RELATIONSHIP SPECIFIC INVESTMENT, ACCOUNTING CONSERVATISM, AUDITOR CHOICE AND AUDIT FEES: THE EFFECT OF CUSTOMERS AND SUPPLIERS

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This study tries to explain accounting practice using transaction cost economics (TCE) method. Specifically, I investigate how specificity, which is one of the three most important attributes for characterizing transactions (Williamson, 1985) can affect accounting conservatism, auditor choice and audit fees in a setting when customers/suppliers as stakeholders of the firm are included. Although, in the past, ample evidence was provided in economics, finance and marketing trying to explain how governance structure will be influenced by transaction cost. However, ‘Compared to the more extensive treatment in economics and marketing, there are far fewer direct applications of TCE logic to empirical phenomena in accounting. This relative dearth of TCE research is somewhat surprising, given the apparent relevance of accounting phenomena to questions of economic organization and performance. (Marcher and Richman, 2008)’.

On the other hand, while prior accounting researches try to explain and predict accounting choice within the explicit contracts between the firm and shareholders, debt-holders, government, and regulators, little attention has been given to the implicit relationship between the firm and its customers/suppliers. According to the theory of accounting, accounting practice is shaped by a set of explicit contracts between the firm and the shareholders, debt-holders, government, employees, and regulators, as well as implicit claims with its customers and supplies (Sunder, 1997). So far, without considering the effect of customers/suppliers, our understanding of accounting is limited and incomplete. This study aims to address these two limitations with two parts on accounting conservatism and auditing respectively.

The first part of the dissertation investigates whether a firm’s conservative
accounting practice is associated with relationship-specific (RS) investment of its customers/suppliers, the value of which by definition depends upon the future prospects of the firm. Customers/suppliers with RS investment have an asymmetric loss function between overinvestment and underinvestment because of the lack of alternative use of such assets. They hence have an asymmetric demand for timely loss versus gain recognition. Accounting conservatism plays a governance role in this situation through the timelier reporting of bad news than good news. Using asymmetric timeliness and customers/suppliers’ research and development intensity as major proxies for accounting conservatism and RS investment, respectively, I find that at both the industry and firm level a firm’s accounting conservatism is positively associated with the RS investment of its customers/suppliers after controlling for the other conservatism divers and the potential endogenous problem. Further, this relationship is weaker when vertical integration (an alternative bonding mechanism) exists between the firm and its customers/suppliers, the market concentration of the firm’s customers/suppliers is low, or when the firm has a long-term relationship with its customers and suppliers.

The second part examines whether customers/suppliers’ RS investment can create a demand for high quality audit services as either a bonding or signaling mechanism to reduce the agency cost associated with RS investment and whether a fee premium is charged accordingly to compensate the incremental fraud risk associated with the RS investment or due to the limited spillover of the specific knowledge investment made by the auditor. Employing R&D intensity of customers/suppliers (Industries) and auditor’s brand name (big vs. non-big) as proxies for customers/suppliers’ RS investment and audit quality respectively, After controlling for other confounding factors, I find on industry and firm level, firms
with high customers/suppliers’ RS investment are more likely to choose high-quality auditors and pay more audit fees.
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