \varphi' Post_t \times Control_{i,t} + \varepsilon_{i,t} \quad (4)$$

Table 6 Panel B shows the descriptive statistics comparing departing versus remaining partners, as well as voluntary versus involuntary departures. Compared to the departing partners, the remaining partners generally perform better (*Performance_Overall*, 0.29, p<0.01), especially in terms of audit quality (*Quality*, 0.50, p<0.05), and are relatively younger (*Age*, 1.34, p<0.05). The only univariate difference between voluntary and involuntary departures is that partners forced to leave had higher competence levels prior to departure (*Competence*, 0.77, p<0.01).

The regression results for involuntary departures are presented in Table 6 Panel C. Column (1) reports the association between *Performance_Overall* and *Exit_Involuntary*, while column (3) separates *Quality* from *Other_Performance*, both across the entire sample period (2007–2017). Columns (2) and (4) report changes over time in these associations by isolating the later period (2017) from the earlier period (2007 and 2012) using interactions with *Post*. Results in column (1) indicate that involuntary departures are negatively associated with

[29] We also classify career paths after departure (untabulated). Most voluntarily departing partners pursued alternative career opportunities in business (18 of 31, 58.06%), possibly reflecting a "brain drain" (Knechel et al. 2021). Involuntary departures transferred to a non-audit function in the firm, joined another audit firm, or pursued alternative careers in business, government, education, or not-for-profits.

Performance_Overall (-0.957, p<0.01) over the entire sample period, while column (2) reveals that this relationship intensifies in the later period (2017) as indicated by the negative and statistically significant coefficient of *Post x Performance Overall* (-2.270, p<0.10). While column (3) does not reveal a significant distinction between *Quality* (-0.781, ns) and *Other_Performance* (-0.340, ns) over the entire sample period, column (4) shows that audit quality becomes an increasingly significant factor for involuntary exits in the later period, indicated by a negative and statistically significant coefficient of *Post x Quality* (-1.717, p<0.05), which role was not significant in the earlier period (*Quality*, -0.477, ns). We do not observe a similar shift for other performance metrics. Subsequent tests (untabulated) focused on the later period confirm that the explanatory power of *Quality* (-2.164, p<0.01) for involuntary departures is significantly larger than *Other_Performance* (1.666, ns).[30] This suggests that the increasing importance of *Performance_Overall* for involuntary departures is driven by *Quality*.[31] These results are consistent with the policy changes described in Section II that audit quality has become significantly more consequential for partner job retention, rejecting our null hypothesis.

Partner Performance and Compensation

Finally, we examine whether policy changes that reduced the emphasis on recent performance and increased the focus on audit quality in calculating partner compensation have been implemented in practice. We first consider the general association between partner

[30] In economic terms, a one-level downgrade of *Quality* corresponds to an increase in the probability of forced resignation by about 10% (untabulated).

[31] Involuntary departures may be subjective and nuanced in practice (e.g., partners with subpar audit quality may be given a chance to resign voluntarily), so we consider all departures. *Exit* is an indicator which includes both involuntary and voluntary departures from the audit function or firm for reasons other than retirement. The results (untabulated) indicate that *Overall_Performance* is negatively associated with departures throughout the entire sample period (-0.846, p<0.01). However, contrary to our analysis of involuntary departures, we do not see a significant change in this relationship from the earlier to the later period. Neither *Quality* nor *Other_Performance* explains general departures over the entire sample period, although *Post x Other_Performance* is positive and significant (3.601, p<0.05), suggesting that partners with above-average performance in categories *other* than Quality are more likely to resign after 2012. Subsequent tests (untabulated) focused on the later period show that *Quality* is negatively and significantly associated with general departures in the later period (*Quality*, -0.803, p<0.01) and that it explains general departures significantly better than *Other_Performance* (1.910, ns).

performance and compensation during our sample period using equation (5). Equation (6) separates the analysis again by time period.

$$Profitshare_{i,t} = \alpha_0 + \beta' Performance_{i,t} + \gamma' Control_{i,t} + \varepsilon_{i,t} \tag{5}$$

$$Profitshare_{i,t} = \alpha_0 + \beta' Performance_{i,t} + \gamma' Control_{i,t} + \alpha_1 Post_t + \delta' Post_t \times Performance_{i,t} + \varphi' Post_t \times Control_{i,t} + \varepsilon_{i,t} \tag{6}$$

Descriptive statistics for our regression variables are reported previously in Table 3.

Table 7 presents the regression results for compensation. Columns (1) and (3) reflect the associations across the entire sample period (2007–2017), while the results separating for the two subperiods are presented in columns (2) and (4). Results in column (1) indicate a significant and positive association between partner overall performance and compensation (0.337, $p<0.01$) over the entire sample period. Column (2) indicates that this association declines in the later period, with a negative coefficient for *Post x Performance_Overall* (-0.234, $p<0.05$).[32] In column (3), in turn, neither *Quality* nor *Other_Performance* explains compensation across the entire sample period. Column (4), however, reveals that *Quality* has a significant and positive association with compensation in the earlier years (*Quality*, 0.172, $p<0.01$). While this association does not significantly change over time, as indicated by the insignificant coefficient of *Post x Quality* (-0.146, ns), in subsequent tests (untabulated) focused on the later period we do not find a significant association between *Quality* and compensation (0.047, ns). This result may seem counterintuitive, but it is consistent with an increased focus on longer-term incentives and equal sharing of profits across partners within competence classes.

The lack of significance for *Quality* may also be due to the introduction of quality penalties by most firms by 2017, whereby audit quality does not influence compensation directly but has an economic effect through new penalty policies in the later period. To gauge

[32] In economic terms, one-standard-deviation increase in *Performance_Overall* corresponds to an average profit share increase of 25% in 2007 and 2012, compared to 10% in 2017 (untabulated).

the implementation of these penalties, we reviewed the frequency, size, and relative impact of audit quality penalties for our sample of 135 unique partners in 2017.[33] Table 7 Panel B details the 16 audit partners known to have received subpar quality evaluations, of whom nine audit partners received monetary penalties for low audit quality. These penalties ranged from €18,000 to €120,000 (4.8% to 32.9% of a partner's profit share) with an average of €60,984 (16.0%). Collectively, these results support rejecting our null hypothesis in that we observe that both overall performance and short-term quality metrics have become less consequential in a firm's decisions in determining partners' profit shares, but newly implemented penalty policies can have real consequences for net partner compensation.

