Audit Quality, Earnings Quality, and the Cost of Capital*
감사품질이 이익의 질과 자본비용에 미치는 영향*

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ABSTRACT: Extant empirical findings in the U.S. show the effects of Big 4 audits on the market responses of their auditees. Khurana and Raman (2004a) find that Big 4 audits are related to a lower ex ante cost of equity capital for auditees than non-Big 4 audits only in highly litigious countries, and suggest that litigation risk is a more essential element than reputation concerns to motivate increases in audit quality in an international setting.

This study examines whether market investors respond to Big 4 audit quality (BIG 4) differently than they do to non-Big 4 audit quality among Korean listed firms. The study examines not only the direct association between BIG 4 and market response (the cost of capital), but also the incremental effects of BIG 4 on the association between the cost of capital and earnings quality.

The regression results show that market investors respond to the earnings quality (earnings management) of Big 4 auditees differently than they do to...
non-Big 4 auditees. In Panel B of Table 5 (The effect of auditor characteristics
and discretionary accruals on cost of debt capital), the OLS regression introduces
BIG4 interaction variables for discretionary accruals and other firm specific
characteristics variables. Discretionary accruals (DACC) is positively related to
cost of debt capital in the first column in Panel B of Table 5. However, the
coefficient of the interaction variable for DACC is negatively related to the cost
of debt capital. This indicates that Big 4 audits reduce the concerns of investors
about discretionary accruals by auditee firms. These results are similar to those
of the cost of equity capital model.

This suggests that external investors are not only concerned about auditor
choice itself, but also consider auditor choice in relation to earnings quality. In
other words, Big 4 audits have incremental effects on the association between
the cost of capital and earnings quality. As litigation risk is very low in Korea,
it is reputation concerns that motivate Big 4 auditors to produce high quality
audit. This result differs from those of prior studies which show that litigation
risk is a more essential element than reputation concerns in affecting perceived
audit quality, and that Big 4 audits are related to a lower ex ante cost of equity
capital for auditees than non-Big 4 audits only in highly litigious countries
because of litigation effects (Khurana and Raman, 2004a). This result also can
be interpreted as Big 4 audits enhancing the information value of discretionary
accruals by reducing the aggressive and opportunistic reporting of the
discretionary accruals (Krishnan, 2003), and investors of Big 4 auditees pricing
the value-relevance of discretionary accruals (i.e., the information value of
discretionary accruals).

The effects of Big 4 audits are notable in firms with poor information environments.
Panel A in Table 7 (The effect of auditor characteristics and discretionary
accruals on cost of capital in weak and strong information environment), the
cost of debt capital regression is examined in both weak and strong information
environments. The coefficients of the discretionary accrual variables are
positively related to the cost of debt capital only in firms with poor information
environments. Additionally, the coefficients of the interaction variables for
discretionary accruals are negatively related to the cost of debt only in firms
with poor information environments. These results are similar to those of the cost
of equity capital model (Panel B in Table 7). This suggests that poorly informed
investors consider Big 4 audits when they respond to earnings quality (i.e.,
discretionary accruals). In other words, investors use audit quality to revise their