AUDITOR INDUSTRY EXPERTISE AND FORECAST QUALITY

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Abstract
This study examines the association between the quality of management earnings forecast, measured by forecast bias and accuracy, and the Big Four industry auditor specialists. This paper focuses on a sample of Taiwan listed firms where management earnings forecast must be reviewed and signed by the two signing auditors as well as by an audit firm. We find that clients of signing auditor specialists, either alone or in conjunction with firm-level specialists, have lower forecast bias and higher forecast accuracy. We, however, find no significant association between industry specialization at the firm level alone and the quality of earnings forecasts. These results document that differential earnings forecast quality due to the Big Four industry-specialist is mainly driven by signing auditor specialists, rather than firm-level industry specialists.

Keywords: partner industry specialist, audit firm industry specialist, management earnings forecasts

I. INTRODUCTION
This study examines if the Big Four industry-specialist auditor is associated with management earnings forecast quality. While prior research on Big Four industry experts focuses exclusively on the effect of industry expert on historical financial statements (e.g., Balsam, 2003; Krishnan, 2003), little work to date explores the relationship between industry expert and management forecast quality. This paper first examines the effect of the Big Four industry expert on management forecast quality, as measured by bias and error. Recent anecdotal evidences and studies argue that audit research should investigate partner or city-specific offices within the Big Four audit firm rather than nation-level analyses (e.g., Francis, et al., 2005; Reichelt and Wang, 2010). This study thus further explores whether the differential quality of management forecast is driven mainly by firm-level, partner-level industry expertise, or a combination of both. Second, this paper further examines whether market response to management forecast is more favorable for firms reviewed by auditor industry experts and whether differential market response is driven primarily by firm-level or partner-level industry expertise.

Industry experts gain more industry specific knowledge and experience than non-experts (Solomon et al., 1999). Thus, recent studies document that the presence of industry auditor specialists is positively associated with higher audit quality (Gramling et al., 2001; Balsam, 2003). In the same vein, industry
experts are better able to use their knowledge and experience to evaluate whether reasonable evidence is available to support underlying assumptions on which financial forecasts are based, and whether forecast has been prepared in accordance with acceptable accounting principles and these assumptions. On the other hand, clients select auditors as part of their overall disclosure strategy. Prior studies argue that clients demand industry specialist for disclosure advice and as a signaling mechanism to investors that the client intends to provide enhanced disclosures. Therefore, clients reviewed by industry auditor specialists are expected to have better management forecast quality. This point is especially relevant given recent evidence by Kasznik (1999) that management forecast quality and earnings management could be simultaneously determined as part of overall reporting strategy.

Extant studies on audit quality concentrate on the effect of auditor quality, measured by Big Eight and non-big Eight, on management forecast, and provide mixed results (i.e., Clarkson, 2000). The potential explanation for the mixed results is that the above work on the association between management forecasts and audit quality implicitly treats the Big Four auditors as a homogeneous group in terms of audit quality. However, recent studies show several contrasting views of conceptualizing the Big Four audit firm operation (Ferguson et al., 2003). The national-level perspective assumes that audit firms capture industry expertise through knowledge-sharing practices such as internal benchmarking of best practices, the use of standardized industry-tailored audit programs, and extending the reach of professionals from their primary local-office clientele to other clients through travel and internal consultative practices. An alternative perspective (i.e. office-level or city-specific perspective) is that auditor expertise is indelibly tied to individual professionals and his/her deep personal knowledge of clients, and thus cannot be readily captured and distributed by the firm to other offices and clients. Recent studies provide evidence more consistent with the latter perspective (e.g., Ferguson et al., 2003; Francis et al., 2005; Reichelt and Wang, 2010). Recent perspective is that, in assessing auditor independence issues, the focus should be on individual partners (SEC 33-7919, 2000).

This paper extends these perspectives by examining the association between management forecast quality and Big Four industry expertise at the partner-level (i.e. signing auditor specialists) as well as at the audit firm-level. This paper further investigates the relative effectiveness of audit firm-level and partner-level industry specialists in management forecast quality, as measured by forecast bias and accuracy, and whether market response to management forecast is more favorable for firms reviewed by auditor industry experts and whether differential market response is driven primarily by audit firm-level or partner-level industry expertise.

