Is There Transparency In Auditor Change Disclosures?

Thomas G. Calderon, (E-mail: tcalderson@uakron.edu), University of Akron
Emeka Ofobike, University of Akron
John J. Cheh, University of Akron

ABSTRACT

In this paper, we examine the reasons disclosed in a small representative sample of Form 8-Ks for switching auditors. We classify auditor switches in terms of changes from big-4 to other big-4, big-4 to non-big-4, non-big-4 to big-4 and non-big-4 to non-big-4. Our primary objective is to assess compliance with the required disclosures for auditor changes and to reflect on the implications for corporate governance. This line of research is important in light of the requirements of SEC Regulation S-K 304 and recent calls for greater transparency in financial reporting, particularly after Sarbanes-Oxley. Our research shows that companies use boilerplate language and adopt a check-the-box approach to compliance with Regulation S-K 304. Contrary to the spirit and intent of corporate governance, their disclosures generally lack transparency and offer little or no insight into the underlying reasons for auditor changes. One of the clearest patterns is that several auditor changes are preceded by such reportable events as going concern uncertainties and material internal control deficiencies that often lead to financial statement restatements. Even so, many companies are less than forthright in the language used to disclose such events. Thus, we conclude that the implied objective of auditor change regulations is not being fulfilled. In general, neither auditors nor clients appear to take the auditor change disclosure requirements seriously. It is vital that the PCAOB, SEC, and the audit committees take note of this weakness in auditor change regulation.

INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOX) has added significant regulations that affect the audit process. This has increased the scope of the audit, with auditors of public companies now being required to attest to management's assessment of internal controls. Scope also increased prior to SOX as a result of such standards as SAS 99, which made auditors responsible for designing the audit to detect fraud if fraud is present in a company's financial statements. Audits of public companies have always been challenging for auditors, particularly non-big-4 firms, because of resource and knowledge commitments. National auditing firms have had significant difficulty staffing audits since SOX came into effect and audit fees have increased considerably (Corporate Controller's Report 2006).

Companies have had to absorb the increasing costs of audit services and the costs of being public, in general. This dynamic places pressure on all parties, and could lead to separations between auditors and their clients. Both auditors and clients have initiated such separations. From October 2004 to August 2005, we identified over 1100 client-initiated and auditor initiated separations.¹ Although there is a well established literature stream on auditor changes, little has been written on the types of disclosure that companies and their auditors make subsequent to an audit separation. This kind of disclosure is mandated by the SEC in Regulation S-K 304. Such regulation is vital for transparency in corporate governance and regulation of the auditing profession. For example, failure to disclose or incomplete disclosures of the underlying reasons for an auditor switch could be a cover for opinion shopping and

¹ Based on statistics obtained from *Compliance Week*. *Compliance Week* is a newsletter on corporate governance and compliance issues that reaches financial and legal executives at U.S. public companies; among others, however, the service provides data on auditor changes through its website: <http://www.complianceweek.com>.

inappropriate selection of auditors. Further, non disclosure or inappropriate disclosure would violate SEC disclosure requirements.

In this paper, we examine the reasons given in Form 8-Ks for switching auditors. We classify auditor switches in terms of changes from big-4 to other big-4, big-4 to non-big-4, non-big-4 to big-4 and non-big-4 to non-big-4. Our objective is primarily to understand the reasons for separations that are documented in companies' 8-K reports filed with the SEC and to reflect on the implications for corporate governance. This research is expected to provide insight into the nature of disclosed reasons for client-auditor separations and whether there are differences in the nature of disclosures for different types of auditors. This line of research is important in light of the requirements of Regulation S-K 304² and recent calls for greater transparency in financial reporting, particularly after Sarbanes-Oxley.

Our research shows that companies use boilerplate language and adopt a check-the-box approach to compliance with Regulation S-K 304. Contrary to the spirit and intent of corporate governance, their disclosures generally lack transparency and offer little or no insight into the underlying reasons for auditor changes. One of the clearest patterns is that several auditor changes are preceded by such reportable events as going concern uncertainties and material internal control deficiencies that often lead to financial statement restatements. Even so, many companies are less than forthright in the language used to disclose such events. Thus, we conclude that the implied objective of auditor change regulations is not being fulfilled. In general, neither auditors nor clients appear to take the auditor change disclosure requirements seriously. It is vital that the PCAOB, SEC, and the audit committees take note of this weakness in auditor change regulation.

