Disclosure Law and External Audit Demand: Evidence from Latin America

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Abstract

The study relies on difference-in-differences to empirically identify the effect of disclosure law changes on external audit demand by private firms across 18 countries in Latin America. Results indicate stronger disclosure law reduces the probability of external audit choice in treated medium-sized firms relative to their untreated counterparts. The finding supports agency theory's prediction that country-level and firm-level governance, represented by disclosure law and external audit choice, respectively, are substitutes in this firm size category. The implication is unintended consequences may result if principals in these firms do not enforce disclosure policy standards.

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Preview

Transparency from disclosure reduces agency frictions (Clatworthy and Peel, 2013; Kausar, Shroff, and White, 2016).[1] This influences corporate governance through effective monitoring by principals (Jensen and Meckling, 1976; Abdel-Khalik, 1993; Bushman and Smith, 2001). It also increases resource allocation efficiency, which enhances investment and economic growth (Greenwood and Jovanovic, 1990; Francis, Huang, Khurana, and Pereira, 2009; Chen, Hope, Li, and Wang, 2011).

These potential gains are not fully realized due to sub-optimal voluntary audit demand (Rennie, Senkow, Rennie, and Wong, 2003; Barton and Waymire, 2004). To address this market failure, audit mandates aim to increase the level of accurate, verified information. However, the effect of this policy intervention on firms' responses cannot be determined *a priori* (Leftwich, Watts, and Zimmerman, 1981). While agency theory argues the two are related, the prediction of how is ambiguous (Doidge, Karolyi, and Stulz, 2007). To resolve this, the article relies on an empirical approach that exploits a quasi-natural experiment arising from changes in disclosure law to investigate its effect on private firms' external audit demand by relying on a difference-in-differences identification technique.

Firm-level analysis is adopted to mitigate aggregation bias (Holderness, 2016). Estimations are separated by firm size category to capture heterogeneity effects. This allows exploration of whether the exogenous shock matters in small firms, which are typically not subject to disclosure mandates. Including firms' features in the analysis allows us to use them to match treated firms to their five closest untreated counterparts in a nearest-neighbor matching robustness check.

Random effects probit estimation results indicate a unit increase in strength of a disclosure law index score reduces the probability of external audit choice in medium-sized firms by 8.8 percentage points. This implies the country-level governance represented by disclosure law, reflecting *ex ante* anti-self-dealing law, substitutes for the firm-level governance represented by external audit choice (Doidge et al., 2007).

The finding suggests policy to strengthen disclosure law influences agency issues in privately held medium-sized firms in the region. If principals rely on the law to enforce disclosure standards in these firms rather than requiring agents to allocate resources to produce external audits voluntarily, dead weight loss is reduced. If this is not the case, frictions may be exacerbated resulting in a "missing middle" in the firm financing topography.[2]

[1] Aguilera, Marano, and Haxhi (2019) discuss non-agency perspectives.

[2] See Hsieh and Olken. (2014) for a discussion on the "missing middle".

Conflict of Interest

The author declares they have no known competing financial interests or personal relationships that could have appeared to influence the work reported in this preview.

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