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Auditor Industry Specialization and Discretionary Accruals: The Role of Client Strategy☆

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Abstract

This study examines the relation between client business strategy and the audit quality of industry specialists. Using a sample of Chinese listed firms for the period 2000 to 2010, this study finds that the negative association between industry specialists and client discretionary accruals is more pronounced when the client's business strategy deviates from the industry-normal strategies. Our results remain valid after controlling for self-selection bias and are robust to alternative measures of discretionary accruals, auditor industry specialization, and strategic deviance. Overall, our findings suggest that the effect of auditor industry specialization is not homogeneous across clients, and client characteristics (e.g., client strategy) moderate the relation between auditor industry expertise and audit quality. This study increases the understanding of the interaction between client business strategy and audit quality.

Keywords: Auditor industry specialization; Discretionary accruals; Business strategy

1. Introduction

Numerous studies have documented that auditors with industry specialization can deliver higher-quality auditing service. However, there is little evidence on how client

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characteristics moderate the industry specialization effect. This study fills the void by investigating the relation between clients' business strategy and the audit quality of industry specialists. Prior literature and anecdotal evidence suggest that business strategy is an important determinant of earnings quality. For example, based on a survey of 169 CFOs of public companies and in-depth interviews of 12 CFOs, Dichev, Graham, Harvey, and Rajgopal (2013) find that the most important factor affecting earnings quality is a firm's business model. Several field studies also suggest that strategic risk is an important component of the business risk audit model (Eilifsen, Knechel, & Wallage, 2001) and that the primary goal of auditors' analytical procedure is to obtain an understanding of the client's business (Hirst & Koonce, 1996). Erickson, Mayhew, and Felix (2000) further ascribe the Lincoln Savings and Loan audit failure to the fact that the audit staff failed to obtain and apply knowledge of the client's business to the audit procedures. Bentley, Omer, and Sharp (2013) provide the first large-sample empirical evidence that business strategy significantly affects both the occurrence of financial reporting irregularities and audit effort. As a result, both the U.S. and international auditing standards require auditors to obtain an understanding of their clients' strategies and the related business risks when planning the audit, e.g., AU Section 314 (American Institute of Certified Public Accountants [AICPA], 2013); ISA 315 (International Auditing and Assurance Standards Board [IAASB], 2006). KPMG even advocates a shift of auditors' focus from the transaction-based approach to a “strategic-systems lens” approach (Bell, Marrs, Solomon, & Thomas, 1997). Surprisingly, few studies investigate the role of client business strategy in the audit process.

In this study, we examine how client business strategy, in general, and strategic deviance, in particular, moderates the relation between industry specialists and audit quality. Strategic deviance represents the extent to which a client's business strategy deviates from the industry strategy norms (Carpenter, 2000; Geletkanycz & Hambrick, 1997; Tang, Crossan, & Rowe, 2011). According to neo-institutional theory, firms following industry-normal strategies can gain legitimacy, get access to external resources, reduce performance uncertainty, and increase the likelihood of survivability (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Tang et al., 2011). However, ambitious or over-confident managers may choose not to conform to the industry's central tendencies and instead adopt a deviant strategy to pursue extreme performance, which leads to either big wins or big losses (Tang et al., 2011), resulting in intra-industry heterogeneity of corporate business strategies.

Client strategic deviance influences the knowledge advantage of industry specialists relative to non-specialists. On the one hand, client strategic deviance may reduce the knowledge gap between industry-specialist auditors and non-specialist auditors because industry specialists may only accumulate knowledge and experiences associated with the typical firms in the industry that follow industry-normal strategies. Hence, both specialists and non-specialists may lack the specific knowledge related to industry-extreme strategies (the reduced knowledge gap hypothesis).

On the other hand, client strategic deviance may enhance the knowledge advantage of industry specialists relative to non-specialists. First, industry experts audit a variety of clients from the same industry. Hence, they are more likely to encounter clients with extreme strategies and to gain understandings in industry-extreme strategies than are

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