

Accounting and Business Research >

Volume 43, 2013 - [Issue 1](#)

6,747 | 57

Views | CrossRef citations to date | Altmetric | 0

Original Articles

# Audit office size, audit quality and audit pricing: evidence from small- and medium-sized enterprises

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Pages 31-55 | Published online: 25 Jul 2012

 Cite this article  <https://doi.org/10.1080/00014788.2012.691710>

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## Abstract

Using Swedish data, we investigate how audit quality and audit pricing vary with audit firm and office size. In contrast to prior studies, we use disciplinary sanctions issued against auditors not meeting the quality requirement as the measure of audit quality. We find no significant differences in the likelihood of sanctions between Big 4 audit firms and the fifth and sixth largest audit firms in Sweden (Grant Thornton and BDO). We refer to these collectively as 'Top 6'. However, we find that the probabilities of warnings or exclusions from the profession are much higher for non-Top 6 auditors in Sweden than for Top 6 auditors. Furthermore, we find a strong negative association between the likelihood of sanctions and audit office size for non-Top 6 auditors. This association is insignificant for Top 6 audit firms. Audit fees follow a similar pattern and indicate that larger audit firms and offices put in more effort or have greater expertise.

These results suggest that audit quality is differentiated in the private segment market. However, contrary to prior studies, our results suggest that the important dimensions are Top 6 versus non-Top 6 and the office size of non-Top 6 audit firms.

Keywords:

audit fees

audit offices

audit quality

private companies

disciplinary sanctions

Top 6 audit firms

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## Acknowledgements

An earlier version of this paper benefited from comments made at the FIBE workshop held at the Norwegian School of Economics in January 2011, and the Sixth EarNet Symposium held at the Norwegian School of Economics in September 2011. We thank Sergey Hambardzumyan for research assistance. Stefan Sundgren gratefully acknowledges financial support from the Academy of Finland (grant 126630). We appreciate helpful comments from the anonymous reviewers.

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## Notes

Disciplinary action may of course also be taken against auditors of publicly held companies. However, the vast majority of all disciplinary cases are related to audits of privately held companies.

The average number of audit assignments held by auditors-in-charge in Sweden was 123 in 2009 (excluding assignments as deputy).

Small firms that are given dispensation from the audit requirement are private limited companies and limited liability companies that for two consecutive years have not exceeded two of the following criteria (2006/43/EC): a balance sheet total of 4.4 million euro, a net turnover of 8.8 million euro and an average of 50 full-time employees. The directive should have been implemented by member states no later than September 2008.

The governmental decision means that companies not exceeding two of the following three size criteria are exempted from the audit requirement: a net turnover of 3 million

SEK (1 EUR = 8.81 SEK, 21 February 2012), a balance sheet total of 1.5 million SEK and an average number of full-time employees of three. If auditing is no longer required, the general meeting should actively take a decision not to have an audit.

Auditing is also required in 21,200 trading partnerships, 15,000 foundations, 1530 foreign branches, 270 insurance companies, 75 banks, 70 economic associations, 15 non-profit organisations, 5 sole proprietorships and 4 European companies (SOU [2008:32](#), p. 124).

In 2006, the two institutes for public accountants in Sweden, Föreningen Auktoriserade Revisorer (FAR), and Svenska Revisorsamfundet (SRS), merged. From September 2006 until March 2010, they used the name FARSR. Since March 2010, this Institute has been called FAR.

In addition to these types of auditor, there are auditors who have gained approval without taking an examination. Such auditors are allowed to audit small firms over a transitional period.

Reported revenues in Sweden for Öhrlings PwC, Ernst & Young, KPMG and Deloitte were 10.383 billion SEK (1 EUR = 8.81 SEK, as of 21 February 2012).

Reported turnover for the largest 10 audit firms in 2009 (in Euros): (1) PricewaterhouseCoopers 471 million, (2) Ernst & Young 296 million, (3) KPMG 218 million, (4) Deloitte 148 million, (5) Grant Thornton 97 million, (6) BDO 60 million, (7) SET Revisionsbyrå 34 million, (8) Baker Tilly 18 million, (9) Nexia 6 million and (10) Rödl & Partners 6 million.

Among the Top 6 audit firms, PwC have a total of 130 audit offices, KPMG 61, Ernst & Young 61, Deloitte 30, Grant Thornton 24 and BDO 19.

The quality controls made by FAR should meet all the requirements stated by the EU.

In the period 2005–2009, a total of 674 disciplinary cases were opened: 177 (26.3%) were initiated as a result of inspections by SBPA or FAR, 145 (21.5%) as a result of tips from tax authorities, 169 (25.1%) based on tips from clients and 183 (27.2%) based on tips from others.

The SBPA opened a total of 674 disciplinary investigations from 2005 to 2009 (SBPA Annual Report, various issues). Two hundred and ninety-five or 44% of these cases led to the issuing of disciplinary sanctions. Thirteen auditors received multiple sanctions.

From 2005 to 2009, the average number of approved and authorised auditors was 4083.

Note that Palmrose ([1988](#)) investigated litigation cases against auditors, not disciplinary sanctions.

During the 1970s and 1980s, there were eight big audit firm networks ('Big 8'). Two big mergers in 1989 reduced the group to 'Big 6'. This became 'Big 5' when Coopers & Lybrand and Price Waterhouse merged in 1998. Since the disappearance of Andersen in 2002, the current large audit firms have been referred to as 'Big 4'.

The following switches of employees were identified. One auditor who had worked for a Big 4 audit firm had switched to a small firm and one auditor who had worked for a small audit firm had switched to a Big 4 firm. Two auditors who had worked for Grant Thornton or BDO switched to small audit firms. Finally, there were a few switches between small audit firms. The few switches indicate that the data at the end of 2009 were also representative of the situation prior to 2009.

Exchange rate at 21 February 2012.

This is the age of the auditors without a sanction in 2007; the mean and the median year of the sanctions in the sample are 2007.

We also ran the regressions in [Table 4](#) separately for Big 4 auditors and for auditors employed by Grant Thornton and BDO. The office size measures were insignificant in all these regressions.

Indeed, a possible alternative explanation is that on average older auditors have more audit assignments, thus implying that they are more exposed to audit failures. We received information about the number of assignments for 3418 of the 4076 auditors in our sample. This information was received from UC, a Swedish credit information agency. The Pearson correlation between the number of assignments and the age of the auditor is 0.17 (p-value < 0.001), showing that older auditors may be more exposed to audit failures. However, as we added the number of assignments as an additional variable into the regressions in [Tables 4](#) and [5](#), the coefficients of AUDAGE are still significant at the 0.01 level in all regressions. The number of assignments also had positive coefficients significant at the 0.01 level in the regressions. The regressions in [Table 4](#) were only run on three outcomes, because the number of assignments for auditors who had lost their certification was not available.

Tables with industry distribution for the audit fee sample, descriptive statistics and a correlation matrix for included variables in the audit fee regression models is available upon request from the authors.

We also calculated the variance inflation factor (VIF) in order to examine whether multicollinearity significantly influenced our empirical results. The highest VIFs in the regressions in [Table 6](#) were 5.28 and 6.69 in [Table 7](#), thus suggesting that multicollinearity is not a problem.

We ran the regressions separately on Big 4 audit firms and Grant Thornton or BDO. LNOFFICESIZE had a positive coefficient significant at the 0.10 level in the regression on the 97 observations audited by Grant Thornton or BDO and a positive but insignificant coefficient in the regression with Big 4 audited companies in the sample.



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