

Auditee Stickiness in Financial Audit Market*

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Abstract

Big-N auditors generally charge substantially higher audit fees than smaller auditors do, whereas all auditors presumably follow the same auditing standards and requirements. Big-N auditors are not only supplying auditing service to but also performing the signaling function for auditees. Our work will contribute to the literature in the following aspects.

First, our study is the first in the literature to directly estimate the equilibrium price (i.e., “signaling premium”) for big-N auditors’ signaling function. We propose a theoretical model of auditor switch that incorporates auditors’ signaling function into a particular market mechanism for audit fee determination. The model underpins an empirical framework to estimate the market value of the signaling function, which provides evidence of the existence of a market for such a function and helps understand the nature of the audit market.

Second, our model allows the signaling premium to vary across auditees with different financial characteristics. Auditees with certain characteristics (e.g., low earnings quality) are expected to be unwilling to pay a high signaling premium. Hence, our approach can be applied by regulators, auditors, and investors to screen a large number of firms and identify those with high risks of earnings manipulation.

Third, our theoretical model draws on the switching cost literature in economics and interpret the signaling premium as a disutility that the auditee will suffer when switching from a high-quality auditor to a low-quality one. In the economics literature, a large body of empirical studies shows the importance of switching cost in firms’ conduct and consumers’ behavior. However, these studies generally remained silent on the significance and magnitude of switching cost. A major reason was the lack of individual-level transaction data, such as histories of individual consumers’ purchase decisions. Utilizing detailed data on auditor switch at the individual auditee level, our proposed study allows the direct estimation of the magnitude of switching cost from one type of auditor to another and fills the gap in the switching cost literature.

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