27 - 29 November 2026 Vienna , Austria

The Implication of Cost from Acquiring Client Specific Expertise for Audit Quality and Auditor Specialization

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Abstract

We theoretically analyze auditor competition in a setting where audit costs are determined by auditee characteristics, auditor capability, and auditor expertise. We show that variation in client characteristics and the cost of acquiring client-specific expertise are key factors that allow auditors with different capabilities to coexist in the same market and encourage auditor specialization. Auditors with different capabilities tend to specialize in distinct client niches. Each auditor provides the highest audit quality within its chosen niche, while quality declines as clients' characteristics diverge from those of the auditor's niche clients. More capable auditors have an inherent advantage in selecting their niches and consequently earn higher profits. In equilibrium, each auditee receives the highest attainable net value from its auditor and cannot benefit from switching to a more capable auditor. Although the maximum audit quality provided by a more capable auditor exceeds that provided by a less capable auditor, more capable auditors do not necessarily deliver higher quality to every client than less capable auditors deliver to their respective clients.

Keywords: Auditor Capability, Auditor Expertise, Auditee Diversity, Auditor Competition, Audit Pricing, Audit Quality