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The effect of diversification on auditor selection in business groups: A case from Taiwan

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ABSTRACT

This study examines effects of group diversification on the number of industry-specialist auditor selections in business groups. Using 2003–2010 Taiwanese business groups as the sample, our results show that unrelated diversification is significantly positively associated with the number of industry-specialist auditor selections in business groups, including audit firms and audit partners. Related diversification is significantly negatively associated with the number of industry-specialist audit partner selections in business groups. Overall, group member firms select different industry-specialist audit firms because of industry diversity and the same industry-specialist audit partners because of industry similarity.

1. Introduction

This study investigated the effects of group diversification strategies on the number of high-quality specialist auditor selections within business groups. Business groups have become one of the most crucial types of organizations worldwide, especially in emerging economies, where they play a critical role in economic development. They are defined as a set of legally independent companies in which ultimate majority shareholders control the group's management. As a legal entity, each member firm of a business group prepares its own financial statements, which are attested by an auditor. Therefore, our study explored what factors drive group member firms to select either different or the same auditors within business groups. Similar to studies on multidivisional organizations, it is important not only to investigate the behaviors or performance of member firms but to examine the group effects of managing different member firms under one business group umbrella. Despite the importance of auditor selection to corporate governance, auditor selections at the business group level have limited evidence in the literature.

For example, the Lian Family Group (LFG) had six public member firms in 2010. Fig. 1 shows detailed information about these six firms. Four of them prepared their own consolidated financial statements, while the other two did not. No public member firm was an accounting entity in the consolidated statements of the other public member firms. The six public member firms were also in three different industries and were audited by three different audit firms. Does industry diversification influence the six public member firms to choose auditors in this way?

Most business groups are diversified (Khanna & Palepu, 1997, 2000b) and follow different diversification strategies. An unrelated diversification strategy involves making investments in various unrelated industries to achieve risk reduction, whereas a related diversification strategy involves adopting horizontal or vertical integration of related industries for economies of scale and scope or

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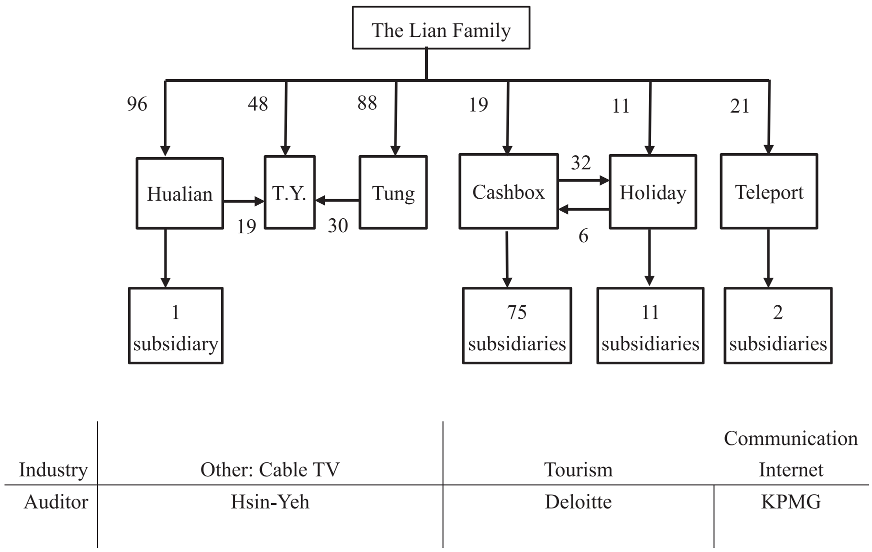

Fig. 1. Shareholdings, industries, and audit firms of six public member firms of the Lian Family Group in 2010. Note: Numbers near to arrow symbol indicate the percentage of shareholding. For example, the Lian Family owns 96% of Hualien. Hualien = Hualien Cable TV Company T.Y. = T.Y. Cable TV Co., Ltd. Tung = Tung Tai Cable TV Cashbox = Cashbox Partyworld Co., Ltd. Holiday = Holiday Entertainment Co., Ltd. Teleport = Teleport Access Services, Inc. Hsin-Yeh = Hsin-Yeh CPAs & Attorneys Deloitte = Taiwan member firm of Deloitte KPMG = Taiwan member firm of KPMG.

for the reduction of market transaction costs. We expected that related and unrelated diversifications would each have a distinct influence on the number of high-quality specialist auditor selections in business groups. Many studies have shown that specialist auditors provide a higher audit quality (e.g., Balsam, Krishnan, & Yang, 2003; Reichelt & Wang, 2010; Romanus, Maher, & Fleming, 2008).

Business and industry between related diversified member firms are similar. The specialized knowledge of the business and industry that a specialist auditor obtains and accumulates from a member firm can easily spill over to the audits of other member firms when the auditor attests multiple member firms in a business group. The same auditor will also be a specialist for each of the member firms in related industries, and the same specialist can audit all of them. Consequently, we expected that in order to seize the benefits of such a knowledge spillover, group member firms in related industries would be more likely to concentrate their selections on the same industry-specialist auditors, resulting in a lower number of industry-specialist auditor selections in these groups.

By contrast, unrelated diversification increases industry diversity, reducing auditors' knowledge-spillover effects. Business groups involved in multiple unrelated industries must also delegate additional power to member firms in response to industry diversity. Nor is an auditor necessarily specialized in each industry in which a business group with unrelated diversification is involved. Because diverse industries contain distinct specialist auditors, we predicted that group member firms in unrelated industries would be more likely to diffuse their selections of different industry-specialist auditors, resulting in a higher number of industry-specialist auditors selected in these groups.

Although audit *firms* can be categorized as industry specialists, not all audit *partners* in these firms are industry specialists. By contrast, although audit firms can be recognized as nonspecialists, individual audit partners in those firms may be industry specialists. We examined specialist auditor selections in business groups at both the audit firm and audit partner levels. Combining the two analyses provided an understanding of whether member firms tended to select the same audit firms and audit partners, the same audit firms but different audit partners, or different audit firms and audit partners in business groups.

Based on the availability of data on audit partners and the vital role that business groups play in Taiwan's economy, for our sample we obtained data on Taiwanese business groups from the period 2003–2010. The results show that unrelated diversification is significantly positively associated with both the numbers of industry-specialist audit firms and of audit partners selected in business groups. By contrast, related diversification is significantly negatively associated with the number of industry-specialist audit partner selections in business groups. In summary, group member firms tend to select different industry-specialist audit firms when the industries in which the groups are involved are diverse, and they select the same industry-specialist audit partners when similarities exist among those industries.

Our contributions are as follows. In the literature on business groups, previous research provides evidence on performance (Chang, 2003; Joh, 2003; Khanna & Palepu, 2000a), dividend policy (Manos, Murinde, & Green 2012), earnings management (Kim & Yi, 2006), and earnings informativeness (Jung & Kwon, 2002). We add empirical evidence to this research stream by investigating auditor selections in business groups. Business group-level auditor selections are a crucial topic related to business group governance, but they have limited empirical evidence (Chang & Chen, 2015; Yang, Kang, Lin, & Ronen, 2016). Our study is less related to Yang