



Client-Auditor Mismatches, Internal Control and Strategic Deviance

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Abstract. Uses A-share listed companies from 2015 to 2020 as research samples, this paper explores the impact of client-auditor mismatches on strategic deviance. The empirical results show that the client-auditor upward mismatches will restrain the strategic deviance to some extent, in contrast the client-auditor downward mismatches will increase the strategic deviance. The above effects are weaker for firms with higher internal control. This paper enriches the research on the economic consequences of client-auditor mismatches, expands the research perspective on the influencing factors of strategic deviance, and has essential reference value and significance for listed companies, investors, and regulatory authorities.

Keywords: Client-auditor mismatches · auditor choice · enterprise strategic deviance · internal control · corporate governance

1 Introduction

While most enterprises follow the conventional procedure formed by the long-term development of the industry to reduce the uncertainty of enterprise development, some enterprises choose to “take the edge of the sword” in pursuit of extreme performance and implement a strategy different from the mainstream of the industry. The degree to which an enterprise’s strategy deviates from the conventional industry strategy is defined as strategic deviance [1]. The research on the influencing factors of strategic deviance is based on both the features of management [1] and the characteristics of the enterprise’s organization [2]. Still, there is little literature to discuss its impact on strategic differentiation from the perspective of auditors. Under the background that the enterprise chooses the strategy that deviates from the industry norm to a large extent, the enterprise risk surges, the external supervision with the independent audit as the essential way becomes particularly important.

On the one hand, high-quality auditor supervision requires auditors to provide reasonable assurance for the authenticity and fairness of the enterprise’s financial report information, to facilitate investors to make relevant decisions; On the other hand, auditors are also required to restrain the opportunistic behavior of enterprise management and reduce the business risk of enterprises in the process of implementing audit procedures for enterprises. In addition, the role of audit supervision also depends on the client company [3]. The auditor and the client jointly decide the audit quality by weighing

games. In addition, China's audit market is a buyer's market [4]. To maintain or expand market share to adapt to the increasingly fierce industry competition, accounting firms will undertake customer groups that do not match their business capabilities, leading to widespread client-auditor mismatches [5]. This mismatch directly determines whether audits can play a supervisory role. However, the current research has not paid enough attention to client-auditor mismatches.

2 Theoretical Analysis and Research Hypothesis

2.1 Client-Auditor Upward Mismatches and Strategic Deviance

The existing research distinguishes the client-auditor mismatches into upward mismatches and downward mismatches. The former refers to that large accounting firms in the market undertake customers that should have been conducted by small and medium-sized accounting firms. In contrast, the latter refers to that small and medium-sized accounting firms in the market undertake customers that should have been conducted by large accounting firms [6]. Auditor supervision is decided jointly by both the client and the auditor [3], and is the result of the game between the client and the auditor. The impact of client-auditor mismatches on audit supervision and governance mainly comes from auditor independence and professional competence [7].

For the client-auditor upward mismatches, on the one hand, large accounting firms have comparative advantages in audit experience, audit resources, and communication with customers. It is easier to find misstatements and omissions in the financial statements of listed companies in the audit process, and improve the quality of information disclosure. Through timely tracking and investigation of management's decision-making behavior [8], information disclosure can reduce the information asymmetry inside and outside the company, and inhibit the control from choosing a more differentiated strategy in pursuit of extreme performance. On the other hand, large accounting firms to maintain their reputation and industry status, often adopt a low-tolerance attitude towards the opportunistic behavior of the management of the customer company. Auditors often focus on the earnings management behavior of the company's management and require the client company to follow the principle of conservatism, effectively control operational risks, and implement more minor strategic deviance. Therefore, we propose:

H1: The client-auditor upward mismatches will restrain the degree of strategic deviance.

2.2 Client-Auditor Downward Mismatches and Strategic Deviance

As for the client-auditor downward mismatches, on the one hand, small and medium-sized accounting firms have limited audit resources, It is difficult to effectively identify and restrain the opportunistic behavior of the management of the client company, and the audit supervision of the direction of the client company is significantly weakened. On the other hand, in the context of the emergence of a consolidation wave in the industry to promote the overall upgrading of local firms, small and medium-sized accounting firms have greater pressure to survive, and they often have a weak voice when facing large customers. They are more likely to improve the tolerance of opportunistic behavior of

the management of the client company for the purpose of to maintain large customers. For the direction of the client company, the external regulatory risk of implementing significant strategic deviance will be significantly reduced. Therefore, we propose:

H2: The client-auditor downward mismatches will increase the degree of strategic deviance.

