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Review

Auditor specialization, accounting information quality and investment efficiency

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ABSTRACT

This study is examined how the auditor specialization moderates the effect of accounting information quality on investment efficiency, i.e., whether the effect of accounting information quality on investment efficiency is increasing or decreasing with the presence of the specialist auditor.

The reached result reveals that the accounting information quality appears to help decrease the overinvestment problem. Similarly, the auditor specialization has been discovered to help greatly in improving investment efficiency, while reducing the underinvestment problem. We further find that the accounting information quality and the auditor specialization are two mechanisms with some degree of substitution in enhancing investment efficiency. The accounting information quality is positively associated with investment efficiency for firms whose auditor is an industry specialist.

In addition, to check the robustness of the main results, this paper investigates the causal relationships between investment efficiency, auditor specialization and accounting information quality from the dynamic simultaneous-equation models.

1. Introduction

A large theoretical and empirical literature examines the role of the accounting information quality (Bushman et al., 2001; Bushman and Smith, 2001; Bagaeva, 2008; Chan et al., 2009; Chan and Lee, 2009; Zhiying et al., 2012; Ran et al., 2015). One line of research (Biddle and Hilary, 2006; McNichols and Stubben, 2008; Biddle et al., 2009; Chen et al., 2011) suggests that higher quality information enables managers to identify better investment opportunities. Several studies also propose that auditor specialization can be used to reduce the information asymmetry problems (Almutairi et al., 2009; DeBoskey et al., 2012; DeBoskey and Jiang, 2012; Yaghoobnezhada et al., 2014): A specialist's knowledge of the industry can be developed through vast auditing experience, specialized staff training, and large investments in information technology. This industry-specific knowledge allows specialist auditors to provide higher quality audit service by reducing the information asymmetry through their greater ability to detect significant anomalies.

Theoretical models (Balsam et al., 2003; Lai, 2011) predict that, despite the limited evidence, a highly acquired audit quality is extremely useful for improving investment efficiencies, especially with respect to overinvestment. Based on these premises, the main purpose of this paper is to combine these two mechanisms and analyze the effect of the accounting information quality (AIQ) and the

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auditor specialization on investment efficiency.

Chen et al. (2011), who examines the relationship between the information quality and investment, find that financial reporting quality enhances investment in private firms in emerging countries. We also expect to find this association in a sample of industrial firms. In relation to the role of the auditor specialization in investment efficiency, to the best of our knowledge, this is the first study that empirically examines its effect on both underinvestment and overinvestment.

As an extension of our research, we examine how the auditor specialization moderates the AIQ effect on investment efficiency, i.e., whether such an AIQ effect on investment efficiency is increasing or decreasing with the presence of a specialist auditor. We could expect both effects:

On the one hand, the reduction of the information asymmetry and more reliable accounting numbers, due to higher AIQ, could lead to a more effective monitoring due to the specialist auditors and, consequently, the AIQ effect on investment efficiency would turn out to be higher for firms with greater AIQ and auditor specialization.

On the other hand, firms with higher accounting quality are likely to help the manager reduce the adverse selection and moral hazard and allow managers to better identify investment opportunities (Biddle and Hilary, 2006). So, under this assumption, we would expect that the importance of AIQ in reducing information asymmetries will be higher in firms whose auditor is an industry specialist than that with a company whose auditor is not a specialist.

Most studies use the discretionary portion as a measure of information quality. Gomariz and Bellesta (2014) consider different proxies for the quality of information: the model of discretionary accruals suggested by Kasznik (1999), the model of accruals quality suggested by Dechow and Dichev (2002) and the model of discretionary revenues developed by McNichols and Stubben (2008).

Our results show that the AIQ reduces overinvestment, while the specialist auditor reduces the underinvestment. Moreover, our results also reveal that the AIQ effect on investment efficiency is positive for the firms whose auditor is an industry specialist, highlighting the substitution role of AIQ and auditor specialization in reducing information asymmetries and monitoring manager's behavior to such a way as expropriation can be greatly restricted.

Our paper contributes to a growing body of literature dealing with empirical evidence on AIQ and auditor specialization roles in improving investment efficiency. Our findings reveal that, in this context, the main concern of auditors is overinvestment, because it is through overinvestment that auditors expropriate managers, and that it is only through higher AIQ and auditor specialization could inefficiency be reduced.

Moreover, the present work constitutes the first study to analyze the interaction effect between the AIQ and the auditor specialization on improving investment efficiency, and our findings suggest that both mechanisms can play a substitution role in reducing overinvestment.

The remainder of this paper is structured as follows: Section 2 comprises a review of the existing literature on investment efficiency, stressing the role of the AIQ and the auditor specialization, and develops our testable hypotheses. Section 3 depicts a thorough description of the research design, along with the applied models, variable measures and studies the sample. As for Section 4, it is devoted to highlighting the finding while the ultimate section depicts the major conclusion of this paper.

2. Literature review and hypothesis development

The purpose of our research is to test, on a sample, the impact of the accounting information quality on the investment efficiency for companies with the specialist auditors.

In this regard, we consider the previously produced literary research works' conceptual framework as a basic background to conduct our theoretical analysis and achieve our targeted objective.

2.1. Investment efficiency and the accounting information quality (AIQ)

A large body of literature shows that companies can improve the accounting information quality. According to the neo-classical theory, (Yoshikawa, 1980; Hayashi, 1982; Andrew, 1983) firms invest until the marginal benefit equals the marginal cost of this investment so as to maximize their values. According to the Keynesian framework (Gordon, 1992; Crotty, 1992) investment is determined by the preference for growth or for financial security, and according to the agency framework (Chen et al., 2011) which considers information asymmetry problems, companies can deviate from their optimal investment levels and therefore suffer from overinvestment or under-investment. Jensen and Meckling (1976), Myers and Majluf (1984) and Gomariz and Bellesta (2014) develop a framework for analyzing the role of the asymmetric information in investment efficiency through information problems, such as moral hazard and adverse selection.

However, in the agency theory (Healy et al., 2001; Healy and Palepu, 2001; Hope and Thomas, 2008; Gomariz and Bellesta, 2014; Martinez et al., 2015), there are various control mechanisms to attenuate information asymmetries and information risk and to enable better supervision of managerial activity that mitigates the opportunistic behavior of managers, such as the AIQ.

A great section of the pertinent literature associates the AIQ with investment efficiency. Since higher AIQ makes managers more accountable by allowing better monitoring, and it may reduce adverse selection and moral hazard, and thereafter decreases information asymmetries, it could thereby greatly reduce the overinvestment and the underinvestment problems. In addition, the AIQ could improve investment efficiency by enabling managers to make better investment decisions through a better identification of projects and more truthful accounting numbers for internal decision makers (Bushman et al., 2001; Bushman and Smith, 2001; McNichols and Stubben, 2008; Gomariz and Bellesta, 2014). Empirically, prior studies argue and find evidence that earnings management leads to overinvestment because it distorts the information used by managers (McNichols and Stubben, 2008). In turn,