Robustness Analysis: Components of Performance

We also tested the four specific components of performance individually, i.e., *Quality, Clients, People,* and *Firm* (all tests in this section are untabulated). Because the number of partner-year observations with available performance evaluation records on all four dimensions is limited, especially in the earlier years, we are only able to re-run some of the previous analyses. The increased availability of the components of partner performance over time illustrates the increased granularity of partner performance evaluations described in Section II. For future promotions and demotions, we find that audit quality continues to be the largest driver of future competence class (*Quality,* 0.176, $p<0.05$), with insignificant coefficients for *Clients*, *People*, and *Firm*.[34] For job retention, audit quality is a significant factor for general departures in the later period (*Quality*, -0.733, $p<0.05$) but not before 2012, which aligns with the findings of our main analysis. Furthermore, we observe that the significant increase over time in general departures of partners with higher performance other than *Quality* is driven by

[33] As described in Section II, only one firm had a quality penalty prior to 2017. Hence, we cannot estimate equation (6) for this analysis due to limited frequency over the years.
[34] We cannot estimate equation (2) for this analysis due to the small sample size available.

People (-1.896, p<0.01; *Post x People*, 4.115, p<0.01).[35] Lastly, the results regarding performance and compensation are qualitatively the same as those of our main analysis. Notably, and consistent with stated policy changes, *Quality* is the only specific performance metric that is associated with profit shares before the policy change (0.161, p<0.05) and not thereafter (*Quality*, 0.039, ns). Changes in the other three performance components are all insignificant over time (*Post x Clients,* 0.125; *Post x People*, 0.008; *Post x Firm*, -0.103).

V. DISCUSSION AND CONCLUSION

In this paper, we examine how audit firms adapt performance measurement, career development, and compensation *policies* for audit partners that emphasize high-quality audits in a period of heightened public concern and regulatory scrutiny. We also examine whether these policy changes translate into day-to-day firm *practices* despite the potentially difficult and delicate transition in an organization's design and internal processes. Using proprietary data from the eight largest audit firms in the Netherlands over a period of elevated public scrutiny (2007 to 2017), we find that audit firms have changed their formal performance management policies to focus more on audit quality when evaluating the performance of audit partners. Our empirical results indicate that these policy changes had real and discernible consequences for audit partners in practice. Specifically, partner performance as reflected in performance measurement metrics has effectively become more consequential for career-related decisions and less associated with short-term compensation. As a result, audit quality has become more influential in determining audit partner career development in terms of promotions and demotions, job retention, and compensation. This holds true despite firms having different legacy systems in place prior to the heightened scrutiny and maintaining some meaningful firm-specific approaches throughout and at the end of our sample period.

[35] We cannot estimate the associations between involuntary departures and the four specific performance metrics due to insufficient sample size.

Two obvious trends we observe are that performance measures have become significantly more granular and audit quality has become more consequential than other aspects of partner performance. We also observe that newly implemented policies regarding financial penalties for low audit quality can have notable consequences for compensation. Furthermore, over time, demotions related to poor audit quality move individuals to lower-compensated competence classes. Thus, firms have shifted the emphasis from short-term compensation (profit share) to career decisions going forward (promotions and demotions). Taken together, this pattern of results strongly suggests that changes to firm performance management policies are real and have had a discernible impact on individual partners. Audit firms appear to be responsive to heightened public scrutiny and able to effectively implement related policy changes, increasingly aligning partner incentives with societal expectations of audit quality.

While our evidence is relatively clear, further research should take into consideration that audit quality also reflects the joint effort of audit partners and their teams, i.e., an individual partner may have limited direct influence on audit quality. This limitation makes other dimensions of performance potentially relevant to audit quality as well. For example, performance related to "people" (i.e., how well audit partners manage their staff) can directly influence the collective performance of an audit team. Furthermore, performance related to "clients" may influence the nature of the interactions with client personnel that are critical for conducting an effective audit (Knechel et al. 2020). These observations suggest that improving audit quality requires a holistic approach for performance management and evaluation.

Our interpretation of the results is subject to several caveats. First, our data was collected for a random sample of audit partners at five-year intervals, and we had to omit observations from two mid-tier audit firms because they were unable to provide the necessary data over the sample period for our regression models. However, our sample is representative of the partner population under study. Second, no information on the clientele of individual partners was provided by the firms to safeguard the anonymity of individual auditors, so we are unable to link partner performance evaluations to observable audit outcomes. Third, there are variations in how the sampled firms describe and implement their policies, so our results might be sensitive to our interpretation of diverse policies given the need to standardize the data for empirical analysis. Fourth, some of the observed changes might have occurred independently of public concern and regulatory scrutiny. Finally, our study reflects the Dutch setting and may not fully represent global trends, although policies for performance management largely align with the globally affiliated network of firms.

Despite these limitations, this study contributes valuable insight into our understanding of performance management for audit partners, facilitating future empirical studies on current practices in the auditing profession, possibly linked to observable measures of audit quality. These insights are relevant for regulators and other stakeholders interested in the audit profession, as they demonstrate how the evolution in performance management policies and practices can facilitate the alignment of goals amongst the firm, audit partners, capital markets, and societal stakeholders. Understanding these changes also allows society to have an informed basis on which to evaluate the overall status and performance of the audit profession.

