Companies flee audit firms who lose big clients, flock to those who win them

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Big accounting firms rely on big-name clients to make a profit and build credibility.

So how bad is it when a firm loses an industry leader client in its audit business due to performance? And how much does winning a big-name client help an auditor to gain subsequent business?

It turns out both the losing and the winning have big spillover effects for the auditor's business prospects, according to new research by Mihir Mehta, assistant professor of accounting at the University of Michigan's Ross School of Business.

Mehta and co-authors Jere Francis of the University of Missouri and Wanli Zhao of Southern Illinois University found that when a Big Six accounting firm loses an industry leader client due to client preferences for a higher quality audit, other companies in that same industry are 36 percent more likely to dismiss the same auditor over the next two years.

Conversely, when a Big Six firm wins a major client, other companies in that same industry are 24 percent more likely to hire that firm.

"If you lose or win a major industry client, there are significant reputational effects," Mehta said. "When companies in an industry see one of the top names in their industry, switch service firms due to quality, there's likely to be a spillover effect.

"We didn't see any crossover effect on clients from other industries—but within the industry, and specifically, in the same city, word gets around. Our findings likely have implications for other types of professional service firms such as banks and law firms."

There are a lot of reasons companies switch auditors, such as changes in management or displeasure over an unfavorable audit opinion.

"But changes due to those reasons don't trigger any followers," Mehta said.

An auditor-client separation over a "quality" issue is not usually spelled out in a press release. But Mehta and his co-authors looked at public audit firm data and determined that when a leading company switches auditing firms and ends up both paying more to the new auditor and having higher quality financial reports, that is a signal that the client switched due to quality reasons.

That's what triggered other companies who closely track their peers in the same industry to follow. The reverse was true when auditing firms gained a new top client despite charging more—they acquired more clients in the same industry.

Winning new business comes with a price, however, for the new clients, the research showed. While an auditing firm that wins a big client can charge higher fees to all of its clients in an industry, the actual quality of the audits go down for a couple of years. That's because a Big Six accounting firm office doesn't have the capacity to immediately service a new client and all of the existing clients.

"It's not easy to hire for firms a lot of qualified auditors that quickly," Mehta said.

It may seem counter-intuitive, but there is a silver lining for companies that don't leave an audit firm after seeing one of their industry peers leave the same auditor. Why? The audit firms that lose business usually have to cut their fees, and their audit quality goes up over the next two years due to excess capacity of qualified auditors who have more time to spend on fewer clients.

Mehta's findings are detailed in the paper "Audit Office Reputation Shocks from Gains and Losses of Major Industry Clients," which has been conditionally accepted for publication in the journal Contemporary Accounting Research.

More information: Francis, Jere R. and Mehta, Mihir N. and Zhao, Wanli, Audit Office Reputation Shocks from Gains and Losses of Major Industry Clients (May 31, 2016). Ross School of Business Paper No. 1317. Available at SSRN: ssrn.com/abstract=2787269

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