BACKGROUND

SEC Regulation S-K 304

Regulation S-K 304 (and Regulation S-B 304 which targets small entities) requires SEC registrants to provide specific disclosures whenever there is an auditor change. Among the disclosures required by the regulation are:

- whether the decision to change accountants was recommended or approved by the audit committee or the board of directors
- whether the audit reports for the past two years contain an adverse opinion/disclaimer, qualification or modification
- whether there were any disagreements between the client and the auditor that could have affected the audit report, and if so, a description of the disagreements
- whether the auditor advised the client of an internal control deficiency
- whether the auditor advised the client that it has pertinent information that prevents an expression of an opinion, or that makes the auditor unwilling to be associated with the financial statements prepared by management
- whether the auditor advised the client of the need to expand the audit scope or has obtained information that would affect the auditor's willingness to express an opinion based on management's representations
- whether the client consulted with the newly engaged auditor two years prior to the engagement on matters related to accounting principles, the audit opinion, or disagreements with the predecessor auditor

In addition, the client must provide the outgoing auditor with a copy of the above disclosures, and require that the auditor furnish the SEC with a letter that states whether or not the auditor agrees with the disclosures.

These disclosures are intended to increase the transparency of the auditor change process and to enhance the market's confidence in the objectivity of that process. In particular, the disclosures address issues related to opinion

² Securities and Exchange Commission Regulation S-K <http://sec.gov/divisions/corpfin/forms/regsk.htm> SEC 1845 (11-2004) Last access February 1, 2006

shopping, and compliance with the regulation should provide evidence that an auditor change was made for genuine business reasons. The regulation, however, does not address the full set of reasons for auditor changes. The prior literature offers significant insight into the various reasons for auditor changes.

Empirical Literature

Most prior studies on client-auditor separations have focused on auditor characteristics and client characteristics as factors that are associated with those separations. For example, Woo and Koh (2001), in a study of companies listed in Singapore, report that the nature of the auditor's opinion, audit fees, and several client characteristics (including changes in management, management stock ownership, income manipulation opportunities through short-term accruals, leverage, client size, growth, merger and acquisition activity, and complexity) are significant factors in explaining auditor changes. Chow and Rice (1982), Palmrose (1984), Healy (1985), Eichenseher and Shields (1989), Haskins and Williams (1990), Johnson and Lys (1990), and DeFond (1992) have all reported similar findings. Chen, Gupta and Senteney (2004) suggest an association between auditor changes and impending firm failure.

Few studies have attempted to examine the underlying reasons for client-auditor separations, and those that did are based on pre-Sarbanes-Oxley evidence. Sankaraguruswamy and Whisenant (2004) used data from 1993 to 1996 to study the reasons for auditor-client realignment. They report that "clients are more likely to cite service-related reasons when dismissing large predecessor auditors, and are more likely to cite fee related reasons when choosing small-successor auditors." (p. 107) Clients that are likely to fail tend to switch from large public accounting firms to smaller ones. In addition, they found auditor change to be related to client size and the existence of reportable events.

Sankaraguruswamy and Whisenant (2004) further observed that early studies on client-auditor separations suggest that clients changed auditors to obtain lower audit fees and better audit services, while more recent studies imply that client size and growth considerations are key drivers of auditor changes. These authors also note that auditor-initiated and client-initiated changes are viewed differently by the market when clients report auditor changes for fee related reasons versus service-related reasons (Hackenbrack and Hogan 2002). Thus, management may have an incentive to obfuscate their reasons for auditor changes depending on the nature of the separation.

