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Research Report

Corporate ethics and auditor choice – international evidence

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ABSTRACT

This paper examines whether firms' auditor choice reflects the strength of corporate ethics. Based on a sample of 132,853 firm year observations from forty-six countries around the globe during the period from 1998 to 2007 and controlling for a number of firm- and country-level factors, we find that firms in countries where "high corporate ethical values" prevail are more likely to hire a Big 4 auditor. We also find that the positive effect of home country corporate ethical values on the likelihood of hiring a high-quality auditor is reinforced by the extent of the firm's board size. These results establish an indirect link between corporate ethics and financial reporting quality through the firms' choice of auditor.

Introduction

A firm's choice of auditor is the outcome of a complex process involving consideration of a number of factors: (1) strategic issues (Hribar, Kravet, & Wilson, 2010); (2) efficiency in contracting considerations (Francis, Khurana, & Pereira, 2003; Kim, Liu, & Zheng, 2012); (3) the degree of information asymmetry (Francis, Maydew, & Sparks, 1999; Kim et al., 2012); (4) the level of information risk (Fan & Wong, 2005); and (5) financial issues (Datar, Feltham, & Hughes, 1991). There is evidence that a higher quality audit results in (or is associated with) higher quality earnings (Francis & Wang, 2008), lower cost of capital and lower IPO under-pricing (Titman & Trueman, 1986; Francis, Nanda, & Olsson, 2008). Thus a high quality audit may appear to be costly but actually be cost effective (Datar et al., 1991; De George, Ferguson, & Spear, 2013).

In the absence of moral hazard, it is rational to expect efficiency considerations to rule auditor choice. That is, larger clients and clients with complex audits have incentives to hire a superior quality auditor, while clients with inherent audit risks and those who stand to lose from the scrutiny of a reputed auditor have incentives to opt for a less reputed auditor (Habib, 2011). The decision will be based on whether the value derived from a superior quality auditor outweighs the cost (Cullinan, Du, & Zheng, 2012). This line of reasoning points to an ethical dimension in auditor choice, suggesting that firms with higher ethical values will make an efficient choice and not an opportunistic one.[1]

Whether the ethical values of firms affect their choice of auditor has not been empirically tested. This is the first study to provide direct evidence on that question. We also investigate the impact of board size on the association between corporate ethics and auditor choice.

Unfortunately, the only data currently available on corporate ethics is at the country level rather than at the firm level. The study, therefore, tests for the impact of

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[1] For the purposes of this paper we regard *values* as the fundamental beliefs and standards held by individuals that define right and just. *Morals* are the values that derive from a system of beliefs such as a religion or political system. *Ethics* is about action with ethical action being consistent with the values held by the group or society to which the individual belongs.

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corporate ethics in a firm's country of domicile rather than the ethics of the firm itself. The study is novel and the results are clearly of interest. However, in relation to the preferred research focus on the firm the study must be regarded as exploratory. The study uses a large sample comprising 132,853 firm-years from 46 countries over the period 1998–2007, which provides a rich basis for investigation of the impact of corporate ethics and gives globally applicable results. We find that firms are more likely to hire a large audit firm (a 'Big 4 auditor') if they operate in a strongly ethical environment and that board size has a reinforcing effect on this relationship. Furthermore, when we control for other country-level factors, we still find a strong association between corporate ethics and the choice of auditor. We thus contribute to the auditor choice literature by showing that corporate ethics appears to be a significant country-level variable in auditor choice.

The rest of the paper is organized as follows. The second section provides a review of the literature on the factors that influence auditor choice and thus gives the basis for our hypotheses. The third section describes the measures used for the dependent, independent and control variables and the sample selection procedure. The fourth section presents our empirical results. The fifth section provides the conclusion.

