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Have the Big Accounting Firms Lost Their Audit Quality Advantage? Evidence from the Returns-Earnings Relation

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This study investigates whether the quality of financial statements, measured by the ability of investors to predict future earnings while estimating firm value, is higher when audits are performed by the big accounting firms. Using data from 1993-2001, we find that investors are better able to "see" future earnings and predict firm value when audits are performed by big accounting firms. However, the relationship between auditor size and the ability to predict future earnings is not significant in the more recent years of the sample. This apparent loss in the audit quality advantage of big accounting firms is consistent with changes in the audit environment including both increased non-audit services and lowered litigation risk for big accounting firms.

INTRODUCTION

Previous research separately shows that financial statement quality improves the ability of investors to predict future earnings and that big accounting firms provide higher quality audits. Measures of audit quality have included levels of informative disclosures, earnings management, audit qualifications, and the pricing of discretionary accruals. Although superior audit quality has been associated with big accounting firms, recent financial reporting scandals and the erosion of investor confidence have stimulated accounting reform and a reassessment of audit quality. At the same time, big accounting firms' revenues from non-audit services have increased to become their most important revenue source. As a result, big accounting firms have been criticized for their increase in non-audit consulting services and the related potential decrease in independence.

In 1995 the Private Securities Litigation Reform Act (PSLRA) replaced joint and several liability with fair share proportionate liability. Although the purpose of this litigation was to discourage frivolous lawsuits against auditor firms with deep pockets, it also raised concerns