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Acquirers' abnormal returns and the non-Big 4 auditor clientele effect ☆

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Abstract

I analyze the effect of auditor choice on acquirers' values around merger announcements and the factors affecting the interaction between auditor size and the market reaction to merger announcements. I find that acquirers audited by non-Big 4 accounting firms outperform those audited by Big 4 firms. This effect is more pronounced when the targets are privately held and when the likelihood of the auditors playing a prominent advisory role increases. While the largest auditing firms are usually assumed to offer superior services, the study suggests that smaller firms have a comparative advantage in assisting their clients in merger transactions.

JEL classification: G34; G38; M41

Keywords: Merger; Auditor size; Auditor clientele; Non-audit services; Private target

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1. Introduction

I analyze the effect of auditor choice on acquirers' market values around merger announcements and the factors affecting the interaction between auditor size and the market reaction to merger announcements. Carpenter and Strawser (1971), in a management survey, find that clients of non-Big 4 audit firms tend to switch to Big 4 firms prior to issuing stocks with the intent of reducing their cost-of-capital.[1] Johnson and Lys (1990) also find that anticipation of acquisitions is associated with a firm's decision to switch to a larger auditor. However, while a substantial proportion of non-Big 4 audit firms' clients switch to more prestigious auditors prior to merger bids, most acquirers audited by non-Big 4 firms do not switch auditors. This suggests that, for most clients of non-Big 4 audit firms, the continued use of non-Big 4 auditors is optimal.

The Big 4 audit firms certainly have more resources than the non-Big 4 firms and arguably provide better quality audit.[2] However, the non-Big 4 firms are likely to have comparative advantages in some areas. Merger and acquisition is probably one such area. Non-Big 4 audit firms' personnel presumably have superior knowledge of the local markets and usually have close and long-time connections with and the trust of their local business communities. According to William E. Balhoff, Chairman, Executive Committee of the AICPA Public Company Practice Section, "[t]he CPA serves as the 'trusted advisor' of the small business owner."[3] In a survey of chief executive officers (CEOs) of privately owned companies, Addams and Davis (1994) find that privately owned firms particularly value personal relationships with their auditors, the auditors' responsiveness, their advice, and their understanding of the companies' businesses. These needs seem to characterize not only privately owned companies but also small businesses in general. Peale (1994) observes that "[s]mall [audit] firms tout their service, and lower prices, as proof that small businesses should stick with small accounting firms." The claim of the smaller audit firms seems consistent with existing studies in the organizational ecology area (see Boone et al., 2000; Carroll et al., 2002). Boone et al. (2000, p. 363), for instance, argue: "[T]he services of small audit firms are much more personalized than those of large auditors. In fact, the small-firm auditor frequently becomes the confidant of the small business manager, providing personal advice and information on many issues … ." Consistent with Boone et al. (2000), Berton (1994) observes that small clients

[1]Throughout the paper, I use Big 4 generically to designate Big 4, Big 5, Big 6, and Big 8 audit firms, depending on the period.

[2]The presumed superior quality audit is reflected in the clients of Big 4 audit firms having higher earnings response coefficients (Teoh and Wong, 1993), higher audit fees (Beatty, 1989; Craswell et al., 1995), lower litigation rates (St. Pierre and Anderson, 1984; Palmrose, 1988; Lys and Watts, 1994), and lower discretionary accruals (Becker et al., 1998). According to Charles D. Niemeier, acting chairman of the new accounting oversight board and former chief accountant in the SEC's enforcement division, Big 4 audit firms are more likely to detect accounting problems (Hilzenrath, 2003). See Dopuch and Simunic (1980), DeAngelo (1981), Titman and Trueman (1986), and Johnson and Lys (1990) for more detail on the relation between audit firm size and audit quality.

[3]Oversight Hearing on "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies." U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 14, 2002.