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The Role of External Auditors in Business Group Governance: Evidence from the Number of Audit Firms Selected in Taiwanese Groups☆

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Abstract

Business groups are currently one of the most crucial organizational forms worldwide. However, unlike stand-alone companies, related companies in business groups experience the agency problem of tunneling. We investigate the association between the agency problem of tunneling and the concentration of audit firm selections in business groups. On the basis of Taiwanese business groups from 1999 to 2007, we use the divergence between voting rights and cash flow rights to measure the agency problem of tunneling. Our results show that higher group divergence decreases the number of audit firm selections in business groups. In addition, auditors who audit more related companies in business groups weaken the negative association between divergence and earnings quality as proxied by discretionary accruals, financial restatements, and value-relevance of earnings. Overall, controlling shareholders with higher divergence concentrate on audit firm selections in their business groups to enhance earnings quality, consistent with the agency hypothesis of the demand for audit quality.

JEL classification: M42
Keywords: Audit firm selections; Business group; Divergence between voting rights and cash flow rights; Tunneling; Ultimate ownership

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1. Introduction

Business groups are currently one of the most crucial organizational forms worldwide. They are defined as a set of legally independent companies under the control of ultimate controlling shareholders. To retain control over related companies in a business group, controlling shareholders use three methods: the issuance of dual-class shares, pyramids, and cross-holdings. Each method leads to a divergence between voting rights and cash flow rights (hereafter divergence) of the controlling shareholders (Bebchuk, Kraakman, & Triantis, 2000). This divergence causes agency issues between controlling and minority shareholders. Non-arm's-length transactions ("tunneling") among related companies that are detrimental to public investors are one of the agency issues encountered by family business groups (Morck & Yeung, 2003). Through related dealings, controlling shareholders transfer resources from a company in which they have small cash flow rights and large voting rights to a company in which they have large cash flow rights and control (Johnson, La Porta, Lopez-de-Silances, & Shleifer, 2000).[1]

Fan and Wong (2005) find that companies with higher divergence tend to select higher-quality audit firms. However, in business groups, all related companies are under the control of controlling shareholders, which could result in correlated audit firm selections. Extending from Fan and Wong (2005), our study examines the association between group divergence and the number of audit firm selections in business groups. Specifically, business groups enable controlling shareholders to engage in tunneling more easily. To alleviate tunneling agency conflicts between controlling and minority shareholders, we examine whether controlling shareholders with higher divergence tend to select different audit firms or concentrate on the same audit firms for related companies in their business groups.

Both the International Standard on Auditing (ISA) 600 (IAASB, 2007) and the Statement on Auditing Standards (SAS) No. 122 (AICPA, 2011) address situations in which more than one auditor is involved in the auditing of group financial statements. Both standards refer to a group as the accounting entities of one set of consolidated statements, different from our business group. One business group may have multiple parent companies and sets of consolidated statements. To illustrate, the Taiwanese Formosa Plastics Group (FPG), which is controlled by the Yung-Ching Wang family, had 131 related companies in 2007, including 10 local listed corporations, 4 local not-for-profit organizations, 54 subsidiaries in China and Hong Kong, 22 overseas companies, and 41 local private companies. Among the 10 local listed companies, 7 prepare their own consolidated statements, whereas the other 3 companies do not. The 10 companies flood related party transactions with each other, and they are audited by KPMG (six companies) and Ernst and Young (four companies). Table 1 shows detailed information about the 10 companies of the FPG. In brief, we examine the number of audit firm selections among various consolidated financial statements in business groups rather than that within consolidated financial statements.

[1] For example, the X family controls and has 30% ownership of Company A, which controls and owns 30% of Company B. Companies A and B are linked by investment and regarded as a business group controlled by the X family. The X family retains the remaining 9% cash flow right in Company B. Suppose that the X family separately expropriates \$1 interest in each company. The family assumes \$0.3 and \$0.09 costs in Companies A and B, respectively. Hence, the self-interested controlling shareholders have incentives to transfer resources from Company B to Company A.