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Engagement partner specialization and corporate disclosure transparency

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ABSTRACT

This paper explores the association of audit partners' industry specialization with corporate disclosure transparency and the latter's informativeness. The distinctive institutional designs of partner signature requirement and Information Disclosure and Transparency Ranking System (*IDTRS*) adopted in Taiwan allow us to empirically address the issue. We posit and find that the rankings from the *IDTRS* are higher for firms audited by industry specialist engagement partners than for firms audited by non-specialist engagement partners. Additionally, the results show that the probability of informed trade (*PIN*) proxy for information asymmetry is negatively associated with the rankings for clients of industry specialist engagement partners, but not for clients of industry non-specialist engagement partners. The results are robust with respect to alternative estimation method and alternative measures of industry specialization. Overall, the evidence suggests that industry specialist engagement partners enhance the credibility of corporate disclosure transparency, through which information asymmetry is further declined. The evidence provides policy implications to the partner signature requirement adopted in Taiwan and China.

1. Introduction

The objective of this paper is to explore the association between audit partners' industry specialization and firms' disclosure transparency, as well as the effect of partner specialization on the relation between disclosure transparency and information asymmetry. According to Healy and Palepu (2001)'s critical review on empirical disclosure literature, information asymmetry and agency problems result in the demand for financial reporting and corporate disclosure, of which regulated financial reports and voluntary communication can play a role in this relationship.¹ Managers can better communicate their superior knowledge directly with investors if information intermediaries, such as regulators, standard setters, and auditors, could enhance the credibility of management disclosure. As such, one research question motivated by Healy and Palepu (2001) is how effective auditors are in increasing the credibility of management disclosure and discovering new information. This paper tests for these empirical relations.

While prior literature (e.g., Dunn & Mayhew, 2004) documents a positive relation between firm-level auditor industry specialization and disclosure quality, the evidence for whether partner-specific industry specialization affects corporate disclosure remains unknown. Yet, it is the engagement partners who are in charge of and responsible for the outcome of audits. Given the dual partner

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¹ A stream of literature has documented that disclosure quality reduces the degree of information asymmetry, which in turn reduces uninformed investors' required rate of return, non-diversifiable information risk, and thus cost of equity capital, and increases the liquidity of stocks (Brown et al., 2009; Diamond, 1985; Diamond & Verrecchia, 1991; Healy & Palepu, 2001; Verrecchia, 2001; Zhang, 2001).

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signature requirement that requires two audit partners to sign on an audit report, as audit partners bear legal liability in the event of an audit failure and make an overall judgment on the audit engagement, it follows that the quality of audit is mainly the outcome of audit partners' decisions. Similarly, to enhance audit quality, China, European Union's (EU's) Eighth Company Law Directive for all EU members to conform with, Australia, International Auditing and Assurance Standards Board, and U.S. all adopt partner signature/disclosure requirement. The widespread adoption of partner signature/disclosure requirement indicates "a global trend toward greater transparency about audits and those who conduct them" (PCAOB, 2009). As such, the research question as to whether audit partners would produce higher audit quality that is desirable for investors and regulatory authority deserves further investigation. We address the following issues: whether audit partner specialization affects corporate disclosure transparency and, furthermore, disclosure transparency's association with information asymmetry.

In an efficient market, if accounting regulation and auditing are imperfect, managers could communicate their superior information with investors and manage their reported performance through their reporting decisions and disclosures (Healy & Palepu, 2001). Corporate disclosures can be provided through regulated financial reports, media, or information intermediaries. External audits provide an independent assessment on whether financial statements conform to GAAP and truthfully reflect the underlying economics of the firm, which improves the reliability of financial reports (Abdel-Khalik & Solomon, 1988). Industry specialist auditors who possess industry-specific knowledge and expertise should have better assessment on whether disclosures are prepared in accordance with the full disclosure principle and whether financial statements reflect the peculiar industry practice, as specified in the conceptual framework for financial reporting. Further, industry specialist auditors could assist clients in improving industry-specific disclosures through providing an annual assessment of disclosure issues for specific industries and implementing enhanced disclosure practices in target industries (Dunn & Mayhew, 2004), and in reviewing financial forecasts and issuing a review report prior to the release of such information. All these assessments require specialist auditors' judgments based on their industry-specific knowledge and expertise. As a result, industry specialist auditors would provide better assurance on the enhanced corporate disclosures and thus improve the credibility of corporate disclosures.

