Journal of Contemporary Accounting & Economics 13 (2017) 209–224

Contents lists available at ScienceDirect

Journal of Contemporary Accounting & Economics

journal homepage: www.elsevier.com/locate/jcae

Determinants and market valuation of the decision to audit or review: Evidence from Taiwan

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ARTICLE INFO

Article history:
Received 16 August 2016
Revised 4 July 2017
Accepted 5 July 2017
Available online 22 September 2017

JEL classification:
M4

Keywords:
Motivation
Audit
Review
Interim reports

ABSTRACT

Using observations of public companies in Taiwan between 2008 and 2012, this study examines the determinants of demand for different assurance services from the perspectives of agency cost, information need, and quality of corporate governance. Our results indicate that the demand for audit assurance is higher in the presence of higher agency costs between controlling and non-controlling shareholders and higher agency costs of debts. We also find that companies with stronger capital need are more likely to have their interim financial statements audited. The quality of corporate governance is found to have a positive effect on the decision to choose audit assurance. Finally, our empirical results demonstrate audited information is more value relevant than reviewed information. This suggests that firms can potentially enjoy benefits from audited information as the market will rely more on their financial information in making investment-related decisions.

1. Introduction

Among the services provided by independent certified public accountants, audit and review are two ways to provide assurance regarding the quality of a company's financial information. In an audit engagement, auditors aim to provide positive assurance that no material misstatement has been detected based on the performed auditing procedures. In a review engagement, auditors do not render their opinions and express only limited assurance. Both substantive tests and analytical procedures are required in an audit engagement to provide positive assurance. In contrast, substantive tests are normally skipped, and only inquiries and analytical procedures are generally performed in a review engagement. As the audit procedures involved in a review engagement are less complex and extensive than those in an audit engagement, the cost of a review engagement is typically lower.

To enhance the transparency of corporations' financial reporting, listed companies having subsidiaries in Taiwan were required to disclose their consolidated semiannual reports along with their parent companies' standalone financial reports starting in 2005.[1] Prior to 2013, the consolidated semiannual financial statements needed to be either audited or reviewed. Although the cost of a review engagement is typically lower than the cost of an audit, not every company chose to review their consolidated semiannual reports before 2013. This observation raises two interesting research questions: (1) What motivates a

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[1] Listed companies without any subsidiaries were required to report their individual financial reports and were subject to the audit requirement before 2013.

https://doi.org/10.1016/j.jcae.2017.09.004
1815-5669/

company to choose an audit engagement when a review engagement is acceptable? (2) Can the market detect the difference between audited and reviewed information?

Most extant research focuses on topics related to audit engagement, and many of these studies examine the demand for audit assurance among private firms (e.g., Blackwell et al., 1998; Collis et al., 2004; Collis, 2012; Dedman et al., 2014; Kim et al., 2011). The frequent use of private-firm sample is in part because external audits are required for publicly traded firms in recognized capital markets. Researchers are able to assess *quality of audit* across different auditors, but they cannot examine the *demand for audit per se* (i.e., voluntary auditing) among public firms. In contrast to public firms, private firms control the decision to audit or review their financial reports, and thus researchers are able to examine the demand for voluntary auditing using private-firm samples. Clearly, in the presence of mandatory public reporting requirements, public firms tend to make decisions in a different way from private firms. The different ownership structures, agency issues, and other characteristics also differentiate the decision-making process between the two groups of firms. While public firms dominate the major capital market and proper regulations are expected to be in place, the understanding of the decision-making process of public firms is particularly important for the regulators.

Different from prior studies on the demand for voluntary auditing, the institutional setting in Taiwan prior to 2013 provides us a basis to examine public companies' preferences between audit and review assurance. In particular, the different agency problems and the less-developed corporate governance mechanism in emerging markets may affect the motivations of public firms differently. More importantly, the institutional setting in Taiwan allows us to examine the market perception toward different assurance levels with a sample consisting of public firms. The value of different assurance services stems from users' ability to recognize the difference in the degrees of audit effort and cost. When users respond to various assurance levels in a similar way, the presence of different assurance services becomes irrelevant and companies lose their motivation for higher assurance. The legal liability of auditors can also be affected when users rely on the assurance conveyed by auditor reports yet fail to recognize the differences in assurance levels. Previously, the user perception toward different assurance levels implied by audit work/reports has mainly been tested through experimental settings. However, the results are mixed and sensitive to the subjects and contexts involved in the experiments (e.g., Pany and Smith, 1982; Johnson et al., 1983; Gay et al., 1998). The market-based approach enables us to examine whether the average market participants are able to identify the dissimilar audit efforts inherent in audit and review engagements, and whether these market participants can value these efforts appropriately.

Based on public companies' audit or review decisions between 2008 and 2012 in Taiwan, we examine the factors affecting companies' decision to choose audit or review assurance for their interim financial statements. We consider the impacts of agency cost, information need, and quality of corporate governance on such decisions. Our empirical results regarding determinants of audit decision are as follows. First, we find that agency cost between controlling and non-controlling shareholders (Type II agency cost) and agency cost of debt both have positive effects on a company's decision to choose audit assurance. Meanwhile, the agency cost between shareholders and managers does not have a significant impact on the demand for audit assurance. Second, we find that audit assurance is preferred when firms issue new shares or new debts. This is consistent with our hypothesis that companies tend to choose an audit to enhance the credibility of their information when they have higher information need. Third, we find that the quality of corporate governance, as measured by the ratio of independent directors and number of financial experts among the directors, is also positively related to the decision to choose an audit.

In addition to the determinants of the demand for different assurance services, we test the difference in value relevance between audited and reviewed information in the final hypothesis. Previous empirical evidence regarding whether information users can detect the difference between audited and reviewed information is fairly scarce because it is difficult to find an institutional environment that allows different assurance levels for mandatory public reporting. Griffin (2003), for instance, analyzes the differences in market reaction between reviewed 10-Q reports and audited 10-K reports. He finds that the market responds stronger around a 10-K report date than a 10-Q date, suggesting that the market tends to give higher weights in valuing audited than reviewed information. However, it is also likely that the market responds differently due to inherent differences between quarterly reports and annual reports. The audit-or-review option for semiannual reports in Taiwan allows us to further investigate if the market can distinguish the differences in assurance level between audited and reviewed information given the same type of interim reports. The empirical results support the hypothesis that audited information is more value relevant than reviewed information. This suggests that the capital market is able to distinguish the differences in assurance level between audited and reviewed financial information.

This study adds to prior literature in several ways. First, the emphasis on determining the motives for choosing between audit and review assurance complements existing studies regarding auditor choices (better vs. inferior audit quality) and voluntary auditing (audits vs. no-audits). We provide evidence that, with the opportunity to choose between audit and review, public companies make decisions based on factors such as agency cost, information need, and quality of corporate governance. Among the factors examined, the Type II agency problem has seldom been addressed in previous literature on audit demand; yet, we find that Type II agency cost plays a significant role in inducing the demand for higher assurance in an emerging market such as Taiwan. These results not only fill the gap in the existing literature but also provide a better understanding of the motivation behind public firms choosing different assurance services.

Moreover, this study contributes to previous literature by addressing user perception toward different assurance levels based on value relevance of audited and reviewed information. This issue is critical, as the ability for users to differentiate