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Appendix A Variable Definitions

Dependent Variables: Career Development and Compensation	
$Competence\_5Year_{i,t}$	Partner *i*'s *Competence* class in year *t+5*. This variable is not available for 2017.
$Exit\_Involuntary_{i}$	An indicator variable with value of 1 if partner *i* exits the audit partner role involuntarily during the sample period 2007-2017, and 0 otherwise.
$Profit\_Share_{i,t}$	The percentage of partner *i*'s total pay divided by the total compensation paid among the sampled partners in the firm in year *t*.
Independent Variables: Performance Measures	
$Performance\_Overall_{i,t}$	A score measure (0-5, the higher the better) that assesses partner *i*'s overall performance relative to other partners in the same firm in year *t*. *Performance_Overall* is constructed as partner *i*'s overall performance benchmarked against the best attainable overall performance evaluation in the same firm and year. Where audit firms use different scales to evaluate partner performance, we normalize firms' original evaluation results to a scale of five, reflecting the most common evaluation range found amongst the firms. Where qualitative terms are used for performance evaluations, we encode these into numerical values by assigning a numerical rank from the lowest to the highest qualitative evaluation level attainable, before normalizing these numerical ranks to a scale of five. The same variable construction method is applied to specific performance measures in *Quality*, *Clients*, *People*, and *Firm.* When specific performance metrics are available, *Performance_Overall* is the weighted average of the specific performance measures, with the weights varying across firms and years following firm policies.
$Quality_{i,t}$	A score measure (0-5, the higher the better) of partner *i*'s performance in audit quality relative to other partners in the same firm in year *t*.
$Other\_Performance_{i,t}$	A combined score (0-5, the higher the better) of partner *i*'s performance other than *Quality* relative to other partners in the same firm in year *t*. It is the average value of *Clients*, *People, and Firm.*
$Clients_{i,t}$	A score measure (0-5, the higher the better) of partner *i*'s performance in clientele management and new clients acquisition relative to other partners in the same firm in year *t*.
$People_{i,t}$	A score measure (0-5, the higher the better) of partner *i*'s performance in team development relative to other partners in the same firm in year *t*.
$Firm_{i,t}$	A score measure (0-5, the higher the better) of partner *i*'s performance in firm operations relative to other partners in the same firm in year *t*.
Control Variables and Interaction Term	
$Competence_{i,t}$	A score measure (0-5, the higher the more highly ranked) that reflects the rank of partner *i*'s competence class in his/her firm at the beginning of year *t* benchmarked against the highest available competence class in the same firm and year. The ranks of competence classes reflect the relative levels of responsibility and role complexity in each firm and year.
$Age_{i,t}$	The age of partner *i* in year *t*.
$Male_{i}$	An indicator variable with value of 1 if partner *i* is male and 0 if female.
$Engage\_Score_{i,t}$	A score measure (0-5, the higher the more audit engagements) that reflects the quantity of audit engagements for partner *i* relative to other partners in the same firm in year *t*. It is constructed as partner *i*'s number of audit engagements relative to the highest number of a single partner's audit engagements in the same firm and year, multiplied by five.
$Post_{t}$	An indicator variable with value of 1 if the dependent variable is measured for year 2017, and 0 otherwise.
Firm Fixed Effects	Indicator variables for audit firms.
Year Fixed Effects	Indicator variables for year 2007, 2012 and 2017.

Table 1: Summary of Policy Changes (2007 – 2017) of Performance Measurement, Career Development, and Compensation for Audit Partners as Presented in the Firms' Policy Documents

Firm	2007	2012	2017
Panel A: Audit Partner Performance Measurement – Performance Measures			
A	Clients, People, Firm, and Quality	No change	No change
B	No performance measurement system used	Clients, People, Firm, and Quality	No change
C	Clients, People, Firm, and Quality	Quality refined to include technical knowledge, process management, thought leadership, and knowledge sharing.	Performance dimensions refined. Quality to include permanent education, accreditations, and contributions to quality improvements.
	Example: *"The pillars that partners are expected to formulate annual targets and be evaluated on are [people, clients, firm, and quality]. These are further detailed in qualitative, high-level terms but partner competence class. For example, for an audit engagement partner these are: "to position [the firm] as first choice in the minds of clients; to be a trusted advisor for key clients; to deliver a high-quality service and output on engagements; to lead and develop engagement teams; to participate in major client pitches; and to contribute to setting engagement team member's objectives and provide valuable feedback following engagements."*	*Example:* *"An audit engagement partner is expected to deliver high quality and robustness of opinion and quality of service provided to clients. (...) To visibly assess and reward aspects of technical audit quality and compliance with standards, regulation, and risk management procedures, we implement an additional competence 'technical knowledge' as part of our performance evaluations. (...) Quality KPI's include [internal quality review] results, compliance with internal quality and risk management procedures, independence rules, process management, thought leadership, and knowledge sharing."*	*Example:* *"In addition to performance in the areas of [internal quality reviews], accreditations, and compliance with risk management rules, the management board also expects partners to contribute to further improving quality in their business units and [the firm] as a whole. (...) Partners are expected to be actively involved in their audit engagements to drive and assure the quality of service delivery. This personal involvement is evident from, among other things, [internal quality reviews], external audit inspections, permanents education, and the absence of compliance issues. (...) In addition, input on quality performance is derived from systems such as [audit file archives], [internal quality review] outcomes, violation registrations, incident registrations, but also from verbal information from various departments and units such as the compliance office, the ethics and independence unit, and the quality and risk management department."*
D	Clients, People, Firm, and Quality	No change	Quality is assessed based on a "quality dashboard" that includes both qualitative and quantitative input using ten unique measures.
	Example: *"Your Personal Scorecard comprises the four business perspectives of [the firm's] Global Balanced Scorecard: [Clients, People, Firm, and Quality]. For each of these business perspectives, document goals as well as measurements and targets, actions and comments that will enable you to achieve your Personal Scorecard goals for the year." Quality is defined as "Provide the highest quality service in our chosen markets and services to external and internal clients. (...) To provide high quality service, we commit to getting the right*		*Example:* *"In recent years, we have significantly refined the measurements used for the quality assessment of each external auditor, primarily to enable us to assess quality in a more objective and positive fashion. The performance of our external auditors is measured across [more than 10] different quality dimensions, resulting in a quality assessment that ultimately determines the overall assessment of the external auditor. (...) The quality dimensions comprise: tone from the top; participation in [internal audit quality reviews; being a facilitator; involvement in quality initiatives; [internal quality review] ratings; results from regulatory reviews; brand and reputation risk; attendance at*

