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Research Report

The emergence of second-tier auditors in the post-SOX era: An analysis of accounting conservatism ☆

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ABSTRACT

The increased resource constraints experienced by Big-N audit firms as a result of the passage of Sarbanes-Oxley Act (SOX) contributed to the emergence of second-tier audit firms as viable alternatives to the Big N for public company clients, as suggested by the PCAOB. This study provides a comparative examination of an important property of accounting numbers, earnings conservatism, for clients of Big-N and second-tier audit firms in both the pre- and post-SOX periods. Our findings indicate that, while there is a general increase in conservatism in the post-SOX period, there is no significant difference in conservatism between clients of Big-N and second-tier auditors in either the pre- or post-SOX periods. In addition, the results show greater conservatism in the post-SOX period among clients of Big-N and second-tier firms relative to that of other (non-Big-N/non-second-tier) audit firms. Overall, the results lend support to the PCAOB's recommendation concerning the use of second-tier auditors as a viable alternative to the Big-N and to the effectiveness of SOX in increasing reporting conservatism among clients of all auditors conducting public company audits in the post-SOX period.

Introduction

The audit market in the United States witnessed dramatic changes following the collapse of Arthur Andersen. These changes included the formation of the Public Company Accounting Oversight Board (PCAOB) and the passage of Sarbanes-Oxley Act (hereafter SOX). The passage of SOX resulted in new audit requirements such as assessing and reporting on the effectiveness of internal control systems, which created additional demands on the resources of the public accounting firms (Nagy & Cenker, 2007). Presumably, because of the SOX-related resource constraints faced by the Big-N audit firms, there has been a shift of clients from Big-N[2] auditors to non Big-N auditors (Byrnes, 2005; Cassell, Giroux, Myers, & Omer, 2008; Gullapalli, 2005; Rama & Read, 2006; Glass Lewis, 2005). The PCAOB has also encouraged the usage of second-tier audit firms as an alternate to Big-N audit firms (Grant Thornton LLP., 2006), suggesting that from the regulatory agency's perspective, there is no difference in the quality of audits of Big-N firms and second-tier firms. We empirically examine this issue and investigate whether there is a difference in the quality of audits of Big-N and second tier firms.

Until recently, a number of researchers have used only two classifications of auditors: Big-N and non-Big-N to examine the quality of audits and have documented that the quality of Big-N audits is relatively high (e.g., Becker, DeFond, Jiambalvo, & Subramanyam, 1998; Francis & Krishnan, 1999; Krishnan & Schauer, 2000; Palmrose, 1988). In this study, rather than using a Big-N/non-Big-N

☆ Data availability: Data used in this study were obtained from publicly available sources identified in the text.

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[2] Big-N refers to accounting firms previously defined in the literature as either Big Eight, Big Six, Big Five, or Big Four.

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dichotomy, we further categorize non-Big-N auditors to identify second-tier auditors. We examine the second-tier firms separately for the following reasons. First, a majority of extant research has focused on the quality of audits of Big-N audit firms and there is a paucity of research on the quality of audits by second-tier audit firms.[3] Second, the second-tier audit firms appear to be growing at a much faster rate compared to Big-N firms (Cassell et al., 2008), suggesting a need for a better understanding about the quality of their audits and the properties of their clients' earnings. The emergence of second-tier audit firms as a "brand name" thus leads to interesting questions regarding the quality of their audits.

In our empirical investigation, we first examine whether there is a difference in conditional conservatism (i.e., asymmetric timeliness of bad news reporting) among clients of Big-N audit firms, second-tier firms, and all other non-Big-N firms. Second, we examine whether this difference has been consistent in the pre- and post-SOX periods. The collapse of Andersen created concerns about the quality of audits/earnings in general and resulted in the passage of Sarbanes-Oxley act in 2002. These developments are likely to have had an impact on the quality of audits with equity holders demanding timelier reporting of bad news. The gap, if any, between the level of conservatism of clients of Big-N and second-tier audit firms is likely to decrease in post-SOX period.

We find the reporting conservatism of clients of Big-N firms and second-tier firms to be similar. There is no difference in earnings conservatism in either the pre- or post-SOX periods. We do, however, find a difference in the conditional conservatism of earnings between Big-N/second-tier and all other audit firms, with conservatism being greater for clients of Big-N and second-tier firms.

We make the following contributions to the literature. First, our study provides empirical evidence supporting the PCAOB's recommendation of engaging second-tier firms as viable substitutes for Big-N audit firms. Second, our study documents significant differences in conservatism among the Big-N/second-tier and all other audit firms, especially in the post-SOX period.

The remainder of the paper is organized as follows. Section 2 provides background and literature review. Section 3 provides details on the methodology. Section 4 presents a description of the data and empirical results and Section 5 concludes.

Background

Cassell et al. (2008) find that the perceived credibility of financial reporting (proxied by cost of equity) increased for client firms of second-tier audit firms for six years following the collapse of Andersen. Further, the credibility of financial statements was found to be comparable to those of clients of Big-N audit firms in the post-SOX period. They also find similar results when examining the earnings response coefficient of client firms of Big-N and second-tier firms. Boone, Khurana, and Raman (2010) also find that the quality of audits of second-tier audit firms, as measured by the quality of reported accruals, is comparable to that of Big-N audit firms. They, however, find that the *ex-ante* cost of equity capital of Big-N clients to be lower to that of second-tier audit firms which they conjecture to be related to insurance considerations such as deep pockets rather than audit quality. Krishnan, Park, and Vijayakumar (2008) examine a sample of Big-N client firms that switched to second-tier and find that second-tier audit firms tolerated greater earnings management in the pre-SOX period. In the post-SOX period, however, they constrain earnings management.

Collectively, prior research finds support for the notion that the quality of earnings as measured by the quality of accruals and the perceived quality of earnings of client firms of Big-N and second-tier auditors to be comparable.

The relation between auditor characteristics and conservatism

Prior research demonstrates that auditor attributes affect the reporting of conservative earnings. Basu, Hwang, and Jan (2001) examine differences in conservatism between Big-N and non-Big-N auditors and find that Big-N auditors are generally more conservative. The authors attribute the increased conservatism to a higher degree of litigation risk faced by Big-N auditors. The implication of these results is that Big-N auditors view conservatism in their clients' financial statements as desired by the courts and, hence, encourage the reporting of conservative earnings by their clients. Krishnan (2003), Krishnan (2005) demonstrates that clients of Big-N, industry specialist auditors engage in less earnings management and report more conservatively than non-specialists. Related to litigation risk, prior research has found that Big-N auditors may have incentives to encourage clients to report more conservatively in order to protect their reputation (Francis & Krishnan, 1999).

The recent emergence of second-tier audit firms as a brand name suggests that the second-tier audit firms also face litigation and reputation concerns, which would create an incentive to influence their client firms to report conservatively.

Methodology

Sample selection

Our study spans the years 1998–2006. Consistent with Boone et al. (2010), we divide our sample into an equal number of years in each of our time periods (i.e., pre and post-SOX). The pre-SOX period consists of fiscal years 1998 through 2001 and the post-SOX period consists of fiscal years 2003 through 2006. We leave out the year 2002, the year SOX was passed into law, as a transitional year. For a given firm-year observation to be included in the study, information on earnings, auditor, and stock returns must be available from the COMPUSTAT or CRSP databases. In order to mitigate the effect of outliers, we delete the top

[3] Although we are measuring conditional conservatism, we feel that relating this measure to extant research on "audit quality" is appropriate to that extent that conditional conservatism is considered a desirable property of audit clients' earnings, which we discuss in the next section.