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Research paper

The Big 4 premium: Does it survive an auditor change? Evidence from Europe

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ABSTRACT

This study presents new evidence on the effects of auditor changes on audit pricing, with a particular focus on the Big 4 premium. We link the fee cutting and Big 4 premium research fields and examine whether the Big 4 premium is influenced by a firm's decision to change its auditor. Applying matching analysis, we compare the audit fees of firms switching to a Big 4 auditor with those switching to a non-Big 4 auditor. Compared with non-switching firms, we find that audit pricing strongly differs for existing versus new clients of Big 4 auditors. The Big 4 premium only exists for mandates in which firms do not change their auditor, whereas upon auditor changes Big 4 auditors are willing to give up their premium or even accept lower fees than non-Big 4 auditors. This discount prevails in most post-change years. We conclude that Big 4 auditors apply a foot-in-the-door strategy and request lower fees to win new clients. Therefore, the existence of the well-known Big 4 premium is strongly influenced by a firm's decision to change its auditor. These findings are based on a data set including all listed German, Italian, Belgian, and Finnish firms from 2007 to 2010.

1. Introduction

First-tier auditors earn an audit fee premium compared with smaller audit firms (Fleischer & Goettsche, 2012; Gul, 1999; Palmrose, 1986; Simunic, 1980). This so-called Big 4 premium[1] may result from various factors, including higher quality services, a more differentiated set of services, and/or the provision of (industry-) specialized teams.

This study investigates the Big 4 premium in more detail and explicitly analyzes the influence of auditor changes. We assume that the two phenomena, the Big 4 premium and fee cutting, cannot be seen as separate effects but affect each other when a firm decides to change its auditor. In an auditor selection process, a firm can differentiate among auditors on perceived or assumed quality of audit services and on pricing. Considering that large auditors earn higher audit fees due to perceived higher quality, amongst other attributes (DeAngelo, 1981b), Big 4 auditors should have the same or even more pricing flexibility when competing for new clients. Assuming further that auditors follow a generally comparable business model, we expect Big 4 auditors to seize this pricing flexibility to win new clients. Therefore, we link previous research on fee cutting and the Big 4 premium and investigate differences between the audit fees of existing customers of Big 4 auditors and those of new clients. In a matching analysis, we compare the audit fees of firms that switch to a Big 4 auditor with fees of firms that switch to a non-Big 4 auditor (new clients). We then compare our results with non-switching firms (existing customer base), by applying a matching analysis to the audit fee differences of Big 4- and non-Big 4-

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[1] In the study, the term Big 4 is also used when referring to earlier studies that investigate the Big 8/6/5 premium.

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audited firms. Thus, we argue that the effect of an auditor change on the Big 4 premium is independent of how the mandate is finally allocated (either in an official request for a proposal or in a contest including a limited number of selected auditors). We claim that an auditor change in which "sellers compete freely with sellers" (Marshall, 1890) should in turn result in diverging levels of Big 4 premiums for firms that change their auditor (switching firms) versus firms that retain their auditor (non-switching firms). Even if auditors do not compete directly for a new mandate and only engage in general advertising activities, Hay and Knechel (2010) show a deviation of fees for Big 4 and non-Big 4 auditors. Similarly, Klein and Leffler (1981) argue that advertising allows for differentiation and competition on quality.

