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Takeover premiums and the perception of auditor independence and reputation

Martin Bugeja*

School of Accounting, The University of Technology, Sydney, 2007 New South Wales, Australia

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A B S T R A C T

This study investigates if there is a positive association between takeover premiums and the bidder's perception of target firm auditor reputation and independence. Using auditor size as a proxy for auditor reputation, the results indicate that in hostile takeovers target shareholders receive a higher takeover premium when a Big 4 auditor audits the target firm prior to the takeover. This result is only significant, however, in the period prior to the highly publicised audit failures. The impact of perceived auditor independence on takeover premiums is studied using the levels and size of non-audit service (NAS) fees provided by the target firm auditor. Using three proxies for auditor independence, the results show no association between perceived auditor independence and takeover premiums. This finding is robust to partitioning the sample by auditor size, takeover hostility and splitting the sample into takeovers pre- and post- the corporate scandals that occurred in 2002.

1. Introduction

The provision of non-audit services (NAS) by auditors to their clients received worldwide regulatory attention in the early 2000's, following high-profile corporate collapses (e.g., Enron and WorldCom (US) and HIH Insurance (Australia)). Underpinning this regulatory reform is the belief that NAS reduces the quality of financial statements by impairing auditor independence. As stated by the US Securities and Exchange Commission, "an auditor's independence is impaired either when the accountant is not independent in fact, or when in light of all relevant facts and circumstances, a reasonable investor would conclude that the auditor would not be capable of acting without bias" (SEC, 2000). This comment highlights the two dimensions of auditor independence, "independence in fact" and "independence in appearance." Prior research examining the first dimension of auditor independence provides inconsistent results with the majority of studies finding that NAS does not impair auditor independence (e.g., DeFond, Raghunandan, & Subramanyam, 2002; Chung & Kallapur, 2003; Hay, Knechel, & Li, 2006). Increasingly, more attention is being devoted to the second dimension of auditor independence (e.g., Glezen & Millar, 1985; Krishnan, Sami, & Zhang, 2005; Khurana & Raman, 2006).

This paper examines whether the perception of auditor independence impacts on investors' decisions. The context used in this study is the premium offered by bidding firms in Australian hostile takeovers. When a company decides to make a takeover offer, the calculation of the offer price is a crucial decision. In a friendly takeover, the target firm can typically conduct a due diligence of the target firm's financial affairs. For example, in the 2006 friendly takeover bid for Qantas Airways

* Tel.: +61 2 9514 3743; fax: +61 2 9514 3669.
E-mail address: martin.bugeja@uts.edu.au.

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Limited by Airline Partners Australia, Qantas indicates in its Target Statement "the Board granted due diligence and management access to the consortium investors after obtaining confidentiality undertakings."[1] In contrast, in a hostile takeover, as the bidding firm (and its advisers) do not have access to inside information about the target firm, the pricing decision must be based on publicly available financial information. In these circumstances, it is expected that any doubt over target firm financial statement credibility will flow through to the premium offered. As a result, this context provides an interesting research setting to determine if the provision of NAS affects the perception of auditor independence and, consequently, influences the premium offered by the acquiring firm. Investigating this association in Australia is advantageous as fees received by auditors are a required disclosure. Furthermore, as Australia is less litigious than the US, Australian auditors have less incentive to remain independent due to the lower concern that litigation will harm their reputation (Francis, 2006 and Gul, Tsui, & Dhaliwal, 2006).

The hypothesis of a positive relationship between takeover premiums and auditor independence is tested using audit and NAS fee data for the target firm collected for the year prior to the takeover announcement. The results indicate there is no association between auditor independence and takeover premiums. These findings add to prior research and raise doubts over whether the introduction of regulation to restrict the provision of NAS by auditors was justified.

