Government Quality, the Adoption of IFRS and Auditor Choice: A Cross Country Analysis

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ABSTRACT

In this study, we examine the association between country-level government quality and firms’ auditor choice. We use a firm’s choice of a Big 4 auditor as a proxy for the demand for high-quality financial reporting. Using a cross-sectional sample of 142,193 firm-year observations from 46 countries over 1998-2007, we examine the link between the appointment of Big 4 auditors by firms and the government quality after controlling for factors that are related to the demands for high-quality financial reporting. We also test whether the adoption of IFRS by high-quality governments increases the demand for high-quality financial reporting (and hence, the appointment of high-quality auditors). We provide new evidence that government quality in the country of a firm’s domicile has a significant positive effect on the likelihood of choosing a Big 4 audit firm. We also show that strong government-quality acts as a catalyst for the likelihood of choosing a Big 4 audit firm in the IFRS-adopting countries. To our knowledge, this is the first study of its kind to provide direct evidence on the role of government quality in firms’ choice of external auditors. The results provide insights to policy makers on the importance of government quality in the firm’s country of domicile to improving financial reporting quality through the firm’s choice of its external auditor.

Key word: Government quality, Big 4, IFRS, Auditor quality, Investor protection

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