

**Organizational Identity and Evolutionary Duality of Service Firms  
in Emerging Markets**

(Short version)

Pengji WANG

Lecture, Business

JCU Singapore

Iris Lin YUAN

Assistant Professor, Management

University of Macau

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## **Abstract**

In this paper, we integrate social identity theory and institutional theory to emphasize the identity-based conceptualization of organizational forms and the change of social identity as the key to evolutionary changes. Theoretically, we develop the concept evolutionary duality, which is the coexistence of institutionalization and deinstitutionalization at the same time among firms with different identities. We test our hypotheses on a unique and comprehensive panel dataset including 3164 listed Chinese firms audited by the top100 largest auditors in China between 2002 and 2008. We find that audit firms with different organizational identities exhibit distinct trends of audit quality evolution during the sample period, based on their identity group's legitimacy. We also find that the influence of organization identity is attenuated by some internal and external factors, such as the focal auditor's own market strength, the local government's ideology and the involvement of local partners.

**Key Words:** Organizational identity; Evolutionary duality; Audit quality

# **Organizational Identity and Evolutionary Duality of Service Firms in Emerging Markets**

## **Introduction**

Do different types of institutional changes coexist at the same time? How do organizational identity and instrumental factors influence institutional change jointly? These questions are the focus of our study.

The topic of institutional change has been at the center of a growing literature in both organizational theory and sociology theory fields (Dillard, Rigsby, & Goodman, 2004; Lawrence, Winn, & Jennings, 2001; Oliver, 1992; Rao, Monin, & Durand, 2003). Institutions are the rules of a game, or more formally, are human produced or enacted constraints and governance structures that shape human interactions (McAdam & Scott, 2002; North, 1990). The change of institutions shapes the way of organizational evolution overtime, and hence is important to understand both organizational and social change (North, 1990). The literature has identified two types of institutional change: (1) institutionalization, which is the formation of institutions; and (2) deinstitutionalization, or the dissolution of existing institutions (DiMaggio & Powell, 1983; Oliver, 1992; Powell & DiMaggio, 1991). Recent studies paid attention to the temporal characteristics of institutionalization, and depicted the process of institutional change as a continuous process which starts with institutionalization and followed by deinstitutionalization (Dillard et al., 2004; Lawrence et al., 2001). Although these studies have tried to combine institutionalization and deinstitutionalization to highlight their time consequence, the coexistence of these two types of institutional changes at the same time has not been studied yet. We argue that organizations with different characteristics may be influenced by different institutional environment factors, and hence may evolve towards different directions. As a consequence, institutional change towards dual directions becomes feasible. We term the dual directions of institutional change and evolution as evolutionary duality.

As for the antecedent of the institutional change, prior studies have emphasized the impact of external and internal factors (DiMaggio & Powell, 1983; Kraatz & Moore, 2002; Oliver,

1992). The examination of external factors answers the question of “where we are” by looking at how the organization adapts to the external environment. It emphasizes the impact of external stakeholders such as authorities, competitors, customers, social media on institutional changes (DiMaggio & Powell, 1983; Oliver, 1992). The investigation of internal factors answers the question of “what we have”. It examines how the resources and the capability of the organization, such as strategic goals, political power, experience, technical capabilities, etc, shape its institutional change (DiMaggio & Powell, 1983; Kraatz & Moore, 2002). However, the literature ignored one important factor- the organizational identity, which answers the question “who we are as an organization”.

To address this notable gap and to better understand how the evolutionary duality forms, in this study we connect to the social identity theory (SIT) in sociology literature, which emphasizes the identity-based conceptualization of organizational forms and the change of social identity as the key to social movement (Hsu & Hannan, 2005; Mamatoğlu, 2010; Rao, Monin, & Durand, 2005). The organizational identity enforces a code of conduct to the organizations, shapes their culture, and promotes changes in their practices (Rao et al., 2003, 2005). It works as a filtering, screening or sorting device through which various kinds of information pass and take on meaning (Smith, 2011). Therefore, equivalent information may be differentially interpreted and reacted to by organizations with dissimilar identities (Smith, 2011), which implies that organizational identity affects the way organizations interpret and respond to internal and external factors. Consequently organizations with distinct identities may behave differently during evolution. However, prior studies have devoted little attention to the contingent effect of the identity factors (Rao et al., 2003). Thus, it is not only appropriate but also important to integrate SIT and institutional theory together and investigate the effect of internal and external factors and organizational identity jointly.

Empirically, we use the sample of audit firms in China from 2002 to 2008 to study the trend of variation of their service quality. Based on the SIT literature, we identify three identity groups- the higher status group, foreign affiliated auditors (FAAs); the lower status group, permanent local auditors (PLAs), and the group which is in the process of straddling from the lower status group to a higher one, temporal local auditors (TLAs) - and examine the contingent effect of identity on the evolution of their service quality.

