



The Role of Independent Assurance Providers in Legitimizing Companies' Environmental, Social and Governance Risks

Senny Harindahyani¹(✉) and Bambang Tjahjadi²

¹ University of Surabaya, Surabaya, Indonesia
senny.h@staff.ubaya.ac.id

² Universitas Airlangga, Surabaya, Indonesia

Abstract. This study aims to examine the impact of environmental, social and governance (ESG) risks in selecting independent auditors based on legitimacy theory. This study expects that companies with lower ESG risk levels will increase user trust by hiring reputable independent auditors to increase the reliability and credibility of their reports. This study conducted empirical testing using the logit model. The data used were obtained from the OSIRIS database, the company's website and the CSRHub database, especially for the ESG risk rating. The results prove that companies with low ESG risk levels will legitimize their reporting by involving reputable auditors (Big-4) to audit their financial reporting.

Keywords: ESG Risk · Big-4 · Legitimacy Theory

1 Introduction

Environmental, social and governance (ESG) risks can threaten business activities, increase the financial risk and disrupt companies' going concern [1]. ESG risk can be identified through reports issued by a company; as stated by Simnett et al. [2], the company's activities are reported simultaneously in financial and non-financial statements. However, only reports that are assured by external parties have a high level of reliability and increase user trust [3–6]. Therefore, this study aims to examine the decision to use independent external parties in order to legitimize the reliability of the company's ESG risk disclosure to increase user trust.

Companies with higher ESG ratings can be interpreted as having lower ESG risk. A high ESG rating is a signal that the company can mitigate its risk to a lower level [7] and this present study sets ESG ratings as a proxy for ESG risk. Using the legitimacy theory perspective, lower ESG risk companies are perceived to increase user trust by hiring reputable auditors to assess their financial statements.

The use of reputable auditors or known as Big-4, to audit financial statements can improve reporting quality. Based on prior studies, Big-4 firms provide higher audit

quality [8–10]. Big-4 can produce higher quality corporate financial reporting by implementing high-risk disclosure [11–13], tightening the practice of using financial reporting standards by companies [14, 15] and improving the value relevance of earnings and quality [16]. The purpose of companies with lower ESG risk using reputable auditors is perceived to strengthen the level of user trust. Lim and Mali [17] interpret that companies with lower risk demand higher audit efforts to overcome information asymmetry and hire Big-4 auditors to confirm the effectiveness of financial reporting systems. The present study contributes to the auditing and assurance literature. This study shows that companies with low ESG risk need reputable auditors to increase their legitimacy and user trust. The change in the audit mode of financial statements to RBAA in the early 2000s had a significant impact on the auditor's efforts to assess risk. Audit testing in the audit program directs the auditor to identify and examine the main risks that can cause material misstatements in the client's financial statements [18]. This deeper identification of the company's business risks resulted in two important stages known as risk assessment and risk response [19, 20], thus, it can be argued that risk assessment of financial statements covers the company's overall business risks including ESG risk. Munoko [21], who used all US public companies covered in the RepRisk database from 2007–2014, revealed that auditors seek higher audit effort for companies with negative ESG issued and that audit accuracy is associated with higher audit quality. Auditors' awareness of the transparency of ESG information is shown through their efforts to improve audit quality [22].

In Asia, the implementation of the RBAA, which stems from adopting International Standards on Auditing (ISA), has gradually brought significant changes to the auditor's understanding in evaluating risk and performing audit procedures. This condition has resulted in the auditor's testing of financial statements not only being limited to specific risks, such as financial statement risk, internal control risk, and inherent risk, but also other risks. For example, in China, the RBAA significantly enhances the relationship between audit effort and corporate governance risk, and reputable auditors are proven superior in their efforts [23]. The findings of Carmona et al. [11] strengthen that Big-4 can carry out high-risk disclosure regarding corporate governance practices.