Research Issues

Our primary research objective is to examine the reasons for auditor changes documented in Form 8-Ks and to assess whether the reasons provided when the client initiates the separation are different from those given when the auditor initiates the separation. We use SEC Regulation S-K 304 as a framework for disclosure. We also explore whether the documented reasons for separations are related to the auditor's size (Big-4 versus non-Big-4). Big-4 and non-Big-4 audit firms have very different capabilities and resources, and the documented reasons for separation may differ when a client switches from a Big-4 to a non-Big-4 auditor and vice-versa. For example, a switch from a Big-4 firm to a non-Big-4 firm might be motivated by fee-related issues (Hackenbrack and Hogan 2002). However, the client might be somewhat hesitant to disclose that the switch was made for fee-related reasons as such a disclosure might be interpreted adversely by the market as a signal of management's willingness to sacrifice service for reduced fees (Hackenbrack and Hogan 2002). On the other hand, a switch from a non-Big-4 to a Big-4 firm might be viewed as a signal of management's interest in service quality. Arguably, in the context of the Sarbanes-Oxley Act, management might be more favorably disposed to disclose the reasons for switches when those reasons are service-related than when they are fee-related.

Client-auditor disagreement prior to a separation represents another factor that might affect the language used in documenting the reasons for an auditor change. Such disagreements must be disclosed in line with the requirements of Regulation S-K 304. When a disagreement precedes a separation, it seems intuitive that such disagreement would be documented in the Form 8-K as a reason for the change. Similarly, it seems logical that an auditor switch immediately after a client receives an adverse audit opinion (or a material deficiency in internal control) might be influenced by the circumstances that led to the adverse opinion. If so, then the language used to document the reasons

for the change could differ depending on whether an auditor switch was preceded by an adverse audit opinion, a modified audit opinion, or a reported deficiency in internal control. Our research sheds light on these issues.

METHOD

We identified 1126 auditor changes that listed both predecessor and successor auditors published by Compliance Week (CW) between October 2004 and August 2005. We excluded 67 changes from the original CW list that were classified as *engaged*, *merger*, or *replaced* since it was not entirely clear from either 8-K disclosures or the literature what those classifications represented. Therefore, our final sample consists of 1059 auditor/client separations. Because our objective is to describe the documented reasons for auditor changes, we selected a stratified random sample of 38 client-auditor separations for detailed analysis.

The primary criteria in selecting our final sample were availability of financial information for the client and an 8-K filed with the SEC by the client. In addition, we wanted a manageable sample to ensure detailed review and analysis. We used information published in CW to classify auditor changes into auditor-initiated and client-initiated categories. Each author and a graduate assistant also read each 8-K report in our final sample to verify the accuracy of CW's classification and to obtain detailed information about the disclosures. We classified changes listed in CW as *dismissed or terminated* as client-initiated, and classified *resigned* as auditor-initiated. Further, we classified changes as Big-4 to Big-4, Big-4 to non-Big-4, non-Big-4 to Big-4, non-Big-4 to non-Big-4.

Table 1 shows the frequency of changes in each category. Our final sample consists of five randomly selected changes within each cell, unless a cell contains fewer than five in which case we selected all available changes (e.g., three available cases of auditor-initiated Big-4 to Big-4). A sample of five changes per cell is small enough to keep the project manageable; it is also sufficient to offer opportunities to understand variations in the underlying qualitative reasons for auditor change. Table 1 represents a typology of auditor changes. Eight types of auditor changes are documented in the table—(1) Auditor initiated changes – Big4 to Big4; (2) Auditor initiated changes – non-Big4 to Big4; (3) Auditor initiated changes – Big4 to non-Big4; (4) Auditor initiated changes – non-Big4 to non-Big4; (5) Client initiated changes – Big4 to Big4; (6) Client initiated changes – non-Big4 to Big4; (7) Client initiated changes – Big4 to non-Big4; and (8) Client initiated changes – non-Big4 to non-Big4. We use this typology to document our findings and analyze our results.

