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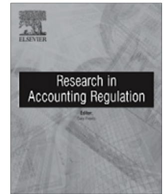

Barriers to entry to the big firm audit market: Evidence from market reaction to switches to second Tier audit firms in the post-sox period

Charles P. Cullinan [a,1], Hui Du [b,*], Xiaochuan Zheng [a,2]

[a] Bryant University, 1150 Douglas Pike, Smithfield, RI 02917, USA
[b] University of Houston – Clear Lake, 2700 Bay Area Blvd, Box 42, Houston, TX 77058, USA

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ABSTRACT

The US Government Accountability Office (GAO) studied concentration in the audit market and found that the Big 4 firms continue to dominate the market for clients with revenue of more than $500 million while non-Big 4 firms have gained market share among clients with revenue of $500 million or less (GAO, 2008). The US Treasury Advisory Committee on the Auditing Profession has expressed concern about barriers to entry that might prevent a non-Big 4 firm from increasing its market share among large publicly-traded clients (Advisory Committee, 2008). One of these barriers may be the potential cost to shareholders if the stock market reacts negatively to the appointment of a non-Big 4 auditor (GAO, 2003). We examine whether the stock market reacts negatively when clients switch from a Big 4 to a non-Big 4, because a negative reaction might make such switching less likely to occur. We find that the market does not react more negatively when clients move from a Big 4 to a Second Tier auditing firm than when clients move from a Big 4 to another Big 4 firm. Our results suggest that a negative market reaction may not represent a significant barrier to entry among Second Tier auditing firms.

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Introduction

Considerable audit market realignments occurred as a result of the mergers of large accounting firms in the 1980s and 1990s, during which the Big 8 accounting firms were reduced to the Big 5. Further consolidation occurred due to the demise of Arthur Andersen in 2002, which reduced the Big 5 firms to the Big 4. In response to these changes, the US General Accounting Office (GAO) studied market concentration in the US public company audit market. The GAO's 2003 study concluded that competition in the audit market had decreased as a result of the reduction in the number of the largest accounting firms. The study also recognized, however, that the audit market in 2003 was in a state of considerable flux and concluded that (GAO, 2003, "Highlights" page):

> ...given the unprecedented changes occurring in the audit market, GAO observes that past behavior may not be indicative of future behavior, and these potential implications may warrant additional study in the future, including preventing further consolidation and maintaining competition.

The changes to which the GAO referred in the 2003 report were the creation of the PCAOB, and the impending implementation of Section 404 of the Sarbanes–Oxley Act of 2002 (SOX), which requires publicly-traded firms to have independent audits of their internal control systems. The US Government Accountability Office[3] (GAO) prepared

* Corresponding author. Tel.: +1 281 283 3144.
E-mail addresses: cullinan@bryant.edu (C.P. Cullinan), duhui1@uhcl.edu (H. Du), xzheng@bryant.edu (X. Zheng).
[1] Tel.: +1 401 232 6421.
[2] Tel.: +1 401 232 6811.

[3] Note that between the 2003 report and the 2008 report, the name of the GAO changed from the General Accounting Office to the Government Accountability Office.

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another study on audit market concentration as of the end of 2006, by which time the PCAOB was well established, and the internal control audit provision of SOX had been in effect for two years. In the 2008 study, the GAO documents a material increase in the market share of non-Big 4 firms (and a decrease in the market share of Big 4 firms) from 2002 to 2006 among publicly-traded firms with $500 million or less in revenue. The Big 4 accounting firms continued to dominate the market for clients with more than $500 million of annual revenue.

The Treasury Advisory Committee (Advisory Committee, 2008) was established to provide advice to the Department of Treasury on the future of the auditing profession in the United States. The committee dealt with a wide variety of issues facing the US auditing profession, including human capital, firm structure and finances, and concentration and competition. Research has begun to examine various aspects of the Advisory Committee's report. For example, Foster, McClain, and Shastri (2010) examined the committee recommendation to improve the audit reporting model. With regard to competition, the committee indicated that the financial markets depend on a viable and competitive audit market, and that the high degree of market concentration by the Big 4 firms in the larger client audit market could be an impediment to the growth of the US financial markets. The committee also provided recommendations to enhance competition by reducing barriers to the growth of non-Big 4 firms.

