Switching Costs, Audit Firm Market Shares and Merger Profitability

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ABSTRACT

Prior research shows that a simple model of audit production with price competition suffices to explain *aggregate* Big Six market shares. We extend prior research to the level of *firm-specific* market share by introducing client switching costs. We estimate a lower bound for clients' auditor switching costs, using 1996 data on 5,090 U.S. public companies and on the number of partners and staff employed by the 270 audit firms that audit them. We find that levels of switching costs consistent with published estimates of initial fee discounts yield firm-specific market shares close to actual. Using profits from pre-merger markets as benchmarks, we estimate likely profit improvements from two proposed 1997 Big Six mergers, one that was completed (Price Waterhouse and Coopers & Lybrand) and one that was canceled (Ernst & Young and KPMG). We find that merger between PW and CL is profit improving over a wide range of switching costs, while merger between EY and KPMG is not profit improving.

Key Words: Audit industry structure, Audit firms, Leverage, Merger, Switching costs.

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