Theoretical framework and hypothesis development

"Ethics is primarily a communal, collective enterprise, not a solitary one," which flows through the firm, and into the public eye, as a result of the values instilled by the board (Azmi, 2006, p. 1). This is supported by former SEC Chairman Donaldson, who states that "the most important thing that a Board of Directors should do is to determine the elements that must be embedded in the company's moral DNA. It should be the foundation on which the board builds a corporate culture based on a philosophy of high ethical standards and accountability"[2] (as cited in Pittman & Navran, 2003). Several academic studies suggest there are many benefits of acting ethically, such as improved financial and nonfinancial firm performance (Verschoor, 1998), as well as the creation of a sustainable competitive advantage (Azmi, 2006).

Information asymmetry between principals and agents provides opportunities for agents to promote their own interests at the expense of the interests of the principals (Eilifsen & Messier, 2000; Salehi, 2010). In order to minimize such behaviour, principals must establish corporate governance monitoring systems, of which the financial statement audit is arguably the most robust (Salehi, 2010). In this role, the auditor provides "reasonable assurance that the financial statements are free from material misstatements" (Fernando, Elder, & Adbel-Meguid, 2010, as cited in Hajiha & Sobhani, 2012, p. 159).

While financial statement audits are potentially a strong corporate governance control mechanism, not all audit firms have the same level of knowledge and expertise, and hence demand for auditing varies based on the quality of the auditor. DeAngelo (1981) notes that, in order to assess audit quality, readers of the financial statements have to make three judgements: (i) whether the quantity and quality of the audit work undertaken is appropriate for the particular client company; (ii) how technically competent the audit staff are to undertake the work; and (iii) how independent the audit firm is and hence how likely it is to report any unadjusted errors or omissions that it discovers. To make these judgements the readers would need to see the audit working papers and interview the key personnel involved in the audit (Moizer, 1997). However, this is not feasible, and therefore indirect ways of assessing audit quality are used, for example, a check whether auditors have been sued for failing to detect and/or report material misstatements.

This makes high quality auditors less willing to accept questionable accounting practices because if they do so, and later an audit failure is suspected, their reputational capital will suffer. Given their significant investment in reputational capital, Beatty (1989) reasons that Big 4 auditors not only have an incentive to provide a higher quality audit but will also be perceived as being more independent. The large portfolios of well-known corporate clients held by Big 4 auditors strengthen the perception of high quality audit services (Beatty, 1989; Daniels & Booker, 2011). Craswell, Francis, & Taylor (1995) further argue that, although all audit firms must comply with certain standards, larger audit firms are more likely to voluntarily invest in higher levels of expertise.

Given the higher quality of service provided by Big 4 auditors, costs will also be higher. We expect that firms operating in a higher ethical business environment will be more willing to meet this additional cost. Furthermore, Hope, Kang, Thomas, & Yoo (2008) suggest that where firms withhold important financial information the risks to auditors of entering into a professional relationship with such firms increase. Therefore, intuitively, high quality auditors are more likely to accept clients operating in countries with high corporate ethical values (Feltham, Hughes, & Simunic, 1991; Simunic & Stein, 1996). Therefore, we expect that the audit of firms operating in countries with high ethical values will be more likely to be conducted by a Big 4 auditor. Thus, our first hypothesis is:

H1:. *There is a positive association between corporate ethical values and choice of a Big 4 auditor.*

H1 is our main hypothesis, as our primary aim is to address the relationship between corporate ethics and auditor choice. However, board size is viewed as another important corporate governance mechanism that may have an effect on auditor choice (Rezaee, 2004; Johansen & Pettersson, 2013). The board of a company provides leadership and strategic guidance, monitors management and exercises decision control. The board reviews company's policies, strategies, major plans of action, risk policy, annual budgets and business plans, compliance with applicable laws, sets performance objectives, and monitors implementation and performance. Specifically, the board approves the code of conduct and ensures that internal controls include checks and balances to reduce the potential for conflict between the specific interests of management and the

[2] Comments before the Economic Club of New York by SEC Chairman William H. Donaldson (May 8, 2003), available at www.sec.gov/news/speech/spch050803whd.htm; see more at: http://corporate.findlaw.com/law-library/corporate-ethics-and-sarbanes-oxley.html#ftn25.