More specifically, we illustrate that audit firms from different identity groups exhibit distinct trends of service quality evolution during the same period of time by referring to the identity-based legitimacy. The audit firms who hold a relative stable identity tend to imitate their own group's behavior, rather than following other group's behavior codes; while those with an intention to upgrade their identity imitate the higher tier group's behavior rather than their own group. The findings suggest that it is important to introduce the identity-based grouping and note the inconsistent evolutionary trends across different identity groups. Moreover, we find that external and internal factors, such as the pressures from local government and local partners who possess different views on the organizational codes, and the focal auditor's own market strength, may attenuate the effect of identity-based legitimacy. Our findings thus show the conditions under which the same identity may generate evolutionary differentiation, and hence enlarge the reach of SIT and institutional theory.

In the next section we first discuss the theoretical background and empirical context. Then we develop our hypotheses, followed by a discussion about the methodological aspects of the study and the results of data analyses. The concluding section summarizes the key conclusions and contributions of the study.

### **Theoretical Background**

Institutional theory (DiMaggio & Powell, 1983; DiMaggio & Powell, 1991; Meyer & Rowan, 1977; Zucker, 1977) concerns about the development of the taken for granted assumptions, beliefs and values underlying organizational characteristics and practices and is becoming a dominant theoretical perspective in organization theory research (Dillard et al., 2004). Early studies of institutional theory focused on the conceptualization and influential factors of institutionalization. For example, Zucker (1977) understood institutionalization as a process by which individual actors transmit what is socially defined as real and right as the codes to shape their behaviors. Powell and DiMaggio (1991), held the belief that isomorphic change may lead the organizations to be more homogenous in structure and behavior. Several organizational level and field level factors such as resource independence and technology uncertainty may predict isomorphic change of organizations.

The landmark study of Oliver (1992) drew the scholar's attention from institutionalization

to deinstitutionalization. She stated that “deinstitutionalization refers here to the erosion or discontinuity of an institutionalized organizational activity or practice”. Oliver (1992) identifies a set of organizational and environmental factors as antecedents of deinstitutionalization, including political pressures, functional pressures and social pressures. Since the publication of Oliver’s (1992) paper, the theory of deinstitutionalization has been widely used to understand regressive evolution of organization. For example, Davis, Diekmann, and Tinsley (1994) used deinstitutionalization to examine the de-conglomeration among Fortune 500.

While early studies paid attention to either institutionalization or deinstitutionalization, recent studies combined these two views and depicted institutionalization as a continuous process whereby institutional practices are established, transposed and decomposed. Several studies have made contribution to this stream. Examining the temporal characteristics of the phenomenon of institutionalization, Lawrence et al. (2001) pointed out a typical pattern of institutionalization process: (1) initial phase of innovation involving few actors; (2) phase of rapid diffusion; (3) saturation and complete legitimization stage and (4) deinstitutionalization phase. Based on institutional and structuration theory, Dillard et al. (2004) developed a framework of the institutionalization processes: creating, adopting and discarding institutional practices.

Although the literature has made some improvement to integrate the institutionalization and deinstitutionalization, the scholars still view institutionalization and deinstitutionalization as a multiple choice question: either A or B at one point of time. The underlying assumption is orthogenesis, that evolution has an inherent directionality toward a certain form (usually the form of improvement or perfection) among all the firms. However, with the recent organizational development such as internationalization and diversification, firms become more diverse. The external environment conditions may exert different influence on firms’ development, which is contingent on firm’s own organizational identity. As a result, firms may exhibit changes toward different directions, which we term as evolutionary duality. There have already been such cases. For example, some firms choose to be more and more focused (i.e., deconglomerate), while others choose to develop towards the direction of conglomerate (such as the Asian family business).

In this paper, we connect to SIT to explore the coexistence of institutionalization and

deinstitutionalization of organizational practice. SIT suggests that individuals categorize themselves and others into social groups by identity (Tajfel & Turner, 1986). While the study of identity on individual level of analysis can be traced back many centuries, the concept of organizational identity dates back only a couple of decades (Hatch & Schultz, 2004). Over the last few years, practical and academic interest in organizational identity has grown substantially (Ackerman, 2010). Organizational identity comprises a perception of an organization's features and actions by internal and external audiences, with identity being a source of legitimacy if it fits within a recognized and clearly defined category of organizations (Hsu & Hannan, 2005). Ackerman (2000) defined it as the unique combination of characteristics that reveals an organization's value-creating potential. Therefore, organizational identity has important effect on the future development of the organization (Ackerman, 2010), such as its strategy and change management (Ackerman, 2000; Gioia & Thomas, 1996; Lawler & Worley, 2006).