	information, consulting with the right people, making the right judgments and taking the right actions. It is critical that partners do that and it is also your responsibility to foster a collaborative and supportive environment." Quality performance indicators are "number of changes made that result in improvement to our processes this year; number of accounts where we establish ourselves in a [key-client] relationship; number of clients rating us at 4+; 100% compliance with annual and quarterly independence confirmation process; 100% compliance with client acceptance and continuance processes; 100% participation of all my team members in at leader one quality related training."		*mandatory training events; timeliness and well prepared compliance with requirements relating to consultation, accounting review and [quality] processes; partner involvement in, and responses to, [internal quality review] process and findings; permanent education requirements. (…) The quality dimensions will be included in a single overview for all partners. This enables comparisons between partners in order to produce relative rankings. (...) The executives of the [professional practice], compliance, legal, and risk management departments – as well as the regional quality leaders who interact with the partner group in their local offices – provide input and rankings for each partner on the quality dimensions. After all, these work closely with our partners throughout the year in specific practice situations as well as in learning events, and therefore have a good perspective on of the tone, quality awareness, and quality performance of this group."*
E	No performance measurement system used	Clients, People, Firm, and Quality	No change
F	Clients, People, Firm, and Quality	No change	Quality refined and based on a "dashboard" that includes quality tone at the top, effective use of quality controls, and putting public interest first.
G	Clients, People, Firm, and Quality	No change	Quality refined to include quality review scores, partner involvement, permanent education, and claims and audit deficiencies.
H	Clients, People, Firm, and Quality	No change	Quality refined to include various audit quality indicators, including client satisfaction and contributions to quality improvements.
	Example: *"Annual goal setting and performance evaluation is based on each of four areas of a "balanced score card" [i.e., clients, people, firm, and quality] and competence group development criteria." For example, the quality performance area is described as "eminence and quality by strengthening the public trust, enhancing [the firm's] reputation and brand, professional presentations, publications, or consultations, and contributions to technical developments."*		*Example:* *"At least one of a maximum of eight KPI's a partner's performance is evaluated on should be 'quality', which includes aspects such as [internal quality review] scores, client service satisfaction assessments, and contributions to the firm's quality initiatives. (…) A partner is expected to have a positive score on the firm's quality standard, comprising external inspections, internal quality reviews, timely audit reporting, the use of new audit tools, partner involvement on the audit, and 'function citizenship' and acting in the public interest."*
Panel B: Audit Partner Performance Measurement – Numerical Ratings and Relative Weights of Performance Measures			
A	Ratings on each performance measure only, weighted equally.	No change	No change
B	No performance measurement system used	Qualitative evaluation only of each performance measure	No change

C	An overall rating only. Weighting not clear. *Example:* *"A partner's annual plan and target setting as well as year-end performance evaluations are based on the four performance measures [clients, people, firm, and quality], resulting in an annual performance rating ranging from [1] 'Needs Improvement' to [5] 'Excellent Performance'."*	No change	Ratings on each measure and an overall rating. Increased weight of Quality to 40% (60% for the other performance measures combined). *Example:* *"Partner performance evaluations result into a rating on each of the four performance areas that add up to an annual total performance rating. (…) The quality-performance rating counts double (40%) compared to the other three measures (each 20%)."*
D	An overall rating and ratings on each performance measure, weighted equally.	No change	A rating on the Quality performance of 1 or 2 (on a scale of 5) automatically results in an overall rating not exceeding 2 respectively 3.
E	No performance measurement system used	An overall rating only. Weighting not clear.	No change
F	An overall rating only. Weighting not clear. *Example:* *"The performance rating, on a scale of [1] 'Does not meet expectations' to [5] 'Excellent', is based on the annual performance evaluation meeting."*	An overall rating and ratings on each performance measure, weighted equally. *Example:* *"Instead of one performance rating as applied up to and including 2010, as from 2011 the performance rating is a numerical computation of [each of the underlying performance measures]. (…) Each element is equality important. The total number of performance points [for profit sharing] in each category will be distributed equality between [all performance measures]."*	Increased weight of the performance measure including Quality to 50% (50% for all other measures) and it being rated at a minimum of 3 (scale of 5) to obtain overall rating higher than 3. *Example:* *"The total number of performance units in each class will be distributed between [the performance measure that includes Quality] and [the other performance areas] in a ratio 50:50. (…) When Quality scores on level [5] or [4] the total performance for [the performance measure that includes Quality] will at least be at level [4]. (…) When Quality scores on level [2] or [1] as a consequence of a non-compliant outcome of a [audit file quality review] the total performance for [the performance measure that includes Quality] is rated at the same level."*
G	An overall rating only. Weighting not clear.	An overall rating and ratings on each performance measure, weighted equally.	No change
H	An overall rating only. Weighting not clear.	No change	No change
Panel C: Audit Partner Career Development – Competence Classes			
A	Competence classes (undefined) for the initiating years of incoming partners only *Example:* *"The number of profit-sharing units follows from the number of calendar years that the partner in question has been a partner in the financial year in question. For incoming partners, the maximum number of units is deducted by 67 percent, increasing to 100% over a period of 10 years."*	No change	No change
B	No competence classes used	No change	No change