We assert that the engagement partner's specialization has a substantial effect on audit quality for two reasons.² First, prior studies have documented the effect of auditor's legal liability on audit quality (Dye, 1993; Lys & Watts, 1994; Palmrose, 1988). In Taiwan, it is the audit partners who are liable in the case of an audit failure. Second, a branch in behavioral audit research has documented that the audit judgment performance differs among individual auditors in terms of knowledge, experience, motivation, and environmental uncertainty (Bonner & Sprinkle, 2002; Libby, 1995). Auditors' investments and experiences in performing audits for clients in the same industry produce economy of scale and savings in audit costs, and create core industry-specific knowledge competencies for experts performing audits in a specific industry (Craswell, Francis, & Taylor, 1995; Hogan & Jeter, 1999). In other words, different audit partners possess varying degrees of industry expertise that are not completely transferrable to other audit partners, and thus differentially enhance the credibility of disclosure quality through their differentiated quality of audits. If industry specialist partners who possess industry-specific knowledge can indeed assist clients in developing industry-specific disclosure strategies and enhancing their disclosures, the imbalance between buy and sell orders among traders and the probability of investors discovering and trading on private information, i.e., probability of informed trade (PIN), would be further reduced (Diamond, 1985, among others).

In view of the distinctive institutional designs of partner signature requirement and Information Transparency and Ranking System (IDTRS) that provides a proxy for disclosure transparency, we choose a sample of firms listed on the Taiwan stock market to test for the predicted relations. The results show that the rankings from the IDTRS are higher for firms whose audit partners are industry specialists than for firms whose audit partners are not industry specialists. This evidence is consistent with the enhancement of partner specialization on corporate disclosure transparency. In addition, the PIN proxy for information asymmetry, which we empirically develop for this study using daily stock market data, is significantly and negatively associated with the rankings for firms audited by industry specialist audit partners, but not for firms audited by industry non-specialist audit partners. These findings suggest that audit partner specialization contributes to the association between greater disclosure transparency and lesser information asymmetry. Additional analyses show that firms whose audit partners are industry specialists only at partner level or at both firm and partner levels have higher rankings from IDTRS than firms whose auditors are not industry specialists. Our results are robust with respect to the alternative estimation method using the propensity score matching models, alternative regression models (two-stage least squares regressions), and alternative operational definitions of industry specialization. Taken as a whole, the evidence suggests that the first partner's specialization has the strongest effect on enhancing disclosure transparency, through which information asymmetry is further declined, when compared to the specialization provided by the audit firm or second audit partner. Our analyses provide insights into the policy implications to the partner signature requirement and IDTRS. The evidence suggests the effectiveness of partner-specific audit quality in improving corporate disclosure transparency and the latter's informativeness, as characterized by its effect on information asymmetry. This evidence also indicates the need for improving firm-level audit quality, which is consistent with the newly mandated disclosure of engagement partner in the audit report in the U.S. (PCAOB, 2016). Moreover, by nature, the purpose of IDTRS is to improve information disclosure and transparency. Our findings provide support for the usefulness of IDTRS, which can be enhanced by industry specialist partners, in reducing information asymmetry.

This study builds on related research and contributes to our further understanding of the partner-specific audit quality in two ways. First, institutional design would affect audit quality. Dunn and Mayhew (2004) find that disclosure quality is positively related to audit firm specialization in the U.S. market. In contrast, given the partner signature requirement in Taiwan, this paper documents

² See DeFond and Zhang (2014) for an extensive review of archival auditing research.

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