We argue that organizational identity affects the evolutionary trend of an organization for two reasons. First, organizational identity, which is segregated and defined by categorical boundary (Rao et al., 2005), entails a code of conduct, or sets of rules, specifying the features that an organization is expected to possess (Hsu & Hannan, 2005). The codes form the belief systems that furnish guide lines for practical action (Friedland & Alford, 1991), and governance structures that consist of the arrangements by which field-level power and authority are exercised (Rao et al., 2003). Therefore, group members within different categorical boundary may conform to different codes of conduct, follow various conducts, and hence evolve towards different evolutionary route.

Another important reason of different behavior of organizations with different identities is the audience members' perception toward their identities. An audience member's perception for a category label characterizes the meaning attached to the label (Negro, Hannan, & Rao, 2010). Prior study argued that if the audience members' perception of an organization's behavior does not fit with its identity, then audience members will devalue the organization and be less attracted by the organization (Hsu, 2006). It implies that to attract more customers, the organization's strategic choice will be limited by its identity value perceived by the customers. For example, customers may associate chocolate producers from European countries with best product quality and high price, while products from emerging markets with low quality and low

price (Deshpandé, 2010). Hence it will be difficult for a firm from Venezuela (a firm embracing the identity of producer from emerging markets) to hire the high quality- high price strategy (Deshpandé, 2010). To be more precise, the strategy of an organization will lead to high performance only when it fits its perceived identity. In terms of conflicts between their strategy and perceived identity by customers, organizations have to either abandon their current strategy or struggle to change their perceived identity. So how organizations present themselves to external audiences is critical (Gioia, Price, Hamilton, & Thomas, 2010). Due to the above two reasons, we argue that organizational identity may entail identity-based legitimacy on the organizations, which leads the organizations bearing different identities to evolve towards different directions.

Although institutional analyses of companies have emphasized a lot of driving factors of institutionalization and deinstitutionalization, they have devoted little attention to organizational identity, and hence neglected the different evolutionary trends among organizations with different identities. We argue that it is necessary to define categorical boundaries to label organizational identities first, and then study the evolutionary duality among identity groups. Moreover, we also argue that organizational identity is dynamic, not fixed (Ackerman, 2010; Empson, 2004). The organizational identity change usually occurs in conjunction with other major changes, such as environmental change (e.g., pressure from intense competition), or the creation of a new vision of the organization (Gioia et al., 2010; Ravasi & Schultz, 2006). The shift of identity means the organization will be disciplined by a different set of conduct code, and the expectation of clients towards their behavior will also change. Therefore, organizational identity shift may change the organization's evolutionary trend.

**\*\*\*The Empirical Context Section is not included due to paper limit\*\*\***

## **HYPOTHESES**

### **Identity-based Legitimacy**

#### **Identity and Evolutionary Trend**

In the first set of hypotheses, we investigate how the identities of auditors shape their evolutionary trend in terms of audit quality. We first examine the evolution of FFA groups.



In the early stage of entry, the FAAs will establish their high-status position and are reluctant to offer low-quality auditing service due to multiple pressures. First, the FAA has to strive for internal legitimacy required by the headquarter in its home-country (Miller & Pisani, 2007). The headquarter of international auditor has a consistent global arrangement for operation in international market. Prior studies have given evidence that international auditors can charge a premium for auditing fees because of their international reputation (Firth, 1997). When they themselves or their clients get litigated, their reputation gets hurt and their auditing fees in the future are negatively affected internationally (Firth, 1997; Ireland & Lennox, 2002). As a result, the headquarter of an international auditor usually rules its member firms to provide high-quality auditing service, in order to set up a good international image (DeAngelo, 1981). Providing high-quality auditing service thus is the global strategy employed by those international auditors. Such a global strategy becomes an internal legitimacy for the local affiliations to conform to. The local affiliations have more incentive to submit to internal legitimacy especially during their early years of operation in a new country, when the local affiliations are more physically attached to headquarter since they may need more resource commitment and support from headquarter (Luo, 2003). Second, FAAs have to seek for external legitimacy upon its entry into the new foreign market. FAAs face the liabilities of foreignness and newness at entry (Lu & Beamish, 2006). The liability of foreignness and newness places foreign subsidiaries in a disadvantageous position in competition with local firms, who are familiar with the local environment and have established good connections with local clients (Lu & Beamish, 2006). To overcome the disadvantages compared with the local auditors and gain legitimacy from the clients, the FAAs have to identify and build up some unique competitive advantages. Many FAAs choose good reputation associated with high audit quality and professional knowledge as their selling point in emerging market upon entry (Dopuch & Simunic, 1980; DeAngelo, 1981; Francis, Maydew, & Sparks, 1999). As a result, the international auditing partners are motivated to leverage their human resources and professional knowledge to increase their local affiliations' audit quality and set up their brand image in the new market.

