The joint effects of social identity and institutional pressures on audit quality: The case of the Chinese Audit Industry

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ABSTRACT

This article examines how social identity links institutional pressures and audit quality. Combining institutional theory and social identity theory, we theoretically argue that the interaction between social and institutional forces shapes audit quality. Through an analysis of Chinese audit firms from 2000 to 2007, we show that isomorphic imitation has a more significant effect on firms belonging to the same identity group than firms across cross-identity groups; foreign-affiliated audit firms are more willing to conform to normative pressure from professional networks than local firms; and foreign-affiliated firms are coerced to adapt to the local government’s expectation, particularly when they have a geographically concentrated customer base. We further reveal that a larger customer base attenuates within-identity group imitation but strengthens cross-identity group imitation. The results shed light on the role of social identity in shaping conformity in the audit industry, thus contributing to international convergence-divergence literature and institutional theory.

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1. Introduction

International convergence of structures, processes, and practices has been suggested by a small but increasing stream of literature in the field of management, such as human resource management (HRM) (e.g., Rowley, Benson, & Warner, 2004; Zhu & Warner, 2000), business ethics and corporate governance (e.g., Brandau, Endenich, Trapp, & Hoffjan, 2013; Davis & Greve, 1997; Long & Driscoll, 2008), internationalization (e.g., Brown, 2011; Davis, Desai, & Francis, 2000), and marketing (e.g., Brouthers, O’Donnell, & Hadjimarcou, 2005; Deligonul, Élg, Cavusgil, & Ghaouri, 2013; Hillebrand, Nijholt, & Nijsen, 2011). Mainly based on institutional theory, various studies have shown that coercive, normative, and mimetic pressures generally lead organizations to become convergent in their practices around the world (e.g., Ahlstrom & Bruton, 2001; Björkman, Smale, Sumelius, Suutari, & Lu, 2008; Brandau et al., 2013; Farndale & Paauwe, 2007; Huo, Han, Zhao, Zhuo, Wood, & Zhai, 2013), the process of which is defined as isomorphism (DiMaggio & Powell, 1983, 1991). Recent studies show that firms typically receive behavioral cues from and experience multiple institutional prescriptions projected by different audiences (Greenwood, Raynard, Kodeih, Micelotta, & Lounsbury, 2011; Greenwood & Meyer, 2008), and thus their practices remain divergent under the influence of institutional pressures (Hannon, Huang, & Jaw, 1995; Kraatz & Zajac, 1996; Marquis & Lounsbury, 2007; Purdy & Gray, 2009). To explain the divergence of organizational practices among firms in a field, prior research has investigated how various firm- and macro-level economic features shape firms’ responses to institutional pressures (Kraatz & Moore, 2002). For example, Marquis and Tilsik (2013) show that firm size and macro-environmental uncertainty moderate firms’ choice of philanthropic contributions when facing industry and community institutional pressures. Li and Parboteeah (2015) find that home country culture affects a firm’s mimetic behavior as a response to institutional influences.

A shortcoming of these studies is that they primarily focus on firms’ economic features while ignoring the social features. In particular, firms are embedded in social structures, as well as different social groups, and their social characteristics also significantly shape their strategic behavior (Rao, Davis, & Ward, 2000; Rao, Monin, & Durand, 2003). For example, firms may actively assess the consistency or conflicts between institutional pressures and their identity, so as to decide how much they conform to or resist institutional pressures. However, most previous studies either combine too many firms from different
social groups, without distinguishing among them, or analyze a homogenous sample (Davis, Diekmann, & Tinsley, 1994; DiMaggio & Powell, 1983; Henisz & Delios, 2001). Such neglect of possible heterogeneity of sub-groups may contribute to the mixed results of firms’ convergent practices under institutional pressures.

Given the social identity differences, how do firms respond to institutional pressures? We explore this key question herein by combining social identity theory and institutional theory. We argue that every firm is attached to certain membership groups in which they must conform to the respective group codes to validate their identities and practices to internal and external stakeholders (Rao et al., 2003; Rao, Monin, & Durand, 2005). Such effort of validating identity will strengthen firms’ conformity to institutional pressures when their identity code and the institutional pressures align; otherwise, firms’ conformity to institutional pressures will be mitigated. Moreover, we argue that the social identity-based reaction to institutional pressure is refined when firms build up their customer base. As a firm increases its customer base, the urgency to validate social identity will diminish. The firm’s ability to hold its social identity will strengthen when its customer base is geographically diverse. Accordingly, the firm will refine its social identity-based reaction to institutional pressure.