2.3 Client-Auditor Mismatches, Internal Control and Strategic Deviance

Bargeron believes that the implementation of internal control provisions is helpful in reducing enterprise risk [9]. Poor internal control may lead to companies manipulating accruals through earnings management intentionally or unintentionally, leading to poor quality of accounting information [10]. Therefore, the higher rate of internal control, the higher rate of accounting information [11], and the more effective internal constraints will be imposed on the opportunistic behavior of enterprise management, and the behavior of choosing more significant strategic deviance to achieve excess performance will also be better monitored. While client-auditor upward mismatches, the supervision function of the external audit will be replaced by the internal governance effectiveness brought by higher internal control to a certain extent; when there are client-auditor downward mismatches, although the auditor's external supervision function is difficult to play effectively, sound risk management and control and internal governance of enterprises with high internal control quality will make up for the lack of external supervision to a certain extent, effectively constrain the opportunistic behavior of management, prevent enterprises from implementing significant strategic differences in pursuit of extreme performance, and increase operational risk. Therefore, we propose:

H3: The effect of client-auditor mismatches on the degree of strategic deviance is weakened in enterprises with high internal control quality.

3 Research Design

3.1 Data Sources

This paper uses A-share listed companies from 2015 to 2020 as research samples. The sample is processed as follows: Exclude the financial industry, ST, PT, and some companies with severe data loss, then indentable according to the standard of 1% up or down. The data in this paper comes from the CSMAR database and is empirically analyzed through the data processing software Stata15.0.

3.2 Model Design

Referring to existing studies [6], this paper designs the following OLS multiple regression model (1) to test the impact of client-auditor mismatches on strategic deviance.

$$\begin{aligned}
 DS_{i,t} = & \alpha_0 + \alpha_1 (Misup_{i,t} \& Misdown_{i,t}) + \alpha_2 Size_{i,t} + \alpha_3 Lev_{i,t} + \alpha_4 ROA_{i,t} \\
 & + \alpha_5 Growth_{i,t} + \alpha_6 EXCP_{i,t} + \alpha_7 Big10_{i,t} + \alpha_8 Inventory_{i,t} \\
 & + \alpha_9 CF_{i,t+} \sum Year_+ \sum Ind + \eta_{i,t}
 \end{aligned} \tag{1}$$

To test hypotheses H1 and H2, this paper uses Misup and Misdown as explanatory variables of the model (1). To test hypothesis H3, this paper further uses internal control quality (IC_Hig) for the grouping test.

3.3 Variable Definition

3.3.1 Client-Auditor Mismatches

Based on the existing research [12], this paper selects the “top ten” to measure the client-auditor mismatches. As China’s major accounting firms to public praise and reputation in the industry, international “big four” and native “six” there was no difference of audit quality [4], so this article published by the China association of certified public accountants “Top 100 Information on Comprehensive Evaluation of Accounting Firms” top 10 certified public accountants as the “top ten”, When the estimated probability of selecting the “top ten” accounting firms is above the optimal critical value, it indicates that the enterprise is a potential client of the “top ten” accounting firms; On the contrary, it is a potential “non-top ten” accounting firm client. The client-auditor mismatches can be obtained by comparing each enterprise’s expected choice of accounting firms with the actual choice, specific models are as follows (2). Misup refers to the client-auditor upward mismatches, when potential “non-top ten” customers choose “top ten” accounting firms, Misup is assigned a value of 1. Otherwise it is 0; Misdown refers to the client-auditor downward mismatches, when potential “top ten” customer selects a “non-top ten” accounting firm, Misdown is assigned a value of 1. Otherwise it is 0.

$$Big10_{i,t} = \beta_0 + \beta_1 Size_{i,t} + \beta_2 Lev_{i,t} + \beta_3 ROA_{i,t} + \beta_4 CR_{i,t} + \beta_5 ATURN_{i,t} + \sum Year + \sum Ind + \theta_{i,t} \quad (2)$$

3.3.2 Strategic Deviance

Based on existing research [1, 13], this paper calculates the allocation of enterprise resources in six key areas, including advertising and publicity investment, period cost investment, R&D investment, capital intensity, fixed assets renewal degree, and enterprise financial leverage. Because China’s listed companies rarely disclose advertising expenses and R&D expenses, this paper uses sales expenses and net intangible assets, respectively, as alternative variables of advertising expenses and R&D expenses. First, calculate the annual average value of the six-dimensional strategic indicators by industry, and then divide the difference between each dimensional indicator and its average yearly value by the standard deviation to standardize and take the absolute value, to obtain the final degree of each enterprise’s departure from the industry average in each dimension. Finally, add the six standardized indicators together and calculate the average value, which is DS.

3.3.3 Internal Control

This paper selects the “internal control index” in DIB internal control and risk management database to measure the internal control quality (IC). When the company’s

annual internal control index is higher than the industry median, the value of IC_Hig is 1. Otherwise it is 0.

3.3.4 Control Variables

Referring to existing research [13], this paper determines the following control variables: Enterprise size(Size), Asset liability ratio(Lev), Return on total assets(ROA), Growth of the company(Growth), Executive compensation(EXCP), Auditor size(Big10), Inventory, Cash flow(CF). In addition, this paper also controls the industry fixed effect(Ind) and year fixed effect(Year).