However, in the long-term, such high-quality practice may not sustain. First, once FAAs have set up a good brand image and achieved a large market share in the host country, their

dependency on its home-country and headquarter will decrease, and hence are less motivated to comply with the internal legitimacy of providing high-quality auditing service (Miller & Pisani, 2007). Second, in the local market, the sheer prevalence of high-quality practice by FAAs has created taken-for-granted understandings about their image by local stakeholders, including regulators, clients, media and so on, and shaped legitimated identity of FAAs' group (Scott, 2001). The perception towards FAAs' identity group by the public will not be contaminated immediately and easily (Rao et al., 2005), even when FAAs reduce their audit quality gradually. Hence, the FAAs could provide localized auditing service to cater for the local client which prefers lower quality auditing while still enjoying the legitimacy (Francis et al., 1999).

We further argue that the strategy of reducing audit quality may help FAAs achieve higher market share and higher financial performance. Prior study found that earnings management is rampant and that CEOs view earnings management as a reasonable mechanism to ensure that their company meets the market's expectations (Loomis, 1999). Therefore, the client companies may be searching for a lower audit quality to facilitate earnings management (Davidson Iii, Jiraporn, & DaDalt, 2006). A lower audit quality likely reduces the quality of information that reaches financial markets, and hence leading to increase in asymmetric information, which may benefit the client company (Davidson Iii et al., 2006). As a result, reduced audit quality may enlarge FAAs' client base. Since their name and reputation has been recognized by the market, they could continue to charge high audit price and earn audit premium in the country (Yang, Dunk, Kilgore, & Lin, 2003). In summary, we propose that by reducing audit quality, the focal FAA can achieve higher financial performance over its rivals. Hence we propose that,

*H1a: In emerging market, the audit quality of FAAs will increase in the short-run, but decrease in the long-run.*

*H1b: In emerging market, lower audit quality of FAAs will lead to higher relative financial performance.*

Compared to local audit firms in emerging markets, the FAAs possess superior knowledge and international reputation. Their entry in emerging markets poses challenge to the survival of local audit firms (Lan, Georgakopoulos, Sotiropoulos, & Galanou, 2010; Suyanto, Salim, & Bloch, 2009; Yang et al., 2003). For example, by the end of 1997, foreign affiliated audit firms had acquired nearly 10 percent of the Chinese auditing market with this participation to be

growing (Yang et al., 2003). Moreover, the entry of FAAs leads to changes in the institutional environment in domestic markets, such as the increase of average cost of production of domestic firms through “market stealing” phenomenon (Aitken & Harrison, 1999). The unexpected changes in the environment which shift existing market power distribution and portend domestic audit firms’ failure or obsolescence may cause domestic audit firms to reevaluate their current practice (Oliver, 1992). Since the clients usually associate the identity of “local audit firm” with low reputation, it prevents local audit firms from charging high audit price and earning audit premium (Yang et al., 2003). Thus under the social pressure, the low-bailing and earnings management practice that violates generally accepted accounting principles becomes common among PLAs (Noronha, Zeng, & Vinten, 2008). The low-quality-low-price strategy also fits clients’ expectation of domestic firms’ identity. We thus predict that using these unethical measures, PLAs could retain or increase their client base, and hence improve their financial performance relative to their rivals (Lan et al., 2010). However, as we have argued, the entry of FFAs squeezed domestic firms’ market share, and posed challenge to their survival. Therefore, the financial performance of PLAs relative to their competitors may decrease overtime after the entry of FFAs. Hence, we propose that

*H2a: In emerging market, the audit quality of PLAs will decrease over the time after the entry of FAAs into domestic market.*

*H2b: In emerging market, the relative financial performance of PLAs will decrease over the time after the entry of FAAs.*

*H2c: In emerging market, low audit quality of PLAs will lead to higher relative financial performance.*

### **Transitional Identity and Evolutionary Trend**

Prior studies found that organizational identity is inherently dynamic and unstable (Ackerman, 2010; Empson, 2004; Rao et al., 2005). The changing of organizational identities is an integrating process, during which the organization suspends its preexisting organizational identity and works toward creating a new identity emerges (Clark, Gioia, Ketchen, & Thomas, 2010; Empson, 2004). Prior research identifies it as “transitional identity”, which is an interim sense held by members about what their organizations is becoming (Clark et al., 2010).

