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The impact of information complexity on audit failures from corporate fraud: Individual auditor level analysis

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ABSTRACT

This study examines the association between related-party transactions, level of diversification and auditor sanctions arising from corporate fraud. Sample firms are manually collected from the list of auditor partners sanctioned due to corporate fraud published according to the Securities and Exchange Act and the Certified Public Accountants Act in Taiwan between 1992 and 2010. Empirical results indicate that the increasing complexity of corporate information with increasing aggregate monetary values of related-party transactions, especially revenue-based related-party transactions (RPTs), increases the probability of auditor sanctions. Moreover, more complex product diversification raises the likelihood of auditor sanctions. These results support the information asymmetry hypothesis, namely that increasing complexity of corporate information reduces the transparency of information, and thus raises information asymmetry between managers and auditors, resulting in higher audit risk. This investigation suggests that auditors should pay proper attention to providing professional audit work when a company has complex related-party transactions and product diversification. Analytical results could provide research-based evidence for the PCAOB to consider when formulating policy on the auditing of related party transactions (PCAOB, 2014) and the disclosure of engagement partners (PCAOB, 2011).

1. Introduction

The use of related-party transactions (hereafter, RPTs) to conceal large debts exploded after Enron in 2001, generating further scandals involving false accounting from companies such WorldCom and Merck. Investors around the world began to question the financial information publicized by corporations and to think that it may contain many implicit problems, such related-party transactions, corporate management practices and poor accounting standards. Taiwan had the high-profile Rebar Group scandal, as well as a scandal involving a dozen photoelectric material manufacturers. These problems become more conspicuous as Taiwanese enterprises internationalize and become more diversified in businesses.

As the global economy grows, reinvestments and business diversity have led to over-investment, which causes complications with information sources. In particular, the intertwined connections of parent-subsidiary companies can become complicated for auditing. Consequently, engagement in investments, financing and other economic activities relies on the authenticity of corporate financial reports. Meanwhile, CPAs play a major role in these new practices, and they assume legal responsibility for financial statement certifications. Blazenko and Scott (1986) argued that a CPA acts as an overseer who can reduce information asymmetry between competent authorities and investors, and helps to promote the accountability of corporate financial reports for stakeholders. In these circumstances, CPAs are responsible for auditing reviews that must be appropriately expressed and with full disclosure, or they face lawsuits or penalties.

Previous academic research on the complexity of related-party transactions and business diversification has mainly focused on the value and business strategies of a company (Dahya, Dimitrov, & McConnell, 2008; Atanasov, Black, Ciccotello, & Gyoshev, 2010; Qian, Khoury, Peng, & Qian, 2010; İbrahim Anıl & Canel, 2013). However, little research has discussed the role of auditors. Those corporate scandals exposed CPAs to risk from lawsuits and

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penalties. For instance, even Arthur Andersen, an accounting firm, was brought down and forced to close, dragging many CPAs into related lawsuits and penalties. Overall, corporate scandals are easily connected with information complexity, such as related-party transactions (Henry, Gordon, Reed, & Louwers, 2012; Bennouri, Nekhili, & Touron, 2015). This is where a CPA plays a critical role. Thus, this research seeks to identify the relationship between the complexity of corporate business diversification and related-party transactions, and the penalties on CPAs resulting from corporate fraud.

Additionally, previous literature on audit failures mainly discussed the impact on audit conservatism (Cahan & Zhang, 2006; Krishnan, 2007; Krishnan, Raghunandan, & Yang, 2007) or on clients' stock prices (Callen & Morel, 2002; Chaney & Philipich, 2002; Asthana, Balsam, & Krishnan, 2003) with a focus on the relevant U.S. litigation environment. Those studies used accounting firms as the study objects, which were largely due to the accounting certification system and related legal acts that impose penalties on CPAs for audit failures. The accounting certification system in Taiwan requires accounting firms and CPAs to disclose their names on the audit reports, while the U.S. only requires the accounting firm name. In addition, a CPA faces a different audit risk environment in the U.S. from Taiwan. In the U.S., the auditor faces higher litigation risks in auditing procedures (Lee & Mande, 2003), while the audit partner in Taiwan with an audit failure mainly faces administrative punishment from supervisory authorities. The prior research did not seek to correlate corporate fraud-related audit failures with corporate information complexity. From this perspective, CPAs in different countries face different litigation-risk environments and different requirements for certification signatures. This work explores these factors for corporate information complexity, such as related-party transactions and business diversification, and investigates whether these complexity factors raise the audit risk leading to corporate fraud-related audit failures on individual auditors.