C	Competencies defined for 3 categories, with 5 or 6 competence classes each (16 in total)	No change	Competencies defined for 4 categories, with 5 to 8 competence classes each (26 in total)
D	Competencies defined for 4 competence classes	No change	Competencies defined for 3 categories, with 3 to 5 competence classes each (11 in total)
E	No competence classes used	No change	No change
F	Competencies defined for three categories, with 5 competence classes each (15 in total) *Example:* *"Mapping is based on the 'Responsibility Framework'. It contains the assessment framework of role descriptions for mapping partners into [competence classes] based on their individual role and responsibility, in three main categories: (1) Partner with standard client portfolio and a supporting role in achieving strategic goals; (2) Partner with an above-average client portfolio and a leading role in achieving strategic goals; (3), Partner leading the development and fulfillment of strategic goals and/or playing a leading role in a strategically important client portfolio. (…) There will not be a new mapping every year based on automatic growth. However, there may be development within the main categories. (…) Responsibility-based mapping has to be explicitly distinguished from performance assessment; an extremely good performance does not signify a change in role or responsibility."*	No change	Competencies defined for 4 categories, with 4 or 5 competence classes each (17 in total): (A) Starting category *Example (all else equal as in 2007):* *"The structural role and responsibility of a partner are mapped within the [four] performance areas of [Clients, People, Firm, and Quality]. Based on this, the partners are classified into one of four categories and within these four categories within a total of 17 sub-categories: (A) Starting category for new partners. A partner who makes a normal contribution to the results of [the firm] and who fulfils a supporting role in achieving strategic goals; (B) A partner who makes a growing contribution to the results of [the firm] and who fulfils a more advanced supporting role in achieving strategic goals; (C) In addition to his/her above-average contributions to the results of [the firm], the partner has a material positive impact on the success of several partners and has a direct role in (clients who are important to) achieving strategic goals; (D) A partner who is leading in the development and achievement of strategic goals on all [four] components of [clients, people, firm, and quality] and/or fulfils a leading role with strategically important clients. (…) No minimum or maximum step-ups or step-downs apply, although developments will be gradual in practice."*
G	Competence classes (undefined) for the initiating years of incoming partners only	No change	No change
H	Competencies are defined for nine competence classes *Example:* *Career development is compared and contrasted within a peer group matrix with nine level. Each level is defined in terms of experience, problem-solving ability, and responsibility. The first three can be considered an initial growth trajectory. Level 4 is considered the base partner profile level and 5 as clearly more experienced on all performance areas. After that, there are levels where growth is expressed in more organizational*	No change	No change

	responsibilities or complexity in client relationships with the associated professional knowledge and skills. Promotion is not dependent on single successes or failures, but on sustainable higher performance and added value to the partnership."		
Panel D: Audit Partner Compensation – Profit-sharing System			
A	Equal profit sharing (stepwise from 60 to 100% in 10 years)	Equal profit sharing (stepwise from 60 to 100% in 7 years)	No change
B	Equal profit sharing (fixed)	No change	No change
C	Equal sharing within a competence class: ranging from 25 to 100 units per class *Example:* *"The number of [profit-sharing] units is based on a combination of (1) maturity and (2) competence. The combination ranges from 25% of base units for a first-year partner to 100% of units based on clearly above average or excellent performance and responsibilities."*	No change	Equal sharing within a competence class: ranging from 230 to 655 units per class *Example:* *"In our profit-sharing model, all partners in the same [class] will have the same [number of units]. The idea behind this is that we expect each partner within the same [class] to perform and contribute to the firm equally, in line with the performance targets of the partner's [class]. (...) In the new [policy] the differentiation ratio is reduced from 4.00 to 2.85. With this change, we strive to embed more solidarity into our profit-sharing model."*
D	Performance-based within competence class: ranging from 280 to 500 units based on class and overall performance for the year *Example:* *"Our policy is to compensate all partners based on overall performance, including an evaluation that takes into account demonstrated capabilities as well as outcomes. (...) The number of units received may vary from year to year, and will depend on a partner's performance (rather than length of service) and local market dynamics. The [partner compensation policy] links directly to the performance ratings and the achievement of agreed goals and development objectives are therefore key factors in determining partner rewards."*	No change	Equal sharing within a competence class: a fixed income per competence class (range undefined) based on pro forma firm profits set in advance *Example:* *"Partners belong automatically to one of three [competence classes]: early-stage partners, general partners, and high earnings partners. A partner's role, responsibility, potential, and change in performance are the main drivers of [three to five sub-classes] variation inside a [competence class]. (...) Partners are compensated based on a retrospective cash-based variation system based on the [proforma earnings] set in advance by firm leadership per [sub-competence class]. [Proforma earnings] are determined based on [the firm's] prior year income plus the difference between prior year's [proforma earnings] and realized earnings."*
E	Equal profit sharing (fixed)	No change	No change
F	Performance-based within competence class: ranging from 40 to 245 "competence" units per class plus 45 to 120 "performance" units per class multiplied by 0 for the lowest to 1.5 for the highest of five performance ratings	Performance-based within competence class: ranging from 40 to 245 "competence" units per class plus 45 to 120 "performance" units per class multiplied by 0 for the lowest to 2.00 for the highest of five performance ratings.	Performance-based within competence class: ranging from 25 to 180 "competence" units per class plus 45 to 200 "performance" units per class multiplied by 0 for the lowest to 1.67 for the highest of five performance ratings

G	Equal profit sharing (stepwise from 25 to 100% in seven years)	No change	No change
H	Equal sharing within a competence class: ranging from 200 to 900 units per class	No change	No change
Panel E: Audit Partner Compensation – Audit Quality Penalties			
A	No penalties	No change	Quality penalty up to 10% of allocated units
B	No penalties	No change	Quality penalty up to 60% of discretionary bonus
C	No penalties	No change	Quality penalty up to 25% of income *Example:* *"A -25% malus [of income] can be applied for quality reasons. The income withheld does not flow back into the profit pool but will be additionally invested in the firm's quality agenda."*
D	No penalties	No change	Quality penalty up to 15% of income
E	No penalties	No change	A cash quality penalty of up to EUR 30,000
F	Quality penalty reducing the number of allocated "performance" units	No change	No change
G	No penalties	No change	A cash quality penalty of up to EUR 30,000 *Example:* *"Partners' compensation should be partly dependent on good quality, subject to certain conditions—good quality should be rewarded and poor quality penalized (reduction in compensation). (...) A 'negative financial effect' resulting from poor quality takes the form of a deduction from [partner income]. In case of quality issues a penalty of a maximum of EUR 30,000 will be applied."*
H	No penalties	No change	Quality penalty up to 15% of allocated units *Example:* *"When failing to comply with our integrity, independence, and quality policy, or when a partner is responsible for evident errors, the board may decide to impose a financial penalty of up to 15% of the [profit-sharing units] awarded to the partner concerned."*