Table 1
Typology Of Auditor Changes And Frequencies*

CHANGE FROM	Change To								Total	
	Big Four				Non-Big Four					
	Auditor-Initiated		Client-Initiated		Auditor-Initiated		Client-Initiated			
	Number	%	Number	%	Number	%	Number	%	Number	%
Big Four	3	0.28	20	1.89	39	3.68	220	20.77	282	26.63
Non-Big Four	16	1.51	17	1.60	265	25.02	479	45.23	777	73.37
Total	19	1.79	37	3.49	304	28.70	699	66.00	1059	100.00

* This table shows the frequency and typology of auditor changes in our sample. Since one firm may change auditors multiple times, the numbers are not synonymous to the number of clients involved in auditor changes. All percentages are based on the total number of auditor changes, (1059) reported by Compliance Weekly during the period between October 2004 and August 2005.

To examine the reasons given for the change, we obtained Form 8-K reports from the SEC's web site and qualitatively analyzed each. Each co-author and a graduate assistant read the Form 8-K and discussed the disclosures to verify that they were coded accurately. We explore differences in the documented reasons for auditor changes across the various classes within our typology that is specified in Table 1.

RESULTS

Results of our study are organized into the eight types of auditor changes presented in Table 1. Almost 95 percent of the total changes in our full sample involved a non-Big4 firm, and 70 percent involved a switch from one non-Big4 to another. Roughly 30 percent of the changes were auditor initiated. The remaining 70 percent were initiated by the client. We present qualitative findings for each classification in our typology. Table 2 summarizes our findings on compliance with Item 304 of Regulation S-K.

Table 2
Auditor Changes And Regulation SK-304 Disclosures In 8-K Reports

Categories And Disclosures	QU1	QU2	QU3	QU4	QU5	QU6	QU7	QU8
Panel A: Auditor Initiated Changes - Big 4 To Big 4								
YES	2	0	0	1	0	0	0	3
NO	0	3	3	0	0	3	3	0
ND	1	0	0	2	3	0	0	0
Panel B: Auditor Initiated Changes - Non Big 4 To Big 4								
YES	5	0	0	1	0	0	0	5
NO	0	5	5	0	0	5	5	0
ND	0	0	0	4	5	0	0	0
Panel C: Auditor Initiated Changes - Big 4 To Non Big 4								
YES	5	0	0	0	0	0	0	5
NO	0	5	5	0	0	5	5	0
ND	0	0	0	5	5	0	0	0
Panel D: Auditor Initiated Changes - Non Big 4 To Non Big 4								
YES	5	2	0	0	0	0	0	4
NO	0	3	5	0	0	5	5	1
ND	0	0	0	5	5	0	0	0
Panel E: Client Initiated Changes - Big 4 To Big 4								
YES	5	0	0	1	0	0	0	5
NO	0	5	5	0	0	5	5	0
ND	0	0	0	4	5	0	0	0
Panel F: Client Initiated Changes - Non Big 4 To Big 4								
YES	5	1	0	1	0	0	0	5
NO	0	4	5	0	0	5	5	0
ND	0	0	0	4	5	0	0	0
Panel G: Client Initiated Changes - Big 4 To Non Big 4								
YES	5	0	0	1	0	0	0	5
NO	0	5	5	0	0	5	5	0
ND	0	0	0	4	5	0	0	0
Panel H: Client Initiated Changes - Non Big 4 To Non Big 4								
YES	4	5	0	0	0	0	0	5
NO	0	0	5	0	0	5	5	0
ND	1	0	0	5	5	0	0	0

Legend

QU1 - whether the decision to change accountants was recommended or approved by the audit committee or the board of directors

QU2 - whether the audit reports for the past two years contain an adverse opinion/disclaimer, qualification or modification

QU3 - whether there were any disagreements between the client and the auditor that could have affected the audit report, and if so, a description of the disagreements

QU4 - whether the auditor advised the client of an internal control deficiency

QU5 - whether the auditor advised the client that it has pertinent information that prevents an expression of an opinion, or that makes the auditor unwilling to be associated with the financial statements prepared by management

QU6 - whether the auditor advised the client of the need to expand the audit scope or has obtained information that would affect the auditor's willingness to express an opinion based on management's representations

QU7 - whether the client consulted with the newly engaged auditor two years prior to the engagement on matters related to accounting principles, the audit opinion, or disagreements with the predecessor auditor

QU8 - whether the client provided the predecessor auditor with a copy of the above disclosures, and required that the auditor furnish the SEC with a letter that states whether or not the auditor agrees with the disclosures.