Most previous research on auditor changes focuses on fee cutting (Craswell & Francis, 1999; DeAngelo, 1981a; Francis, 1984).[2] While Simunic (1980) and Francis (1984) do not find evidence for fee cutting, Gregory and Collier (1996) show fee cutting for up to three years following an auditor change. We contribute to previous literature by simultaneously analyzing fee cutting and the Big 4 premium. We concur with prior literature and note that the presence of fee cutting generally reflects differentiated pricing for an auditor's existing customer base versus new clients. Considering our analyses, it is important to note that we investigate probable fee-cutting behavior after a firm changes its auditor, as auditors generally may use fee cutting as a strategy to win a new client. However, we extend previous research and combine the literature on the Big 4 premium and the literature on fee cutting. More precisely, we examine whether the Big 4 premium is influenced by a firm's decision to change its auditor. We assume that a firm that changes its auditor will no longer pay a Big 4 premium compared with a firm that does not change its auditor. Our results confirm this assumption. We even observe a Big 4 discount that persists in most years following the auditor change. In contrast, all the firms audited by a Big 4 auditor that do not change their auditor still pay a premium. We conclude that first-tier auditors only request a Big 4 premium from their existing customer base. In comparison, new customers receive a Big 4 discount. Accordingly, after an auditor change, first-tier auditors are no longer able to realize a fee premium for new customers. In fact, they exhibit a foot-in-the-door strategy to acquire new clients by asking for even lower fees than non-Big 4 auditors. These results are relevant for researchers as well as for auditing educators and practitioners, as they show that the common understanding of the existence of a Big 4 premium, based on the past research findings, does not consider the effects of an auditor change appropriately. Our results are important for future audit fee research, as the effects might be strengthened by mandatory auditor rotation principles as well as the increasing application of joint audits.

Extant audit pricing research analyzes several international markets, including the U.S., the U.K., Australia, Hong Kong, and Germany (Antle, Gordon, Narayanamoorthy, & Zhou, 2006; Fleischer & Goettsche, 2012; Francis, 1984; Gul, 1999; Palmrose, 1986). These studies mainly focus on one single country or compare their results with a second country when controlling for robustness (Antle et al., 2006). Hence, another incremental contribution of this study is that we use a multinational approach investigating a subset of the European Union audit market, namely Germany, Italy, Belgium, and Finland.[3] Our findings are thus not limited to a single country. Investigating a multinational dataset from the European Union is meaningful as statutory audits in the European Union are regulated by a directive of the European Parliament and Council that aims at harmonizing the statutory audit requirements among the member states.[4]

Although we exactly match the firms according to their country, which avoids influences of country-specific effects, the selection of the four countries should not have any effect on the results. The legal frameworks of the four countries are all based on code law. Furthermore, the countries do not request joint audits (Heß, 2014), which might influence the pricing of audit relationships after an audit switch. Moreover, the results of previous Big 4 premium research in the individual countries indicate that the phenomenon shown should prevail for our whole data set, as the Big 4 premium is found in every country under study. For Belgium, Knechel and Willekens (2006) include the Big 4 premium as a factor of a governance index. The coefficient for the index is positive and significant. Simon (2005) and Fleischer and Goettsche (2012) find evidence for a significantly positive relation between audit fees and Big 4 audits in Germany. For Italian firms, Cameran (2005) finds evidence for the Big 4 premium. To the best our knowledge, no study investigates the Big 4 premium in the Finnish market. However, Niemi (2004) finds a positive association between auditor size and audit pricing when examining hourly billing rates and auditor characteristics of small Finnish auditors.

The study also makes a methodological contribution, as it uses a nearest-neighbor distance-matching approach, based on Abadie and Imbens (2002), which allows it to describe directly effects such as fee cutting or Big 4 premiums based on absolute fees. Considering the theoretical foundation together with the typical structure of audit fee data sets, the estimator is superior to standard regression analysis and other matching estimators. As audit fees could be influenced by country-specific characteristics, for example the market leadership of a certain auditor or country-specific litigation regulations, we only match firms from the same country. Propensity score matching and standard regression analysis support our results. We recommend basing future research on audit fees on the preferable nearest-neighbor distance-matching approach to avoid any biases, particularly if the research question analyzes a treatment effect.

The remainder of this study is organized as follows. Section 2 summarizes the relevant literature and develops our hypotheses. Section 3 describes the methodology and model specification applied in our empirical analysis. Our data set is described in Section 4, and Section 5 presents and discusses the results of this study. The last section concludes and provides recommendations for future research.

[2] We follow Francis (1984) in understanding fee cutting as a special case of low balling (DeAngelo, 1981a) in which fee cutting means that the future fee-raising potential drives the initial fees below the future fee levels.

[3] We limit our analysis to countries from the European Monetary Union (EMU) to avoid currency exchange rate effects over time.

[4] For the period under study statutory audits are regulated by the directive 2006/43/EEC of the European Parliament and Council.