Findings from previous research indicate that large audit firms provide a higher quality audit (e.g., Palmrose, 1988 and Beatty, 1989) This study extends this line of research by examining if target firms using Big 4 auditors receive a higher takeover premium in hostile bids. In hostile bids the greater financial statement credibility offered by the use of a large auditor is predicted to result in the payment of a higher premium. Furthermore, this study determines if the association between takeover premiums and auditor type was impacted by the auditing failures that occurred in the early 2000's. The results indicate that in hostile takeovers higher takeover premiums are paid to target firms engaging large auditors. This additional premium however is eliminated in the period following the auditing scandals in the early 2000s. This finding is consistent with a loss in reputation for the large auditing firms following the auditing failures.

The remainder of the paper is structured as follows. Section 2 discusses prior literature and develops hypotheses. The subsequent section discusses the research design and is followed by a description of the data collection process. Section 5 presents the results and the final section of the paper provides a conclusion.

2. Prior literature and hypotheses development

2.1. Auditor reputation and independence

As auditor reputation is not directly observable, prior research uses auditor size and brand name as an indicator of auditor reputation and quality. The use of size as a proxy for audit quality is advocated by DeAngelo (1981). She argues that, as larger audit firms have a greater potential loss of client specific quasi-rents from breaching audit independence, they have a greater ability to perform their duties free of management's influence. Likewise, size will be a valid proxy for quality because large auditors have an incentive to protect their investment in brand name and reputation (Klein & Leffler, 1981 and Shapiro, 1983). The findings of prior research (e.g. Ashbaugh, LaFond, & Mayhew, 2003; Craswell, Francis, & Taylor, 1995Choi, Kim, Liu, & Simunic, 2008; Francis, 1984; Francis & Stokes, 1986; Francis & Simon, 1987; Gist, 1992; Pong & Whittington, 1994 and Palmrose, 1986) of an audit fee premium being paid to large auditors is typically interpreted as being consistent with such auditors providing a higher quality product.[2]

Studies examining the outcomes of the audit process are also consistent with large auditors providing higher quality audits. For example, prior studies indicate that large auditors have a lower incidence of litigation (Palmrose, 1988),[3] have higher earnings quality (e.g., Becker, DeFond, Jiambalvo, & Subramanyam, 1998; Francis & Wang, 2008 and Krishnan, 2003) and are associated with lower underpricing in initial public offerings (IPOs) (Balvers, McDonald, & Miller, 1988 and Beatty, 1989).[4] In addition, Menon and Williams (1991) find that the majority of auditor changes in an IPO are to a large auditor consistent with such auditors increasing financial statement credibility. Furthermore, Lee, Stokes, Taylor, and Walter (2003) show that firms in IPO's using a large auditor are more likely to provide earnings forecasts.

In the case that an auditor provides NAS to their audit clients, it is argued that cost savings arising from knowledge spillovers create an economic bond between the client and auditor (Beck, Frecka, & Solomon, 1988; Simunic, 1984). It is contended that this economic dependence results in the auditor being more willing to compromise their independence and acquiesce to the will of management. This contention assumes that the costs of breaching independence (e.g., litigation and loss of reputation) are less than the benefits of client retention. Additionally, it is claimed that, as NAS provides a greater financial return, auditors will not want to take actions that jeopardise this lucrative revenue stream. For example, Arthur Levitt, the chairman of the US SEC, stated, "the audit function is simply being used as a springboard to more lucrative consulting services" (Levitt, 2000).

[1] Qantas Airways Limited, Target Statement, p 13. Available on the ASX website: http://www.asx.com.au.

[2] Not all studies document a Big 4 audit fee premium. For instance, Antle et al. (2006) document otherwise.

[3] In contrast, Lys and Watts (1994) find the probability of litigation is not associated with auditor size.

[4] Chang, Gygax, Oon, and Zhang (2008) find greater underpricing in Australian IPO's when a large auditor is used. They interpret this result as indicating that the use of a quality auditor signals a higher after-market value of the newly listed firm.