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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.
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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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industry specialists can outperform non-specialists in forming risk judgments for strategically deviant clients that are generally subject to greater performance uncertainty.

Fourth, non-specialists can assess a client's true financial performance by comparing the client's performance with a comparable firm from the same industry. However, non-specialists have difficulty finding industry benchmarks to assess the appropriateness of those deviant clients' accounting policies and procedures, while industry specialists can use their prior experiences with extreme-strategy clients to facilitate their audits.

Fifth, clients with deviant strategies are also more likely plagued by the information asymmetry problem because it is difficult for outsiders to understand deviant firms' strategies and business models.[2] Thus, industry specialists can play a more important role in this case. Taken together, client strategic deviance will enlarge the relative knowledge gap between industry specialists and non-specialists. We thus have the following alternative hypothesis:

H1b. (The Enlarged Knowledge Gap Hypothesis): The positive association between auditor industry specialization and audit quality will be more pronounced for clients with deviant strategies.

3. Sample and variables

3.1. Sample

Our sample initially comprises all A-share companies listed on the Shanghai Stock Exchange and the Shenzhen Stock Exchange from 2000 to 2010. We obtain data from the China Stock Market and Accounting Research (CSMAR) database. We then remove firm-years with missing information to calculate the empirical variables. The final sample contains 12,253 firm-year observations representing 1590 unique firms.

3.2. Variables

3.2.1. Discretionary accruals

Following prior studies (Jaggi, Chin, Lin, & Lee, 2006; Krishnan, 2003; Leuz, Nanda, & Wysocki, 2003), we use discretionary accruals as our proxy for audit quality. We follow Dechow and Dichev (2002) to estimate discretionary accruals, which is defined as the difference between working capital accruals and the fitted values from the cash-flow-adjusted *Jones* model (McNichols, 2002). Specifically, we estimate the following model to derive discretionary accruals:

$$\Delta WC_{it} = \beta_0 + \beta_1 CFO_{i,t-1} + \beta_2 CFO_{i,t} + \beta_3 CFO_{i,t+1} + \beta_4 \Delta REV_{it} + \beta_5 PPE_{it} + \varepsilon_{it} \qquad (1)$$

where ΔWCis the change in working capital, *CFO* is cash flow from operations, ΔREV is the change in revenues, and *PPE* is the level of fixed assets. *i* and *t* denote firm *i* and year *t*, respectively. All variables are scaled by total assets at the beginning of year *t*. We estimate

[2] Untabulated results indicate that strategic deviant clients attract fewer analysts and are subject to higher analyst forecast errors.

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How does auditors' work stress affect audit quality? Empirical evidence from the Chinese stock market

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A B S T R A C T

With reference to the Job Demands–Control Model, we empirically examine the effect of auditors' work stress on audit quality using a sample of Chinese A-share listed companies and their signature auditors from 2009 to 2013. The results show that (1) there is generally no pervasive deterioration in audit quality resulting from auditors' work stress; (2) there is a significant negative association between work stress and audit quality in the initial audits of new clients; and (3) the perception of work stress depends on auditors' individual characteristics. Auditors from international audit firms and those in the role of partner respond more strongly to work stress than industry experts. Auditors tend to react more intensively when dealing with state-owned companies. We suggest that audit firms attach more importance to auditors' work stress and rationalize their allocation of audit resources to ensure high audit quality.

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1. Introduction

Work stress has been referred to as an "occupational flu" in this era of the knowledge-driven economy (Lu, 2006). Under the mechanism of market competition, various professionals such as lawyers, doctors and executives all face some degree of work stress, as do auditors, who enjoy the reputation of the economic police. In the US, the Public Company Accounting Oversight Board has expressed concern that audit quality might be compromised due to auditors' workload or time pressure.[1] Auditors in China suffer from pervasive work

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[1] Auditing Standard No. 7-Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards.

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work stress and audit quality remains an empirical question that is yet to be tested. Thus, we propose the following hypothesis:

H1. Auditors' work stress affects audit quality.

Next, we consider whether the relationship between auditors' work stress and audit quality is subject to other factors due to the distinctiveness of auditing work. Audit tenure may be one such factor. Specifically, to evaluate the audit risk during the initial audit of a new client, the auditor must gain a comprehensive understanding of the client's operating characteristics, accounting policies, industry development and other information. In this case, the auditor needs to invest more initial audit costs in the new client, including working hours, human and material resources and so on. The more clients an auditor is responsible for, the greater the total workload and the fewer working hours and audit resources he will able to spend on each client, especially new clients. This is how the direct conflict between work demand and work control is created. Moreover, the more intense the conflict, the greater the work stress and its negative effects are likely to be, and the greater the negative consequences on the audit performance, the provision of sufficient evidence and the efficiency of the audit judgment. Correspondingly, in non-initial audits for continuing clients,[5] given a certain total workload and stress, the effectiveness of work controls on work demands tends to improve with subsequent audits, and the accumulation of experience and knowledge acquired through the familiarity with and mastery of specific client and industry information. The improvement in effectiveness then mitigates the negative effects of work stress on audit quality. This analysis leads to the second hypothesis:

H2. The influence of auditors' work stress on audit quality is mainly observed in the initial audit engagement of a new client.