In this study, we assess whether changing to a non-Big 4 auditing firm has resulted the stock market reacting negatively to clients making such an auditor change. The potential negative reactions could inhibit clients from making such changes, and thus be a barrier to growth of non-Big 4 auditing firms. Changes to non-Big 4 could be regarded negatively for a number of reasons. These reasons include the concern that the use of a non-Big 4 auditor could reduce the credibility of accounting information, as Big 4 firms may be perceived to provide higher quality audits (e.g., Simunic, 1980). Alternatively (or complementarily), the selection of a non-Big 4 auditor could signal that the company is not an attractive client for a Big 4 firm, which may be more selective in their choice of clients. In this case, moving from a Big 4 to non-Big 4 may be an unfavorable signal to the marketplace about the client's future prospects. Either of these effects could result in a cost to stockholders from a switch from a Big 4 to a non-Big 4 accounting firm.

Consistent with the GAO's classification scheme and with other recent research on the audit market (e.g., Hogan & Martin, 2009), we categorize auditors into three size-based market segments: Big 4 firms, Second Tier firms,[4] and Third Tier firms. Using stock market reaction to client switching from Big 4 to non-Big 4, we find that the market-imposed shareholder cost of clients switching from Big 4 to Second Tier firms is not significantly different from if these clients engaged another Big 4 auditor. However, the market does impose more cost to shareholders on those clients changing from Big 4 to Third Tier auditing firms. Specifically, we document a negative market reaction that equates to a median loss in market capitalization of over $1 million for a client making a change from a Big 4 to a Third Tier firm.

Our study is important because the GAO (2003) has expressed concern about concentration in the market for audits of publicly-traded companies. Similarly, the US Treasury Advisory Committee (Advisory Committee, 2008) has indicated that barriers to growth of non-Big 4 accounting firms could inhibit efforts to reduce this concentration. If the selection of a non-Big 4 auditor imposes stock price declines on shareholders, clients may be reluctant to make such a switch. Market concentration by Big 4 firms may therefore persist, leading to less competitive audit markets. Alternatively, if the market does not react unfavorably to a switch from Big 4 to non-Big 4 auditors, clients may be more willing to switch from Big 4 auditors, which could facilitate enhanced competition in the audit market of publicly traded companies. It is also relevant to distinguish Second Tier and Third Tier firms among non-Big 4 auditors and understand whether the cost to shareholders is different between these tiers of auditing firms because of the material growth in market share among Second Tier auditors. Our findings suggest that the GAO's interest in ensuring competition in the audit market may be achieved without an adverse effect on the company's market value when switching from a Big 4 to a Second Tier accounting firm.

The remainder of this paper is organized as follows. First, we present the prior research and the development of hypotheses. We then describe the research methods used and discuss the results of our testing. The paper concludes with a summary of the findings and their implications.

Prior research and hypotheses

In this section, we first examine the evolving nature of the public-company audit market, including the decreasing market share of the Big 4 firms in the smaller client segment of the audit market. We then examine the potential audit quality differences among Big 4, Second Tier and Third Tier auditing firms and discuss client-auditor alignment. Our hypothesis development is presented last in this section.

The audit market

Recent changes in the audit market

The GAO (2008) documents a material decrease in the market share of Big 4 firms in a number of segments of the audit market between 2002 and 2006.[5] Table 1 present

[4] These firms are BDO Seidman, Crowe Chizek, Grant Thornton and McGladrey Pullen, which we use in our study to ensure consistency with the US Government Accountability Office (GAO) (2008). These four firms were also included in the Second Tier measure of Hogan and Martin (2009). Other researchers have used variations in the specific firms they included in the Second Tier (e.g., Chang, Cheng, & Reichelt, 2010; Fuerman & Kraten 2009).

[5] The change in the audit market during this period is generally attributed to the demise of Andersen, and the implementation of the Sarbanes-Oxley Act internal control reporting provisions (Hogan & Martin 2009; Landsman, Nelson, & Rountree, 2009). Both of these events resulted in increased demand on the limited resources of the Big 4 firms.

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