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Auditor specialization, perceived audit quality, and audit fees in the local government audit market

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Abstract

Prior governmental research implies a positive relation between auditor specialization and audit quality, but the effect of specialization on audit fees is mixed. However, no single governmental study investigates the effect of auditor specialization on both audit quality and audit fees. Also, prior studies focus on either large- or small audit firms and often employ indirect proxies for audit quality. We study the effects of auditor specialization on perceived audit quality and audit fees. Our data represent both Big 5 and smaller audit firms and include three market-based measures of specialization. We survey 241 Florida local government finance directors and find that specialization is positively associated with perceived audit quality but not with audit fees. We also find that Big 5 auditors, often used as a proxy for higher audit quality in prior research, are not uniformly associated with increased perceived audit quality but consistently charge higher audit fees. Our results confirm a relation between measures of audit firm specialization and audit quality and raise questions regarding audit firm size and audit quality

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in the municipal sector. Our findings suggest that engaging specialized auditors may be good policy for many local governments.

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1. Introduction

Policy suggests that governments should endeavor to obtain high-quality audits at reasonable cost (Gauthier, 2005; GAO, 1987), but the extent to which this objective is met in practice is unknown due to limited existing research findings. Prior studies of the effect of auditor specialization on governmental audit quality reveal a positive relation between specialization and quality; however these studies often omit segments of the audit market by focusing on only Big 5 firms or non-Big 5 firms and do not consider the effects of audit fees. While Elder (1997) argues that cost considerations are also relevant to the auditor appointment decision, the available evidence concerning the effect of auditor specialization on government audit fees is limited, inconsistent, and does not incorporate measures of audit quality. In sum, the extant literature provides incomplete guidance to government officials charged with optimizing auditor procurement decisions.

We report a study of the effects of auditor specialization on perceived audit quality and audit fees in a competitive market in which specialized audit firms play a considerable role. Our study employs continuous, market-based measures of specialization rather than relying on ad hoc definitions of government audit “specialists” used in previous studies.

We survey 241 finance directors of Florida local governments regarding their perceptions of the quality of the audit their government received. We also obtain data on audit fees and other audit-related control variables. We find that auditor specialization is positively related to perceived audit quality but unrelated to audit fees. In contrast, controlling for specialization, our results indicate that Big 5 auditors are not associated with differential perceived audit quality yet charge premium audit fees.¹

Our findings substantiate Jensen and Payne’s suggestion (2005) that specialized auditors provide high-quality audits at reduced fee levels and are consistent with Copley’s observation (1991) that non-Big 5 firms provide

¹ During the period examined in this study, the five largest public accounting firms (Big 5) became the Big 4 public accounting firms, following the demise of Arthur Andersen. These firms are generally comparable to the Big 6 in research prior to the merger of Price Waterhouse and Coopers and Lybrand. We continue to refer to the firms as the Big 5 throughout the study except where researchers studied Big 6 firms and when the current Big 4 are discussed in the conclusion.

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