The transitional identity evolves to allow a firm to meet changing conditions in the market

(Ackerman, 2010). Institutional changes in the emerging markets caused by the entry of FAAs may lead to identity change of some local audit firms (TLAs), which choose to be affiliated with international audit firms by becoming a member firm in the network of international auditor.<sup>1</sup> In such a network, all the members recognize that they share a similar client base and are co-specialized to bring a unique value-added capability, such as a knowledge resource or market access, to the network (Brown, Cooper, Greenwood, & Hinings, 1996; Koza & Lewin, 1999). All the member firms should attempt to achieve a common strategy, a common image, and consistent service standard (Brown et al., 1996). Hence, the selection of potential affiliation by international audit firm is strict, especially in emerging market where audit firms are characterized by lower service quality and a lack of reputation. To successfully transform their organizational identity from a lower status group to a higher status one, the TLAs would improve their current practice and demonstrate their partner firm an idealized image by maximizing perceived similarities and minimizing perceived differences between themselves and the behavioral code of the higher status group. For example, they may develop a set of forms and a procedure for a more formalized client service approach program to meet the common standard of international audit firm (Brown et al., 1996). Before the affiliation, or in another word, identity transforming, TLAs may refer to the behavioral code of FAAs and continuously strive to set up a good reputation by improving their audit quality.

Although the TLAs expect the strategy of establishing a good reputation should enable them to change their identity and hence enable them to charge a high audit fee and earn audit premium in the long term (Yang et al., 2003), in the short term, clients still tend to perceive them as low-status member and associate them with low quality audit service for two reasons. First, firms usually released the news of affiliation after successfully forming the partnership. Before that, the clients may still view TLAs as pure domestic audit firms, whose audit quality and service charge should be low. Second, audiences may not immediately accept the identity change of the focal firm even they have observed such change. Before the prevalence of such practice among all the domestic firms, the struggle of identity change may lead to negative evaluation by the audience (Rao et al., 2005) since offering high quality audit service

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<sup>1</sup> This membership structure is a typical organizational form among large international audit firms. Prior studies use the concept of strategic alliance network to denote this organizational form.

contradicts the TLAs' identity perceived by clients. Clients are not willing to pay high price to buy their service. In the meantime, TLAs' market share is squeezed by the FAAs who are competing for the same group of clients. Therefore, TLAs' financial performance relative to their rivals will decrease over the time after the entry of FAAs. Higher audit quality of TLAs will lead to lower financial performance. We hence propose that:

*H3a: In the emerging market, the audit quality of TLAs will improve over the time after the entry of FAAs into domestic market.*

*H3b: In the emerging market, the relative financial performance of TLAs will decrease over the time after the entry of FAAs.*

*H3c: In the emerging market, higher audit quality of TLAs will lead to lower relative financial performance.*

### **Construction of Identity Legitimacy through Inter- and Intra-group Imitation**

According to SIT, firms within the same category or group will have a dominant norm of conduct, or sets of rules, specifying the features that an organization is expected to possess (Campbell, 2003; Hsu & Hannan, 2005). An observed violation of a code generally causes an audience to devalue the organization (Hsu & Hannan, 2005). Hence, these code of conduct or sets of rules enforce the group members of this category to follow similar conduct. Institutionalisms also argued that organizations tend to become isomorphic (or in another words, be similar) to attain legitimacy within their environments (DiMaggio & Powell, 1983). Among the three types of institutional isomorphisms, mimetic isomorphism is most frequently used to explain the strategy of firms to tackle with uncertainty (Greve, 2000; Henisz & Delios, 2001). Consistent with those arguments, some literature shows that MNCs will imitate their peers' strategy to counter uncertainty when making a decision on international expansion (Henisz & Delios, 2001). Imitation allows MNCs to fill gaps in specialized capabilities by tapping into the collective wisdom of other firms (Brouthers, O'Donnell, & Hadjimarcou, 2005) and to minimize their decision-making costs (Haveman, 1993).

Based on SIT, we argue that the strategies employed by most FAAs shape the dominant institutional norms of the group, which the focal FAA will have to conform to. In the short term, the focal FAA may imitate other FAAs' strategy in the same region, i.e., offering high quality audit service to set up their reputation, since they compete for the same set of clients. Violation

of this group code will hinder the focal FAA to set up its reputation, and hence even jeopardize being recognized as a member of high status group. In the long term, other FAAs may lower their audit quality to attract more customers. As a consequence, the potential clients may perceive the lower audit quality as behavioral code of FAAs' identity group. Since the customers may expect all the FAAs to behave similarly, the focal FAA will have to follow this strategy as well in fear that they may lose potential customers due to violation of audiences' perception of their identity group. Hence, we propose the following hypothesis:

*H4a: In emerging market, the audit quality of the focal FAA is positively related to the average audit quality of other FAAs' in the same region.*

A focal firm's incentive to imitate the identity group's behavior code may be attenuated as it gains more capability to challenge the existing dominant norm. As the focal FAA has gained more clients, it can gain more knowledge about the customers, which the focal FAA may assimilate into its knowledge base towards creating and maintaining unique competitive advantages. This could gradually improve a firm's own routines and help the firm to develop new knowledge and capabilities necessary for survival (Fiol & Lyles, 1985; Uotila, Maula, Keil, & Zahra, 2009). The perceived utility of mimicking other group members' practice code deteriorates (Oliver, 1992). Moreover, due to requirement for greater adaptability and differentiation, the focal FAA is more willing to challenge the code of its categorical group by emphasizing its uniqueness, and hence will exhibit less imitation. Thus we expect that larger clients portfolio reinforce FAAs' ability to challenge and change existing group code, which will attenuate within group imitation.

