Having clients from many industries can hurt the effectiveness of auditing firms

July 30 2020

Credit: Sharon McCutcheon

A recent study finds that when an accounting firm has an industry diversified client portfolio, the quality of the firm's audits suffers—and the more industry sectors it audits, the worse those audits are.

"We defined 'good' audit quality based on the probability of a restatement of a company's financial statements," says Nathan Goldman,

co-author of a paper on the work and an assistant professor of accounting in North Carolina State University's Poole College of Management. "A restatement occurs when, after issuing financial statements, a company or auditor identifies a material error in the quantitative or qualitative information in the financial statements. If the audit team did its job, and the audit was performed with high quality, then the audit team should have identified any misstatements before the financial statements were issued."

For the study, researchers looked at data from 2002 to 2015. The number of years' worth of data they had for each firm varied, but their dataset came to 35,265 firm-years in total.

"We found that taking on clients from many different industry sectors hurt auditing performance," Goldman says. "The effect was most obvious in cases where audit offices had an industry diversified client portfolio—those auditors had the lowest audit quality."

The researchers also found that the size of the auditing firm, and whether it was considered an "industry specialist," didn't necessarily have an effect on audit quality.

"An auditing office can have a lot of high-profile clients in a particular industry and still be considered industry-diverse if it also audits clients in a variety of other industries," Goldman says. "And the effect we saw was true for some of these so-called 'industry specialists' – the study wasn't just picking up audit offices that are not industry experts. Similar points can be made for office size, in that we provide evidence that the relation between industry diversity and audit quality exists for both large and small audit offices."

As part of the study, the researchers also considered the possibility that offices are auditing small subsets of clients that form "clusters," rather

than a wide array of random clients in different industries. The researchers found that when a firm's clients included these clusters, the adverse effect on audit quality was reduced. This result suggests that current measures of the expertise of audit offices or firms do not adequately represent the point at which concentrations in an industry benefit audit quality.

"This finding is consistent with the notion that while having an industry diversified client portfolio reduces audit quality for the overall portfolio, isolated improvement can occur for focused subsets of clients," Goldman says.

"This suggests that executives or audit committees looking to improve the quality of financial statement audits do not need to seek the audit office or firm with the most clients in the industry," Goldman adds. "Instead they should consider audit offices or firms that have sufficient knowledge of the industry that can arise from clusters of three or more clients from the same industry."

The paper, "Audit Office Industry Diversity and Audit Quality," is published in the Journal of Accounting, Auditing & Finance. The paper was co-authored by Erik Beardsley of the University of Notre Dame and Thomas Omer of the University of Nebraska.

More information: Erik L. Beardsley et al. Audit Office Industry Diversity and Audit Quality, *Journal of Accounting, Auditing & Finance* (2020). DOI: 10.1177/0148558X20942618

Provided by North Carolina State University