The legitimacy of companies to choose quality financial statement auditors is more easily achieved using the Big-4. Boone et al. [24] prove that although second-tier audit firms also have audit quality that appears to be similar; from the beginning, investors perceive that equity risk premium to be lower for Big-4 clients. Investor perceptions, especially long-term institutional ownership, towards Big-4 are based on investor confidence in their ability to carry out corporate monitoring [25]. Additionally, Big-4, in assessing risk, is supported by audit information technology investments that are superior to non-Big-4 [21, 26, 27]. Therefore, the Big-4 is perceived can interpret business risk more broadly and conduct a comprehensive risk assessment, including sharpening the focus on ESG risk, which is currently known as an emerging issue. Based on previous research, the audit quality of Big-4 firms in ASEAN 5 is perceived to be higher than non-Big-4 firms [28–31]. Therefore, this study perceives that companies with low ESG risk in ASEAN 5 will legitimize their reporting by hiring Big-4. The first hypothesis of this paper is as follows:

H1: Firms with lower levels of ESG risk are more likely to hire Big-4 firms to audit their financial statements.

2 Research Method

The sample used in this study was companies in ASEAN 5 (Indonesia, Malaysia, Philippines, Singapore and Thailand) from 2016 to 2019. Compared to other ASEAN countries, ASEAN 5 are emerging countries with the highest economic growth value [27]. Logistic regression models can be formulated as follows:

$$P(BIG - 4)_{it} = \beta_0 + \beta_1 L_ESGrisk_{it} + \beta_2 SIZE_{it} + \beta_3 ROA_{it} + \beta_4 DAR_{it} \\ + \beta_5 LOSS_{it} + \beta_6 TMTsize_{it} + \beta_7 BODsize_{it} + \beta_8 CPI_{it} + \beta_9 ESI_{it} + \varepsilon_{it}$$

The dependent variables used in this study are Big-4. To test H1, companies whose financial statements are audited by Big-4 are scored 1 and 0 if audited by non-Big-4. Big-4 consisting of Deloitte, EY, KPMG and PwC, are auditors with a better reputation than non-Big-4 because they are proven to produce higher audit quality [8–10]. Using Big-4 will ease companies to achieve their legitimacy because, from the beginning, investors perceive the equity risk premium to be lower for Big-4 clients [24] and Big-4 is more effective in conducting corporate monitoring [25]. Furthermore, the independent variable in this study is low ESG risk (L_ESGrisk), which was measured using the overall rating from the CSRHub database.

3 Results and Discussion

The test results of model indicate that L_ESGrisk is positively and significantly associated with Big-4; thus, H1 is supported (L_ESGrisk, $b = 0.047$, $p < 0.05$). This means that firms with lower levels of ESG risk in ASEAN 5 are more likely to audit their financial reporting by hiring the Big-4 to legitimize their reporting. These results are in line with the results of previous studies, which stated that the audit quality of Big-4 in ASEAN 5 was higher than non-Big-4 [29–32] (Table 1).

Table 1. Logistic regression analyses.

Independent variables	Model 1 (Big-4)	Robustness checks
L_ESGrisk	0.047** (0.019)	0.052*** (0.020)
SIZE	0.158* (0.091)	0.210** (0.097)
ROA	0.327 (1.393)	0.619 (1.456)
DAR	0.011 (0.101)	0.005 (0.100)
LOSS	-0.270 (0.412)	-0.260 (0.415)
TMTsize	-0.049*** (0.016)	-0.059*** (0.017)
BODsize	0.072* (0.041)	0.000 (0.047)
CPI	-0.012 (0.273)	-0.044 (0.283)
ESI	-0.789*** (0.305)	-0.869*** (0.313)
Big-4	-	-
Constant	-3.377 (2.160)	-3.735 (2.277)
Year controls	-	Yes
Country controls	-	Yes
Negelkerke R ²	0.082	0.100
n	953	953
Hosmer and Lemeshow test	0.71	0.389

4 Conclusion

ESG momentum increases the awareness of companies in ASEAN 5 to mitigate ESG risks. An important point that needs to be underlined is how companies legitimize statements regarding the success of the mitigation in order to gain user trust. The results of this study indicate that based on the pooled sample, companies with low ESG risk in ASEAN 5 prefer Big-4 to audit their financial statements.

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