*H4b: In emerging market, the client portfolio will moderate the relationship between other and the focal FAA's audit.*

The entry of FAAs and the changes in the market environment caused by their entry are unexpected and irrefutable events for domestic audit firms, and as a result, imply more uncertainties for domestic audit firms. When the processes and strategies for achieving goals become unclear, the focal domestic firm may tap into the collective wisdom of other domestic firms to fine-tune or re-establish its practice. Since the group straddling of TLAs cannot be identified by either the clients or the other audit firms until it releases the news to public, the PLAs may address the uncertainty in the environment by benchmarking both PLAs and TLAs

(as the domestic auditor group). On the other side, the clients may perceive the code of domestic audit firms based on the common behavior and strategy of PLAs and TLAs. In turn, the clients' perception may discipline the audit firms (Hsu, 2006; Rao et al., 2003, 2005). They only recognize and value the audit firm which fits such code, while giving negative evaluations to the violation by a focal firm (Negro et al., 2010; Rao et al., 2005). Moreover, due to the need of intimacy of supplier and demander in the production-delivery process in service industry, the service firms are likely to be restricted by the geographic market segment (Carman & Langeard, 1980). Hence domestic audit firms in the same geographic region are more likely to be compared by the same clients base. As the result, PLAs are more likely to imitate the domestic auditors in the same region in fear of losing potential customers.

By comparison, although the rival group (the FAAs' group) may influence PLAs through competition, the influence of FAAs' practice code will be less significant than the category code of the domestic firms. Due to the competitive disadvantage of PLAs such as lack of international reputation, they are less able to imitate FAAs' practice. The clients may also differentiate FAAs from domestic audit firms group, and have different understanding and expectations towards their behavior. Hence, we propose that the focal PLA will imitate other PLAs and TLAs more than FAAs, especially those in the same geographic region.

*H5: In emerging market, the average audit quality of PLAs and TLAs in the same region will have a stronger positive effect on the audit quality of the focal PLA than the average audit quality of FAAs in the same region does.*

TLAs are the audit firms who will straddle from a lower status group to higher one. Except for the competition with FAAs, an important uncertainty facing by firms holding transitional identities is whether they could clarify the ambiguity in their identity and successfully upgrade their identity. Scott (2001) proposed that mimetic mechanisms provide a cognitive foundation for the construction of identity. As we have argued before, one important prerequisite of such identity transition is to improve their audit quality according to the standard of FAAs, or in another word, the behavioral code of FAAs' identity group (Although the FAAs' audit quality may decrease in the long-term, in general their audit quality is still much higher than the domestic firms.). Hence, prior to the group straddling, the influence of code of lower status group (domestic firms as a whole, since the focal TLA is not able to identify other TLAs from

PLAs) is less significant than the influence of higher status group. Imitating the strategy of FAAs may reduce the uncertainty of identity change process. Therefore, we propose that,

*H6: In emerging market, the average audit quality of FAAs in the same region will have a stronger positive effect on the audit quality of the focal TLA than the average audit quality of TLAs and PLAs in the same region does.*

### **External and Internal Factors Distorting the Identity Legitimacy**

The identity-based legitimacy may be deformed by the pressures from external and internal stakeholders of the organizations. In this set of hypothesis, we focus on FFA group, identify local government and individual partners as two of the most important external and internal stakeholders, and investigate how the two factors distort FAAs' identity-based strategy.

#### **Government Intervention**

Pressures from external stakeholders can cause organizations to question the necessity or appropriateness of maintaining an existing organizational practice (Oliver, 1992). The need for resources, including financial and physical resources as well as information, obtained from the external stakeholders, makes organizations potentially dependent on them (Pfeffer & Salancik, 2003). In emerging economies such as China where the market is underdeveloped, the local government is such an important external stakeholder who could provide resources and exert pressure on organizations. For example, when operating their business in emerging economies, FAAs are subject to the pressure from local government as they may depend on local government for preferential treatment, including client source, tax reduction, human resource, low-cost property, quick approval procedure, and other resources (Boycko, Shleifer, & Vishny, 1996; Kornai, 1979, 1980; Shleifer & Vishny, 1994). These preferential treatments enable FAAs to overcome the liabilities of foreignness compared to the domestic firms and gain competitive advantages. Hence, they have to adjust their strategy according to the local government's preference.