Table 1 summarizes the policy changes of audit partners' performance measures (Panel A), numerical ratings and relative weights of performance measures in overall performance evaluation (Panel B), career development (Panel C), profit-sharing systems (Panel D), and audit quality penalties in compensation (Panel E) based on firm policy documents. As to identify patterns of meaningful changes to these policies, we use two shadings: "whole-system" changes in dark grey and "within-system" changes in light grey. We only highlight the year in which a change is made. For example, the implementation of a performance management system by Firms B and E between 2007 and 2012 is marked as a "whole-system" change only once (Panel A) as changes in the other elements result from that implementation as such. Likewise, "within-system" changes that merely follow from other changes, are not again marked as "real" changes (e.g., equal weighting of performance measures for Firms F and G in 2012 in Panel B merely follows from the use of ratings on each performance measure implemented by these same firms by 2012 in Panel A). For selected firm-years with changes, we include examples of original policy language in italic to illustrate the pattern of changes. All examples are drawn from the original firm policy documents. Some policy examples are in English, while others are in Dutch and translated to English. Audit firms are identified by a unique letter (A to H) throughout the manuscript. Brackets (i.e., […]) indicate anonymized firm specific language to safeguard confidentiality. Data confidentiality and anonymity ensure that information cannot be traced back to an individual audit firm. Any presumed resemblance to a specific firm is purely coincidental.

Table 2: Sample Construction for Empirical Analysis

Panel A: Sample Selection

Number of audit partners	**Big 4**	**Non-Big 4**	**Total**
Financial year 2007	493	92	585
Financial year 2012	429	101	530
Financial year 2017	361	105	466
Average number of audit partners per year	**428**	**99**	**527**
Total number of unique audit partners 2007-2017	**706**	**194**	**900**
Exclude: Retiring partners before financial year 2017	(208)	(28)	(236)
Exclude: Entry partners in financial year 2017	(11)	(9)	(20)
Total number of valid unique audit partners 2007-2017	**487**	**157**	**644**
Number of systemic randomly sampled unique audit partners	**143**	**47**	**190**
Omitted unique partners due to originally missing data from two firms	(0)	(16)	(16)
Number of unique audit partners for empirical analysis	**143**	**31**	**174**
Number of unique audit partners per year			
Financial year 2007	88	18	106
Financial year 2012	103	25	128
Financial year 2017	109	26	135
Number of partner-year observations for empirical analyses	**300**	**69**	**369**

Panel B: Sample construction for each of the empirical analyses

	Promotion/Demotion	**Job Retention**	**Compensation**
Number of partner-year observations	369	369	369
Less: measurement of *Competence_5Year* over two five-year periods	(172)	0	0
Base number of partner-year observations for empirical analysis	**197**	**369**	**369**
Less: observations with missing data	(45)	(61)	(61)
Number of partner-year observations for analyses on overall performance	**152**	**308**	**308**
Less: observations with missing data for specific performance	(95)	(171)	(171)
Number of partner-year observations for analyses on specific performance	**57**	**137**	**137**

Table 2 Panel A summarizes the structured sampling process with a random start, where approximately one third of partners are randomly sampled from the population at all eight firms that participate in this study. Sample composition is not tabulated on the firm-level for confidentiality reasons. Table 2 Panel B provides details about the restrictions in sample sizes for regression analyses on partner promotion or demotion, job retention, and compensation respectively.

Table 3: Descriptive Statistics

Variable	N	Mean	Median	SD	Min	P25	P75	Max
Dependent Variables: Career Development and Compensation								
Competence_5Year	197	2.95	3.00	1.37	0.33	1.88	4.17	5.00
Exit_Involuntary	369	0.14	0.00	0.34	0.00	0.00	0.00	1.00
Exit	369	0.28	0.00	0.45	0.00	0.00	1.00	1.00
Profit_Share	369	4.88%	4.08%	3.01%	1.22%	3.02%	5.59%	16.67%
Independent Variables: Performance Measures								
Performance_Overall	308	3.33	3.00	0.68	1.00	3.00	3.75	5.00
Quality	153	3.41	3.00	1.01	1.00	3.00	4.00	5.00
Other_Performance	209	3.22	3.00	0.57	1.67	3.00	3.67	4.67
Clients	209	3.31	3.00	0.70	2.00	3.00	4.00	5.00
People	209	3.21	3.00	0.68	1.67	3.00	3.75	5.00
Firm	209	3.15	3.00	0.77	1.00	3.00	3.75	5.00
Control Variables								
Competence	369	2.68	2.49	1.35	0.17	1.56	3.78	5.00
Age	369	47.80	48.00	5.77	35.00	43.00	52.00	60.00
Male	369	0.95	1.00	0.22	0.00	1.00	1.00	1.00
Engage_Score	365	1.90	1.71	1.37	0.00	0.79	2.64	5.00

Table 3 provides descriptive statistics for the variables in our empirical analysis based on our sample of 174 unique audit partners in years 2007, 2012 and 2017. All variables are defined in Appendix A.

Table 4: Correlation Matrix

Panel A: Competence_5Year through Other_Performance

		(1)	(2)	(3)	(4)	(5)	(6)	(7)
(1)	Competence_5Year	1.00						
(2)	Exit_Involuntary	-0.08	1.00					
(3)	Exit	-0.19***	0.63***	1.00				
(4)	Profit_Share	0.61***	0.00	0.15***	1.00			
(5)	Performance_Overall	0.10	-0.20***	-0.17***	0.12**	1.00		
(6)	Quality	0.00	-0.19**	-0.19**	0.03	0.41***	1.00	
(7)	Other_Performance	-0.22**	-0.10	-0.06	0.21***	0.85***	0.10	1.00
(8)	Clients	-0.22**	-0.13*	-0.04	0.14**	0.73***	0.09	0.82***
(9)	People	-0.08	-0.12*	-0.09	0.23***	0.68***	0.04	0.80***
(10)	Firm	-0.25**	-0.01	-0.01	0.14**	0.66***	0.11	0.80***
(11)	Competence	0.68***	-0.06	0.08	0.69***	0.09	0.10	0.04
(12)	Age	-0.11	0.10**	0.05	-0.03	-0.19***	-0.02	-0.19***
(13)	Male	0.07	-0.02	-0.02	0.13**	-0.04	-0.14*	-0.05
(14)	Engage_Score	-0.24***	0.04	-0.03	-0.05	-0.11**	-0.02	-0.09