The audit industry in China offers a unique setting to examine the contingent effects of social identity and institutional pressure. China has an institutional environment characterized by both unpredictable and inefficient bureaucracy (Ando & Ding, 2014; Bruton & Ahlstrom, 2003; Chan, Isobe, & Makino, 2008; Khanna & Palepu, 2000) and an open economy that welcomes foreign investment (Buckley & Ghauri, 2015). Such an institutional environment implies that the government dominates one set of institutional arrangements among local audit firms while foreign-affiliated audit firms link their Chinese activities to a set of more market-based institutions located offshore (Fuller, 2010). This situation creates divergence of audit practices among ownership identity groups but convergence within identity groups. Accordingly, we use a sample of audit firms in China from 2000 to 2007 and identify two social identity groups (i.e., foreign-affiliated audit firms and local audit firms) to examine how audit firms bearing different identities respond to mimetic, normative, and coercive pressures.

Our results firstly contribute to the literature on institutional theory and social identity theory. We identify social identity as the contingency to explain firms’ divergent reactions to the same set of institutional pressures. We show that within the observed period, firms from different identity groups respond to institutional pressures differently, while those from the same identity group respond in a similar way. Such selective isomorphism is due to the alignment between institutional pressures and social identity. Moreover, we take a more dynamic view and show that as an audit firm grows its market, it refines its social identity–based reaction to institutional pressure. Second, our findings contribute to the ongoing international convergence–divergence research in management studies and international business studies. We reveal the limited convergence toward standardized audit service quality in China due to the audit firms’ concerns with maintaining their social identities, which serve as an important marketing cue to cater to their target market segment. In this sense, the convergence–divergence decision is actually an adaptive strategy carrying significant marketing implication for both foreign and local players.

We begin the following sections with a review of a conceptual development, after which we present the empirical context in which we define the two identity groups in the Chinese audit industry. We then develop our hypotheses and discuss the methodology and results. We conclude by presenting the main findings, identifying the contributions to multiple disciplines, and discussing limitations and future research avenues.

2. Literature review and conceptual development

2.1. Integrating institutional and social identity theories

Institutional theory is one of the most important theories to explicate the ongoing international convergence–divergence debate in management and international business literature (Beckert, 2010). Institutional theory contends that three types of institutional pressures in the environment shape firms’ strategic behaviors: coercive, mimetic, and normative pressures (DiMaggio & Powell, 1983). One school of thought assumes that firms’ practices will show similarity along the evolution (isomorphic process) when they face similar institutional pressures (Kostova, Roth, & Dacin, 2008). Thus, institutional pressures are equally effective among firms in enforcing conformity and finally lead to convergent practices in the field (Greenwood & Suddaby, 2006; Lounsbury, 2002; Purdy & Gray, 2009). Another school argues that divergent practices remain contested in the field under institutional pressures (Marquis & Lounsbury, 2007; Purdy & Gray, 2009), such that the three types of pressures convey different courses, respectively (Purdy & Gray, 2009). Such logic to explain the divergence of firms’ practices rests on an important assumption—only one clear-cut course is prescribed by one type of institutional pressure, and therefore all firms follow that course. However, one type of institutional pressure may prescribe more than one course. Moreover, even if there is one clear-cut course, not all the firms take that course at the same rate or to the same extent, particularly before the isomorphism process has come to the stable phase. For example, upon KFC’s initial introduction to the Asian market, opposite mimetic pressures simultaneously came from some consumers who always go to KFC and some who never go to KFC. In this situation, different sets of peers offer different behavioral cues for mimicry (Greenwood et al., 2011). Institutional theory has little power in further differentiating the conditions under which consumers will conform to or resist mimetic pressure.

Social identity theory may help address this gap. Social identity of an organization refers to the social group to which it is assigned. It entails codes of conduct, beliefs, and practical guidelines that specify the features an organization is expected to possess (Hsu & Hannan, 2005). It also influences an organization’s features and actions through two channels: self-enforcement and consumer preference (Rao et al., 2000, 2003). On the one hand, internal audiences (e.g., shareholders, managers, employees) voluntarily adopt the social identity codes to self-justify and validate their existence and decisions and to minimize decision-making costs and uncertainty (Haveman, 1993). A positive “self-enforcement” effect on organizational practice is created (Weber, 1978). On the other hand, to cater to external audiences’ expectations (“customer preference”) of its identity, an organization must adopt the identity codes, or else customers may devalue and be less attracted to the organization (Hsu, 2006).

As a result, social identity serves as a mechanism of legitimization because organizations tend to behave in ways that fit their assigned social category (Hsu & Hannan, 2005). Thus, a firm’s social identity will dictate whether it will conform to the course prescribed by one type of institutional pressure. The effect of institutional forces is reinforced when these forces prescribe the same behavior as a firm’s social identity but is weakened when the behavior dictated by institutional forces contradicts a firm’s social identity. Continuing with the previous example, upon KFC’s entry into Asian countries, consumers who assign themselves with international identity will favor the Western culture and follow the mimic pressure to go to KFC, while consumers who assign
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