The local government's preference is represented by its goal to keep the listing quota and listed firms' income within its regimen. Such a goal is triggered by the facts that (1) listing quota can bring low-cost financial resources from the stock market and is a valuable resource



particularly under the tight listing quota system<sup>2</sup>; (2) listed firms are usually the engine to promote local economic growth and stability, and thus reflect the local government officials' political achievement (Mooderjee & Yu, 1999). To achieve such a goal, it is not uncommon that the local government pushes FAAs to help with the listed firms' earnings management. For example, Chen, Li, and Lee (2003) gave evidence that local governments often help firms to polish their financial reports by providing subsidies. Dai, Lao and Yang (2000) and Chan, Lin and Mo (2006) found that in China, local government often pushes local audit firms to allow local listed firms not to disclose earnings manipulation to the CSRC. In a word, the local government can shape the auditor-client relationship in a much more salient way in the relationship-based Chinese environment than in the market-based US environment (Choi, Kim, Qiu & Zang, 2006). Such an intervention in the audit practice of domestic firms has a long history (Yang et al., 2003). Therefore, the local government intervention is less likely to change their behavior as compared to FAAs, whose behavioral code conflicts with government's need. Hence, under the sovereign of local government, FAAs have to adjust their strategies associated with the high-status by lowering their audit quality. Accordingly, we propose,

*H7a: In emerging market, more local government intervention will trigger the FAAs to reduce their audit quality.*

According to Oliver (1992), if an organization's continuity of a practice is sustained by the demands or expectations of an external stakeholder, the perceived institutional value of an established practice is likely to erode if the organization's dependency on this stakeholder declines or disappears. As a result, the organization's procedural conformity with the stakeholder's expectations will consequently decline. In this study, when an FAA has a wide portfolio of clients in multiple regions to get revenue, its dependence on one regional market will be lower. The pressure from one single local government will not be that critical for its survival. Therefore, we propose the following hypothesis:

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<sup>2</sup> To assure stable and manageable stock market development, the central government imposed a quota system in regulating the listing of firms in the market. Under the system, the central government set a target for total proceeds to be raised in the stock market, and then this total amount would be allocated across provinces who have the authority to recommend the list of public offerings. After April 1 2001, the approval system took the place of the quota system. Within the new system, a company must obtain approval from CSRC to be listed in the exchanges. Within the tight listing system, the listing quota is a valuable and scarce resource for the firms.

*H7b: In emerging market, the diversity of clients' location distribution will moderate the relationship between local government intervention and audit quality of FAAs.*

### **Partnership**

The identity-based strategy is further reshaped by the important internal stakeholders who hold different views.

The professional service firms are dominated by a unique governance and ownership structure: private partnership (Hodges & Young, 2009). Firms are typically organized around individual partners, who are joint owners and business directors of the firm. Typically, they expand through this partnership system. The international auditors or FAAs also rely on this institutional structure to explore host country market. The incorporation of individual local partners as new internal stakeholders will influence the evolution of FAAs in the host country, since the organizational identity is formed by the agglomeration of the distinctive attributes of individual members (Empson, 2004). Prior studies suggest that consensus among individuals on the meaning, value and validity of an organizational form or activity is a fundamental condition of ongoing conformity to institutional practices (Berger & Luckmann, 1967; Meyer & Rowan 1977; Scott, 1987). Therefore, the disagreement among organizational members on the value of a particular practice will be a critical antecedent of deinstitutionalization of an existing behavior code.

The local partners normally are senior professionals who have served in the domestic audit industry for a long time, even before the entry of FAAs (since the large-scale operation of FAAs in Chinese markets is very recent, as compared to the development of local audit industry). They generally have taken the domestic audit firms' practice and culture for granted, which is the tradition of using earning management to satisfy the clients, in order to attract and maintain more clients (Chan, Lin & Mo, 2002).

Upon joining the FAAs, the domestic partners may introduce a new culture and practice into the organization. The cultural and value system of the two collaborative parties (foreign affiliates and local partners) may conflict and lead to tension between two parties, since both parties may want to imprint their own value and practice on the local entity. The conflicts and poor collaboration may lead to deterioration of audit quality. Even after the integration stage, the new culture introduced by the local partners may disrupt the historical continuity of FAAs'

value system, throw taken-for-granted organizational practices into high relief, cause organizations to question the validity of such practices, and create social pressures on the organization to revise its established procedures (Oliver, 1992). The practice and culture of offering low quality audit service will dominate when more local partners are involved, and hence lead to lower level of the audit quality. Hence, we proposed the following hypothesis:

*H8: In emerging market, the number of local partners is negatively related to FAAs' audit quality.*