Panel B: Clients through Engage_Score

		(8)	(9)	(10)	(11)	(12)	(13)	(14)
(8)	Clients	1.00						
(9)	People	0.53***	1.00					
(10)	Firm	0.46***	0.44***	1.00				
(11)	Competence	-0.03	0.01	0.10	1.00			
(12)	Age	-0.25***	-0.22***	-0.00	0.10**	1.00		
(13)	Male	-0.04	-0.11	0.02	0.09*	0.09	1.00	
(14)	Engage_Score	-0.01	-0.04	-0.15**	-0.27***	-0.09	0.08	1.00

Table 4 provides a pairwise correlation matrix for the variables in our empirical analysis for the entire sample period based on our sample of 174 unique audit partners. All variables are defined in Appendix A. *, **, *** represent statistical significance (two-sided) at 10%, 5% and 1% respectively.

Table 5: Audit Partner Promotions and Demotions

Panel A: Sample Distribution

Period	From 2007 to 2012		From 2012 to 2017		Total for Two 5-Year Periods		From 2007 to 2017	
	N	%	N	%	N	%	N	%
Promoted Partners	33	36.26%	68	64.15%	101	51.27%	46	63.89%
Demoted Partners	41	45.05%	27	25.47%	68	34.52%	14	19.44%
Unchanged	17	18.68%	11	10.38%	28	14.21%	12	16.67%
Total	**91**	**100.00%**	**106**	**100.00%**	**197**	**100.00%**	**72**	**100.00%**

Panel B: Descriptive Statistics

	All Partners				Promoted Partners		Demoted Partners		
	N	Mean	Median	SD	N	Mean	N	Mean	Mean.Diff.
Dependent Variable: Promotions and Demotions									
Competence_5Year	197	2.95	3.00	1.37	101	3.34	68	2.00	-1.35***
Independent Variables: Performance Measures									
Performance_Overall	152	3.42	3.33	0.73	83	3.44	46	3.35	-0.09
Quality	57	3.56	3.38	0.90	27	3.52	23	3.57	0.05
Other_Performance	93	3.26	3.33	0.67	46	3.04	39	3.47	0.43***
Clients	93	3.41	3.00	0.74	46	3.26	39	3.54	0.28*
People	93	3.23	3.00	0.74	46	3.00	39	3.44	0.44***
Firm	93	3.15	3.00	0.89	46	2.84	39	3.43	0.59***
Control Variables									
Competence	197	2.54	2.28	1.31	101	2.13	68	2.59	0.46**
Age	197	46.30	47.00	5.60	101	45.61	68	47.55	1.94**
Male	197	0.96	1.00	0.19	101	0.97	68	0.99	0.01
Engage_Score	196	2.10	1.97	1.40	101	2.04	68	2.40	0.36*

Table 5 Panel A provides sample distribution of promotions, demotions, and cases where competence classes are unchanged over two five-year periods from 2007 to 2012 and from 2012 to 2017, and over one ten-year period from 2007 to 2017. Data is only available for partners who stay in their positions during each of the two examined periods, resulting in a reduced sample size. Panel B provides descriptive statistics five years before promotions/demotions for the subsample used in the promotion tests (equations (1)-(2)) and compares descriptive statistics between promoted and demoted partners. Mean differences between two samples are tested using two-sided t-tests with unequal variances and Welch's approximation. All variables are defined in Appendix A. *, **, *** represent statistical significance (two-sided) at 10%, 5% and 1% respectively.

Panel C: Regression Analysis of Audit Partner Promotions and Demotions				
Dependent Variable: Competence_5Year	**(1)**	**(2)**	**(3)**	**(4)**
Performance_Overall	0.163**	0.160		
	(0.077)	(0.208)		
Post x Performance_Overall		0.129		
		(0.211)		
Quality			0.176**	0.068
			(0.074)	(0.195)
Post x Quality				0.064
				(0.166)
Other_Performance			-0.079	0.575***
			(0.128)	(0.195)
Post x Other_Performance				-0.744***
				(0.255)
Post		-1.631		3.945*
		(1.992)		(2.046)
Competence	0.586***	0.669***	0.327**	0.284**
	(0.087)	(0.211)	(0.141)	(0.139)
Post x Competence		-0.044		-0.113
		(0.268)		(0.099)
Age	-0.002	-0.030	0.075***	0.122**
	(0.017)	(0.033)	(0.027)	(0.052)
Post x Age		0.034		-0.014
		(0.040)		(0.046)
Male	0.194	0.290	0.132	-0.226
	(0.137)	(0.208)	(0.172)	(0.176)
Post x Male		-0.249		
		(0.236)		
Engage_Score	-0.113***	-0.107**	-0.102**	0.194***
	(0.044)	(0.050)	(0.051)	(0.071)
Post x Engage_Score		0.026		-0.426***
		(0.065)		(0.092)
Year Fixed Effects	Yes	No	Yes	No
Firm Fixed Effects	Yes	Yes	Yes	Yes
N	152	152	57	57
Model $\chi 2$	793.24	2992.584	1530.44	1872.644
Model P-value	0.000	0.000	0.000	0.000

Table 5 Panel C presents regression results of audit partners' competence class changes in the subsequent five years after performance evaluation. All variables are defined in Appendix A. Columns (1) and (3) show estimation results of equation (1), and columns (2) and (4) show the estimation results of equation (2). Our multi-year analyses are estimated using mixed models via maximum likelihood allowing intercepts to vary across different partners. Year indicators used to control for year fixed effects are absorbed by the variable *Post* in the interaction model (columns (2) and (4)). $\chi 2$ statistics are reported for each model. Intercepts are not tabulated. Robust standard errors clustered by partner are reported in the parentheses. *, **, *** represent statistical significance (two-sided) at 10%, 5% and 1% respectively.