This investigation found that audit partners are more prone to corporate fraud-related audit failures with larger related-party transactions, particularly those that are revenue-based. This may be because the high monetary value of related-party transactions motivates corporations to hide them through delayed payments or unauthentic transaction records, by exploiting the accounting uncertainty linked with the definition and reporting of RPTs (Bennouri et al., 2015). They thus increase the information asymmetry, causing audit failures from corporate information concealment. Consequently, CPAs may be misled into signing an “unqualified opinion”, increasing their chances of penalization. Moreover, this study also found that CPAs are prone to fraud-related audit failures owing to higher levels of business diversification. From the perspective of agency theory, this work speculates that higher business diversification creates higher operational uncertainty and complexity, which can further increase information asymmetry, thus raising audit risk and putting CPAs at risk. Additionally, this investigation concludes that audit partners who belong to Big 4 audit firms, and have long audit tenure and high industry expertise, have low likelihood of audit failures.

This study makes the following contributions. First, in contrast to the U.S., CPAs in emerging economies face less litigation risk due to lower investor protection, and, especially in Taiwan, the punishment is mainly administrative penalties imposed on individual CPAs by competent authorities. This research mainly discusses individual CPA audit failures due to corporate frauds; the accompanying punishment imposed by supervisory authorities, and the correlation between audit failure and corporate information complexity. Chen, Sun, and Wu (2010) noted that CPA certification behavior might be different from an accounting firm's decision making as a whole. Therefore, this work provides a better understanding of audit failures by individual CPAs than previous investigations on accounting firms.

Second, this study is the first to explore corporate fraud-related audit failure by individual CPAs, as well as its correlation with corporate information complexity. Previous research on audit failures (based on accounting firms) mostly discussed the association with audit quality/conservatism (Cahan & Zhang, 2006; Krishnan, 2007; Krishnan et al., 2007), and impact on client stock prices (Krishnamurthy, Zhou, & Zhou, 2002; Barbera & Martinez, 2006; Brito & Peres, 2006; Dee, Lulseged, & Zhang, 2011). However, this investigation gathers corporate information complexity and corporate fraud to analyze the causes of audit failures by individual CPAs.

Third, this work fills in the knowledge gap in the literature on corporate information transparency. The academic literature on related-party transactions/diversification mainly discussed the impact on firm performance (Dahya et al., 2008; Kohlbeck & Mayhew, 2010; Qian et al., 2010; İbrahim Anıl & Canel, 2013) and earnings quality (Jian & Wong, 2010; Chen, Cheng, & Xiao, 2011). However, few studies have discussed the role of auditors; of these, most consider it from the perspective of auditor choice (Francis, Richard, & Vanstraelen, 2009; Liu & Lai, 2012; Bennouri et al., 2015) or audit fee (Habib, Jiang, & Zhou, 2015). The influence of corporate information complexity on audit failure risks, even on investor capital risks, can be better comprehended through the study of related-party transactions and business diversification.

Finally, the research results can help competent authorities understand corporate information complexity and its impact on interested parties, CPAs and investors. Meanwhile, this research can provide academic evidence for the Public Company Accounting Oversight Board (PCAOB) regarding the auditing of related-party transactions (PCAOB, 2014) and the disclosure of audit partners (PCAOB, 2011).

Section 1 outlines the motivations of this study, as well as its main findings. The rest of this paper is structured as follows. Section 2 reviews the literature on which the hypotheses are based. Section 3 outlines the sample selection procedure and research methodology. Sections 4 and 5 analyze the empirical results. Section 6 summarizes our conclusions.

2. Literature review and hypotheses development

2.1. Signature requirements of audit partners

Taiwanese regulations have required dual CPA signatures in audit reports since 1983, specifically from both the engagement and review partners. Additionally, the U.K. and other EU countries (such as France, Germany, Luxembourg and the Netherlands) gradually require the engagement partner to sign the audit report. In the U.S., the Public Company Accounting Oversight Board (PCAOB) has issued a recommendation requiring disclosure of the name of the engagement partner in the report, but with no requirement that they personally sign the report (PCAOB, 2011). The Board trusts that mere public disclosure of the name of the engagement partner in the report is adequate to increase accountability and transparency, similar to requiring a partner to sign an audit report (PCAOB, 2011). This study provides research-based evidence for the Board to consider in formulating policy on the identification of audit partners.

2.2. Related-party transactions

The International Accounting Standards No. 24 (IASB, 2009)