**\*\*\*Methodology Section is not included due to paper limit\*\*\***

## **DISCUSSION**

We began by suggesting although there is a large amount of studies examining institutionalization and deinstitutionalization as a sequential evolution, there is a puzzle regarding why some firms tend to institutionalize their strategies towards one direction (e.g., conglomerate) while at the same time others follow the opposite direction (e.g., deconglomerate). We name it as the evolution duality. To resolve this puzzle, we introduced the concept of organizational identity and argued that organizations will choose their strategies based on their perceived identities or categories. Specifically, we used the sample of foreign affiliated auditing firms and local auditing firms in China to study the evolutionary duality in terms of the service quality in auditing industry. We posited and tested multiple predictions regarding: (1) whether the evolutionary trends of the service quality strategy employed by the auditors vary across their different identities, and whether such an identity-based strategy has some implications on their economic returns; (2) how the inter- and intra-group imitation influence the evolutionary trend of auditors bearing different identities; (3) the distortion effect of local government's intervention and the local partners' involvement on the auditors' identity-based strategy.

To better understand the dual existence of institutionalization and deinstitutionalization, we employed the concept of identity-based conceptualization of organizational forms in sociology literature. We differentiated the auditors into three categories: foreign affiliated auditors (FAAs), temporary local auditors (TLAs), and permanent local auditors (PLAs). We found auditors with

different identities tend to adopt different strategies regarding service quality, which creates the dual existence of institutionalization and deinstitutionalization. While FAAs and TLAs tend to offer high quality service as they have been or would like to be perceived as high-quality audit provider by the clients and themselves, PLAs tend to offer low quality service. Their practices are motivated and reinforced by the higher economic returns associated with choosing the proper identity-determined strategy (Hsu & Hannan, 2005).

We also found intra and inter group imitation plays an important role in reinforcement or construction of identity code. Since the perceived identity is associated with a set of common practice employed by all the group members, those organizations which hold a stable identity tend to choose their strategy following their peers in the same identity group. By comparison, organizations holding transitional identities tend to reconstruct their identity group's legitimacy by referring to the dominant norm of higher-status group.

We next found that several internal and external factors may deteriorate the dominance of the identity-based legitimacy. By examining the strategic adaptation of FAAs, we found first, the identity-based legitimacy may be devalued when the auditor has a strong market position. In this situation, it has more knowledge and is more capable to challenge the dominant norm of their identity group. Second, the identity-based legitimacy may be attenuated by the value system in the broad environment, represented by the internal and external constituents the auditor has to deal with. The local partners are the most important internal constituents in our case. With rich experience in operating domestic auditing firms, local partners are deeply influenced by the local value system applied in domestic auditor firms, which is to offer lower-quality service to cater to local clients. They tend to implant the local value systems into the FAAs, which may deteriorate the dominance of FAAs' identity group code. One of the most important external constituents is the local government. As the resource provider, the local government has the capability to influence the organizations' decision to their discretion, in our case, by pushing auditors to provide low-quality audit service to help listed firms' earnings manipulation (Chan, Lin & Mo, 2006; Dai, Lao & Yang, 2000). To avoid the impact of the local government, the FAA may choose to establish a large geographic portfolio of their business. Thus, the FAAs do not need to depend on single or a few local governments and markets for its survival and sustainability. FAAs can have more autonomy to implement their

identity-determined strategy.

Our study also contributes to the organizational identity theory by providing evidence for the dynamic transcending of organizational identity. Some scholars believe that organizational identity can, and must, evolve to allow a company to stay current with changing market conditions (Oliver & Burgi, 2005; Fiol, 2001; Gioia & Thomas, 1996). Thus, organizational identity shifts are necessary to prevent the organization from becoming too rigid in the face of change. In line with this theory, we found that to transcend and gain strategic advantage in the long term, some local auditors (we recognize them as TLAs) tend to benchmark the high-status group's practice, i.e., following FAAs to offer high-quality audit service, rather than following their domestic auditors to offer low-quality audit service. Thus they first signal their intention to change their status. Such a signal can help them get the chance to ally with the foreign auditors and finally change their identities. By proactively upgrading their identities, these TLAs are able to gain positive image to win in the quality-based competition in the long-term.

The findings of this study have several implications for managers of firms in emerging market. First, our results suggest that it is not only the instrumental factors but also organizational identity that matters for change management. It is important for managers to make decision based on their perceived organizational identity. Decision which conflicts perceived identity by clients may impair firms' performance unless it fits the clients' need (such as FFAs' lower audit quality in the long term), or the organization successfully change its identity (e.g., TLAs' identity change to FFAs). On the other hand, decision which conforms to organization's perceived identity will benefit the firm. Secondly, our findings show that organizational identity is flexible rather than fixed. Straddling from a lower status group to higher one may benefit the firm in the long-term, but imitation to higher status group's behavior (which is the precondition of identity change in TLA's case) before identity successfully changed may impair focal firm's performance. Therefore, managers must balance the immediate benefits with the potential longer-term gains offered by identity change.