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Do Reviews by External Auditors Improve the Information Content of Interim Financial Statements?☆

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Abstract

In the last decades, regulators around the world have increasingly mandated stricter assurance requirements for interim reporting. In several countries, firms must have their interim financial statements reviewed by an external auditor. However, there is little evidence to indicate whether auditor assurance is desirable for interim financial statements. We address this gap and analyze whether investors care about a review of interim financial statements. By exploiting a setting in which firms can voluntarily decide to buy a review, we find that the publication of reviewed interim financial statements causes more abnormal return volatility as well as abnormal trading volume than the publication of un-reviewed interim financial statements. Additional analyses reveal that the increase in information content is largely driven by a signaling effect of the review rather than by an increase in earnings quality. The findings inform the current political debate of mandating reviews for interim financial statements in several jurisdictions.
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1. Introduction

The assurance of financial statements by an external auditor is an important mechanism to add credibility to the information provided by firms.[2] Given information asymmetry between managers and stakeholders, firms have difficulties in faithfully representing their financial position without external assurance. In the last decades, there has been a trend toward more and stricter involvement of external auditors in the preparation of financial statements. This trend has been fueled by regulators commonly responding to accounting scandals with tighter audit requirements.[3] While the benefits of assurance of annual financial statements are well documented in the literature (e.g., Blackwell, Noland, & Winters, 1998; Minnis, 2011), it is far from conclusive whether auditor assurance is also desirable for *interim* financial statements. However, regulators around the world have increasingly mandated stricter assurance requirements for interim reporting as well. For instance, the U.S. Securities and Exchange Commission (SEC) mandated listed entities to have their interim financial statements reviewed by an external auditor on a timely basis in 2000. Previously, SEC registrants could choose between a timely review and a year-end retrospective review combined with the annual audit. Moreover, several other countries such as Australia and France have started to require interim reviews for public firms. In contrast, Germany, Canada and the UK do not mandate reviews of interim financial statements.

The divergent regulations suggest a strong disagreement on the costs and benefits of auditor assurance of interim financial statements. Empirical evidence on this issue is scarce. Ettredge, Simon, Smith, and Stone (2000) demonstrate that U.S. firms choosing a timely review under the old SEC regulation show fewer fourth quarter adjustments compared to companies opting for the retrospective review. Manry, Tiras, and Wheatley (2003) document a more timely return–earnings relation for U.S. quarterly earnings with timely reviews instead of retrospective reviews. Bédard and Courteau (2015) analyze the effect of interim reviews on audit costs and earnings quality for a sample of Canadian firms from 2004 to 2005 and find an increase in audit costs but no effect on earnings quality. These prior studies, however, either address the effect of a different review timing or focus on indirect consequences of reviews such as earnings quality. In contrast, we analyze the capital market consequences of reviews in the form of investor reactions upon the release of interim financial statements. Thereby, we investigate whether investors place more emphasis on reviewed versus un-reviewed interim financial statements for their investment decisions. We believe that investor reactions are a suitable benchmark to assess the effect of a review given that interim financial statements are an important source of information in equity markets (e.g. Wiedmann, 2007) and investors are among the primary users to whom interim financial information is addressed. Moreover, an analysis of trading activity is a more direct test than an analysis of accruals. Our findings help in understanding the

[2] For an overview of the literature see Francis (2011) or Knechel, Krishnan, Pevzner, Shefchik, and Velury (2013).

[3] Some examples are the introduction of the Sarbanes–Oxley Act in 2002 as a response to the Enron and Worldcom scandals and the European Commission's green paper "Audit Policy: Lessons from the Crisis" from 2010 as a response to the financial crisis in 2007/2008. Dye and Sunder (2001) call this behavior by regulators the "*law of the instrument.*"

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