Table 6: Audit Partner Job Retention

Panel A: Sample Distribution

	Unique Partners		Partner-Year Observations	
	N	**%**	**N**	**%**
Involuntary Departures				
From 2007 to 2012	8	4.60%	25	6.78%
From 2013 to 2017	17	9.77%	25	6.78%
Total Involuntary Departures	**25**	**14.37%**	**50**	**13.55%**
Voluntary Departures				
From 2007 to 2012	12	6.90%	31	8.40%
From 2013 to 2017	19	10.92%	23	6.23%
Total Voluntary Departures	**31**	**17.82%**	**54**	**14.63%**
Total Departures	**56**	**32.18%**	**104**	**28.18%**
Retention	118	67.82%	265	71.82%
Total	**174**	**100.00%**	**369**	**100.00%**

Panel B: Descriptive Statistics

		Departed Partners		Remained Partners		Mean	Voluntarily Departed Partners		Involuntarily Departed Partners		Mean
Variable	***Total***	**N**	**Mean**	**N**	**Mean**	**Diff.**	**N**	**Mean**	**N**	**Mean**	**Diff.**
Independent Variables: Performance Measures											
Performance_Overall	*308*	75	3.11	233	3.40	0.29***	39	3.18	36	3.04	-0.15
Quality	*153*	27	3.00	126	3.49	0.50**	8	3.25	19	2.89	-0.36
Other_Performance	*209*	42	3.11	167	3.25	0.15	18	3.07	24	3.13	0.06
Clients	*209*	42	3.13	167	3.36	0.23*	18	2.99	24	3.23	0.24
People	*209*	42	3.06	167	3.25	0.20*	18	3.08	24	3.04	-0.04
Firm	*209*	42	3.14	167	3.15	0.01	18	3.16	24	3.13	-0.03
Control Variables											
Competence	*369*	104	2.54	265	2.73	0.19	54	2.17	50	2.95	0.77***
Age	*369*	104	48.77	265	47.43	-1.34**	54	49.03	50	48.48	-0.54
Male	*369*	104	0.94	265	0.95	0.01	54	0.94	50	0.94	0.00
Engage_Score	*365*	102	1.97	263	1.87	-0.11	54	2.14	48	1.79	-0.35

Table 6 Panel A provides sample distribution of involuntary departures, voluntary departures, and retention during the sample period 2007-2017. Table 6 Panel B compares descriptive statistics used to estimate equations (3)-(4) between departed versus remaining partners, as well as voluntarily departed and involuntarily departed partners. Mean differences between two samples are tested using two-sided t-tests with unequal variances and Welch's approximation. All variables are defined in Appendix A. *, **, *** represent statistical significance (two-sided) at 10%, 5% and 1% respectively.

Panel C: Regression Analysis of Audit Partner Involuntary Departure				
Dependent Variable: Exit_Involuntary	**(1)**	**(2)**	**(3)**	**(4)**
Performance_Overall	-0.957***	-0.769**		
	(0.298)	(0.306)		
Post x Performance_Overall		-2.270*		
		(1.214)		
Quality			-0.781	-0.447
			(0.507)	(0.531)
Post x Quality				-1.717**
				(0.744)
Other_Performance			-0.340	-1.137
			(0.799)	(1.087)
Post x Other_Performance				2.804
				(2.015)
Post		2.149		-44.192***
		(7.346)		(14.554)
Control Variables	Yes	Yes	Yes	Yes
Interaction with Control Variables		Yes		Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes
N	308	308	137	137
Pseudo R2	0.145	0.195	0.267	0.380
Model $\chi 2$	31.287	38.042	37.409	62.409
Model P-value	0.002	0.013	0.000	0.000

Table 6 Panel C presents logit estimations by maximum likelihood of audit partner involuntary departures in the subsequent years after performance evaluation. All variables are defined in Appendix A. Columns (1) and (3) show estimation results of equation (3), columns (2) and (4) show the estimation results of equation (4). $\chi 2$ statistics are reported for each model. Control variables and interaction with control variables are as in Table 5 Panel C. Robust standard errors clustered by partner are reported in the parentheses. *, **, *** represent statistical significance (two-sided) at 10%, 5% and 1% respectively.

Table 7: Regression Analysis of Audit Partner Compensation

Panel A: Regression Analysis of Audit Partner Profit Shares

Dependent Variable: Profit_Share	**(1)**	**(2)**	**(3)**	**(4)**
Performance_Overall	0.337***	0.355***		
	(0.067)	(0.081)		
Post x Performance_Overall		-0.234**		
		(0.097)		
Quality			0.046	0.172***
			(0.086)	(0.061)
Post x Quality				-0.146
				(0.090)
Other_Performance			0.120	0.045
			(0.126)	(0.133)
Post x Other_Performance				0.061
				(0.171)
Post		1.742**		2.824**
		(0.812)		(1.177)
Control Variables	Yes	Yes	Yes	Yes
Interaction with Control Variables		Yes		Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes	Yes
N	308	308	137	137
Model $\chi 2$	7795.03	12652.743	7825.50	36263.710
Model P-value	0.000	0.000	0.000	0.000

Panel B: Review of Audit Quality Penalties Issued in 2017

	N	**%**
Unique partners in 2017 with sub-par audit quality performance	16	
Of whom received an audit quality penalty from the firm	9	56.3%
Range of audit quality penalties	€18,000–120,000	4.8–32.9%
Average of audit quality penalties	€60,984	16.0%

Table 7 Panel A presents regression results of audit partner profit share percentages on current year performance evaluation. All variables are defined in Appendix A. Columns (1) and (3) show estimation results of equation (5), columns (2) and (4) show the estimation results of equation (6). Our multi-year analyses are estimated using mixed models via maximum likelihood allowing intercepts to vary across different partners. $\chi 2$ statistics are reported for each model. Control variables and interaction with control variables are as in Table 5 Panel C. Robust standard errors clustered by partner are reported in the parentheses. *, **, *** represent statistical significance (two-sided) at 10%, 5% and 1% respectively. Table 7 Panel B presents a review of audit quality penalties issued to our sample of 135 unique audit partners in 2017. Percentage of the range and average of audit quality penalties is calculated relative to the focal partners' gross profit share.