4. Research design

4.1. Sample and data

Our sample comprises A-share companies listed on the Shanghai and Shenzhen stock markets from 2009 to 2013. Financial data for these companies are derived from the CSMAR database, and each auditor's personal information is manually collated and corrected according to company annual reports and information system of the CICPA. Consistent with former studies, we remove (1) companies in the finance industry; (2) companies with missing financial data for the previous year, with initial public offerings or with less than 15 industry-year observations in the calculation of discretionary accruals; and (3) companies with missing data on the signature auditor. Additionally, we winsorize the continuous variables in the intervals 0–1% and 99–100%. The final sample includes 9639 firm-year observations.

4.2. Variables and model

4.2.1. Variable definitions

(1) Auditors' work stress (*WS*). Work stress is measured by the number of listed companies audited by an auditor, taking into consideration both the number of companies and the business complexity of each company. Therefore, we estimate work stress by the following equation:

$$WS = \frac{\sum_{i=1}^{m}\sum_{j=1}^{n} TAij}{m} \tag{a1}$$

where for listed company j audited by auditor i, TA_{ij} refers to the natural logarithm of total assets; n is the total number of listed companies audited by auditor i in the fiscal year; and m is the number of signature auditors of specific company j. In the majority of cases, there are two auditors in charge of audit-

[5] In this paper, an "old client" refers to a company that has been audited by a signature auditor at least once; that is, the audit tenure is at least two years.

The Effect of Corporate Governance, Auditor Choice and Global Activities on EU Company Disclosures of Estimates and Judgments

ABSTRACT

Following the 2005 EU adoption of IFRS, several studies noted that some companies omitted a separate disclosure of key judgments and estimation uncertainty within the notes to the financial statements, and other companies limited their separate disclosure to boilerplate narrative. We determine if the choice of specific Big-4 audit firm and the independent variables included in the international financial reporting literature associated with voluntary disclosure are related to the decision to include a separate disclosure of judgments and estimates that provides more than boilerplate narrative. We also test if these independent variables affect the qualitative characteristics of the separate disclosures. We find that several of our independent variables are significant in the decision to make a disclosure that contains more than boilerplate, and affect the length and content of the separate disclosure. These findings add to the literature by identifying factors that influence discretionary disclosure. Our study also contributes to the current financial statement disclosure discussion among standard setters and regulators by detailing the format and content of disclosures among a sample of EU companies. This is an important area of inquiry, given that prior research finds that the way information is displayed affects how that information is actually used.

Keywords: IFRS, Estimates, Judgments, Disclosure, IAS 1, Big-4 Auditor

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as having at least one foreign listing other than in the U.S., and the extent of foreign sales relative to total sales revenue. This leads us to our fourth hypothesis:

H4(a): *The level of global activities – as measured by foreign listing and the percentage of foreign revenue – is associated with a higher probability that a company will provide a separate disclosure of critical judgments and estimation uncertainty that contains accounting topics and IAS 1 suggested disclosure subjects (e.g., MORETHANBP) within the financial statement notes.*

Consistent with the other hypotheses, we also believe that greater globalization affects companies' disclosure practices. As such, we further hypothesize:

H4(b): *The level of global activities – as measured by foreign listing and the percentage of foreign revenue – is associated with differences in the qualitative characteristics (e.g., the length, number of topics, and the number of referenced notes) of the companies' separate disclosures of critical judgments and estimation uncertainty.*

2.8. Control Variables

Consistent with other studies, we control for industry, country, and financial variables. The results of the prior studies of industry effect on voluntary disclosure are mixed. Meek et al. (1995) find significant industry and country/region effects related to voluntary disclosure; however, neither Chau and Gray (2002) nor Chau and Gray (2010) find a significant industry effect. In a more recent study, Ali et al. (2014) find a negative relationship between industry concentration—as measured using U.S. Census industry concentration measures that incorporate both public and private U.S. firms—and analysts' firm disclosure ratings included in the *Report of the Association for Investment Management and Research.* The authors explain the results suggest "firms in more concentrated industries disclose less" (p. 241).

Many prior studies of financial reporting practices control for country specific effects. In their study of voluntary IFRS adoption, Francis et al. (2008) rely on surrogate measures for the legal environment, judicial functions, financial development, and designation as historic code or

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