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Audit quality in common-law and code-law emerging markets: Evidence on earnings conservatism, agency costs and cost of equity

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ABSTRACT

This study focuses on firms that are audited by a big auditor and examines the differentiation in the earnings management potential and the level of conservatism. It also investigates whether being audited by a big auditor would lead to lower agency costs and lower cost of equity. The study focuses on emerging common-law South Africa and code-law Brazil, and seeks to identify whether there are material differences given their dissimilar institutional characteristics. The study reports that even though firms may be audited by high quality auditors, their institutional differences influence significantly firms' earnings conservatism, agency costs and cost of equity. Client firms of big auditors in both common-law South Africa and code-law Brazil exhibit lower discretionary accruals. The study has found evidence of more conservative earnings for South Africa but insufficient levels for Brazil. For common-law South Africa, the presence of effective corporate governance mechanisms reduces agency costs. For code-law Brazil, the corporate governance mechanisms generally display an insignificant impact on reducing agency costs. For common-law South Africa, firm-level performance, growth and market determinants tend to lead to a lower cost of equity. For code-law Brazil, it is found that significant discretionary accruals, market beta and analyst forecast dispersion would result in higher uncertainty and would consequently raise the cost of equity.
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1. Introduction

In light of the recent global financial crisis and the collapse of large financial institutions, such as Lehman Brothers, as well as the audit scandals with worldwide impact, such as Enron and WorldCom, this study seeks to determine the quality of auditing as captured by earnings conservatism, agency costs and the cost of equity, which influence managerial behaviour and reported earnings. Managerial opportunism is associated with the private information that managers possess and which they might use for their own benefit (Easley and O'Hara, 2004). The use of earnings management to increase managerial compensation, to avoid debt covenant violation, to influence investors' expectations and to obtain external capital on better terms would lead to a conflict between managers and shareholders and would give rise to agency costs, thereby making not optimal or suboptimal decisions and harming the long-term financial prosperity of the firm (Fields et al., 2001; Jensen, 1986). For example, managers may manipulate their financial numbers by altering their accounting methods, influencing the estimates and assumptions of key accounting figures, misappropriating assets, misrecording revenues, influencing provisions for bad debts, etc. (Beasley et al., 1999).

Efficient corporate governance mechanisms, such as the existence of an audit committee, of a nomination committee, the presence of independent and non-executive directors on the board of the company, and managerial and institutional ownership, would act as devices for monitoring managers' decision-making process (LaFond and Watts, 2008). For example, a high percentage of outside directors onboard the audit committee would reduce the probability of accounting fraud (Xie et al., 2003). Also, earnings management is less frequent when boards are dominated by company outsiders or when independent nominating and compensation committees are in place (Epps and Ismail, 2009). In a similar vein, auditing reports on the validity of reported financial numbers, assesses the extent to which managers maintain financial reporting integrity and reinforces the company's monitoring structures and effectiveness. The implications of good corporate governance are similar to the implications of a good audit report in the sense that they discourage earnings management and enhance investors' trust and firm value (Balasubramanian et al., 2010; Black, 2001; Borokhovich et al., 2004). High quality auditing would provide investor protection and would enhance firm value (Black et al., 2006). Auditors would seek to assess managers' stewardship and to examine how well they look after the interests and needs of shareholders. Audit controls that are independent and comply with the code of ethics would reduce the possibility of audit failure and would enhance auditors' reputation. It follows that it would be in the economic self interest of auditors to carry out independent and transparent audit procedures.

Conservatism is defined as “the accountant's tendency to require a higher degree of verification to recognise good news as profits than to recognise bad news as losses” (Basu, 1997, p. 7). Earnings conservatism would reduce uncertainty, managerial discretion over overstating earnings as well as the resulting agency costs, investors' scepticism and the cost of equity (LaFond and Watts, 2008). Conservatism would imply that firms provide stakeholders with difficult-to-verify accounting information, such as losses, which would be less prone to manipulation (Basu, 2005). It follows that if auditing increases the level of earnings conservatism and confirms the accuracy of difficult-to-verify items or of judgmental and subjective areas, then, it would provide market participants with higher assurance about the quality of financial reporting. However, the quality of audit practices as well as the independence of audit firms varies significantly.

High quality accounting disclosures verified by good audit reports would reduce information asymmetry between users of accounting information and would subsequently lead to lower cost of equity and better terms of financing (Ashbaugh-Skaife et al., 2006; Botosan and Plumlee, 2002). In contrast, information asymmetry would make investors reluctant to invest their capital and might also lead to situations of market illiquidity, more dispersed financial analyst forecasts, higher bid–ask spreads and higher cost of equity (Healy et al., 1999; Lang and Lundholm, 1996). Being audited by a big 4 auditor would reflect company's determination to commit to high quality financial reporting and to provide stakeholders with proprietary and private information, thereby reducing the scope for accounting manipulations (Palea, 2007).

The level of investment in emerging markets has increased significantly. Emerging markets have liberalised and give substantial expected returns attracting global investors (Harvey, 1995). This study focuses on two emerging markets, namely Brazil and South Africa, which display significantly different institutional characteristics. In particular, South Africa is a common-law country, while Brazil is a code-law country.

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