4 Empirical Results and Analysis

4.1 Statistical Description

Table 1 shows the statistical description results. It can be seen that the average of strategic deviance (DS) is 0.507, and the minimum and maximum values are 0.085 and 1.724, respectively, indicating that there are significant differences in the degree of strategic deviance of the enterprises in the sample from the industry conventions. In the descriptive statistics of the total model, the client-auditor upward mismatches accounted for 33.0%, and the client-auditor downward mismatches accounted for 13.6%, indicating that there have more upward mismatches in the client-auditor mismatches, and customers are more willing to seek high-quality audit.

Table 1. Descriptive statistics of variables

variables	sample	mean	sd	min	p50	max
DS	14978	0.507	0.281	0.085	0.447	1.724
Misup	14978	0.330	0.470	0.000	0.000	1.000
Misdown	14978	0.136	0.343	0.000	0.000	1.000
Size	14978	22.323	1.338	19.984	22.151	26.388
Lev	14978	0.425	0.202	0.061	0.416	0.897
ROA	14978	0.034	0.069	-0.339	0.036	0.188
Growth	14978	0.169	0.416	-0.568	0.092	2.620
EXCP	14978	14.499	0.676	12.953	14.457	16.499
Big10	14978	0.593	0.491	0.000	1.000	1.000
Inventory	14978	0.139	0.130	0.000	0.107	0.681
CF	14978	0.047	0.067	-0.157	0.046	0.236

4.2 Regression Result

4.2.1 Client-Auditor Mismatches and Strategic Deviance

Table 2(1) shows the regression results between client-auditor mismatches and strategic deviance. It can be seen when there are client-auditor upward mismatches, the auditors of large accounting firms have strong professional solid competence and independence, can give full play to the external governance supervision role of independent auditors, and reduce the strategic deviance. Therefore, the impact of the client-auditor upward mismatches on strategic deviance is significantly negative at 1%, and hypothesis H1 is verified. Under the control of other variables, the client-auditor downward mismatches have a significant positive impact on strategic deviance. Hypothesis H2 is verified.

4.2.2 Client-Auditor Mismatches, Internal Control and Strategic Deviance

Table 2(2) and (3) are the empirical results from the internal control perspective to verify the impact of client-auditor mismatches on strategic deviance. It can be seen that in enterprises with high quality of internal control, both the regression coefficients of client-auditor upward mismatches and downward mismatches are not significant; However, in the enterprises with low internal control quality, the coefficients of client-auditor upward mismatches and downward mismatches are effective at the level of 1%. The Chow test results in Table 2(4) shows that there is a significant difference in the coefficients between the two groups. This paper assumes that H3 is verified.

5 Conclusions

Based on the perspective of the mismatch between customers and auditors, this paper explores the role of client-auditor mismatches on strategic deviance, and further analyzed the impact of internal control quality on the above relationship. The empirical results show that the client-auditor upward mismatches will restrain the degree of strategic deviance to some extent. In contrast, the client-auditor downward mismatches will increase the strategic deviance. The above effects are weaker for firms with higher internal control.

Table 2. Client-auditor mismatches, internal control and strategic deviance

variables	DS			
	(1) Main regression results	(2) IC_Hig = 1	(3) IC_Hig = 0	(4) Test of coefficient difference between groups
Misup	-0.038***	-0.018	-0.057***	-0.057***
	(-5.411)	(-1.249)	(-6.668)	(-6.509)
Misdown	0.037***	0.015	0.077***	0.077***
	(4.644)	(1.593)	(3.500)	(3.417)
Size	-0.008***	0.007*	-0.028***	-0.028***
	(-3.066)	(1.871)	(-7.154)	(-6.984)
Lev	0.100***	0.097***	0.105***	0.105***
	(6.765)	(4.531)	(5.104)	(4.983)
ROA	-0.623***	-0.621***	-0.621***	-0.621***
	(-16.258)	(-11.437)	(-11.402)	(-11.131)
Growth	-0.003	0.012	-0.019**	-0.019**
	(-0.561)	(1.583)	(-2.482)	(-2.422)
EXCP	-0.008**	-0.013**	-0.001	-0.001
	(-2.073)	(-2.540)	(-0.174)	(-0.170)
Big10	0.043***	0.018	0.067***	0.067***
	(5.832)	(1.522)	(5.196)	(5.072)
Inventory	-0.331***	-0.300***	-0.349***	-0.349***
	(-15.112)	(-9.649)	(-11.241)	(-10.974)
CF	-0.003	0.038	-0.048	-0.048
	(-0.084)	(0.727)	(-0.981)	(-0.958)
Constant	0.994***	0.710***	1.370***	1.370***
	(15.300)	(7.406)	(13.876)	(13.546)
IND/Year	YES	YES	YES	YES
N	14978	7413	7487	14900
adj. R-sq	0.153	0.137	0.177	0.156
F	80.398	35.595	48.197	41.036

Note: t-statistics are given in parentheses. ***, **, and * denote significance at the 1%, 5% and 10% levels

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