II. Methodology

This paper takes listed companies in the Taiwan Stock Exchange (TSE) from 1996 to 2014. Management earnings forecasts, financial data, corporate governance characteristics, and industry-specialist auditor of sample companies are taken from the Taiwan Economic Journal (TEJ) database.

To test whether firms retaining the industry-specialist auditor offer higher quality of management earnings forecast, we run the regressions as below:

\[ FE = \beta_0 + \beta_1 SIZE + \beta_2 AGE + \beta_3 HORIZON + \beta_4 MB + \beta_5 LOSS + \beta_6 CPA1 + \beta_7 CPA2 + \beta_8 CPA3 + \delta \cdot YEAR + \phi \cdot INDUSTRY + \epsilon \]  

(1)
\[ |FE| = \beta_0 + \beta_1 SIZE + \beta_2 AGE + \beta_3 HORIZON + \beta_4 MB + \beta_5 LOSS + \beta_6 CPA1 + \beta_7 CPA2 + \beta_8 CPA3 + \delta \cdot YEAR + \phi \cdot INDUSTRY + \epsilon \]  

(2)

Following prior studies (Ajinkya et al., 2005), we calculate forecast bias (\(FE\)) as the difference between forecast earnings and reported earnings deflated by the beginning market value. A positive value for \(FE\) implies that firms have an optimistic bias while a negative value indicates a pessimistic bias. Forecast accuracy is defined as the absolute value of the forecast bias (|\(FE|\)). |\(FE|\) is the primary metric used to evaluate forecast accuracy. Calculation of forecast error can be based on the initial forecast predictions, i.e., predictions for the first time in a fiscal year. The control variables in equations (1) and (2) are mainly based on paper by Chin et al. (2007) in the context of Taiwanese management forecasts.

### III. FINDINGS

Empirical results reveal that signing auditor specialists, either alone or in conjunction with firm-level specialists, are significantly associated with less optimism and higher accuracy in management earnings forecasts, consistent with our prediction. Contrary to our expectation, we find no evidence that firm-level auditor specialists alone are associated with management earnings forecast quality. The results suggest that the differential quality of management earnings forecasts due to Big Four industry expertise is primarily attributable to partner specialists rather than auditor specialists at the firm level. This paper further finds that market response to management earnings forecast is positively related to industry experts, and the differential market response is driven mainly by the industry expert at the partner level. In addition, the market response to management earnings forecasts has no association with the industry expert at the firm level alone.

### IV. IMPLICATIONS

Using Taiwanese sample firms as the context for research, we provide consistent evidence that political connections are negatively associated with firm performance. The findings are informative for capital market participants in making their investment and lending decisions. The results also provide implications for firms’ corporate governance practices. In particular, firms should consider the possible negative impact of political connections when hiring or electing top managers and directors.

However, our findings are subject to several limitations and should be interpreted with some caveats. First, this study does not consider the potential differential effects of industrial life cycles as well as the macroeconomic environment. Second, while we consider firms’ incentives to become politically connected, the analysis may be incomplete. For example, we do not include firms that use political connections to conduct fraud or to avoid regulatory investigations. Third, due to data limitations, our measures of political connections include only those available from public sources. These definitions may not be inclusive, since political connections can also be obtained through friendship and social networks that are difficult to measure.

### V. CONTRIBUTION

We expect our paper to make the following contributions. First, our results have implications for securities administrators and standard setters. Given the erosion of financial reporting quality and auditor reputation as evidenced by the proliferation of financial scandals such as Enron and WorldCom in the U.S. and Procomp in Taiwan, our findings, linking auditor industry expertise to voluntary disclosure, are likely to be of interest to policy makers. Our empirical results document that industry expertise and quality of
management earnings forecast are linked. Furthermore, our results should be likely to be of interest to investors and financial analysts.

Second, this paper also contributes to academic literature on both voluntary disclosure and auditor industry expertise by documenting the positive association between quality of management earnings forecasts and auditor industry expertise. This paper employs the full sample of management earnings forecast issued by firms listed in Taiwan Stock Exchange. Thus, our findings can generalize to all listed companies, regardless of whether companies are IPOs or not.

Reference