Yes = A disclosure was made that responded yes to question

NO = A disclosure was made that responded no to the question

ND = No disclosure was made.

Auditor Initiated Changes – Big4 To Big4

Auditor initiated Big4 to Big4 switches were very rare. Of our total of 1059 auditor/client separations, only 3 (0.28%) were in this category. While prior research has focused on client's reasons for changing auditors (Sankaraguruswamy and Whisenant 2004; Hackenbrack and Hogan 2002), auditors' reasons for initiating a separation from the client have not been as well documented. Factors that could trigger the auditor's separation might include unacceptable audit risk associated with the client, unacceptable economic value of the audit, and issues related to expertise and specialization. Given the homogeneity of the Big4 audit firms in terms of size, resident technical expertise, aversion to unacceptable risk levels, and audit cost structures, it is not surprising that there are relatively few separations in this category.

The change was approved by the audit committee of the board in two of the three cases we selected for detailed study. The third 8-K contained no statement about the audit committee's role in the decision to change auditors. While the audit committee may have viewed the change as an auditor initiated issue that did not require their involvement, failure to disclose a role for the audit committee in the auditor selection process is unusual.

In each case, the client reported no disagreements with the auditor; no issues related to the scope of the audit and the ability to express an opinion; and no consultation with the successor auditor for two years prior to the engagement on matters related to the financial statements. Management in each of the five cases provided the auditor with a copy of its 8-K disclosures. In response, the auditors consistently indicated in their letters to the SEC that they resigned—an observable statement of fact—but consistently wrote that they have no basis to agree or disagree with management's 8-K disclosures, which for the most part represent opinions rather than observable facts.

Two of the three 8-K reports contained boilerplate language to indicate compliance with the disclosure requirements of Regulation S-K 304, but provided no disclosures that clarified the reason for the separation. The third 8-K report contained mostly boilerplate, but also included a relatively detailed disclosure to indicate the company's controls and procedures were not effective due to material weaknesses identified in the business segment reporting process, the financial statement closing process, and the income tax process. Management also disclosed in the 8-K that the auditor issued an adverse opinion on the overall effectiveness of internal controls over financial reporting because of material weaknesses. It is interesting to observe that although the client and the auditor agreed that the internal controls and procedures were ineffective, the auditors issued a clean opinion on the consolidated financial statements. It is plausible that the auditor compensated for the high audit risk associated with this client by expanding the scope of the audit and by increasing the level of substantive testing, thus making the audit relatively less attractive economically. Both risk and economics could have played a part in the auditor's decision to resign.

Auditor Initiated Changes – Non-Big4 To Big4

Auditor initiated changes from non-Big4 to Big4 were rare, with only 1.51 percent (16 cases) of the 1059 changes falling into this category. Issues related to audit risk associated with an SEC client as well as financial risk to the audit firm are possible motivations behind such switches. Furthermore, the literature suggests a relationship between service levels and non-Big 4 to Big 4 auditor changes (Sankaraguruswamy and Whisenant 2004). With one exception, the 8-K disclosures offer little insight into the underlying reasons for the auditor changes.

The change was approved by the audit committee of the board in all five cases. In each case, the client reported no disagreements with the auditor; no issues related to the scope of the audit and the ability to express an opinion; and no consultation with the successor auditor for two years prior to the engagement on matters related to the financial statements. As in the case of auditor initiated Big4 to Big4 auditor switches, each client provided the auditor with a copy of its 8-K disclosures. In complying with the request, each auditor indicated that they had resigned but uniformly stated that they had no basis to agree or disagree with management's 8-K disclosures. It appears that the auditors were willing to concede the observable facts, but were unwilling to comment on statements that may be construed as management's opinions.

One of the 8-K reports contained a detailed disclosure of a material internal control weakness that was documented in both the client's 10-K for 2004 and in its 10-Q for the first quarter of 2005. The disclosure included the following:

[The company] lacked sufficient complement of personnel with a level of financial expertise commensurate with the Company's financial reporting requirements. This material weakness contributed to the following individual material weaknesses: (a) the Company lacked segregation of accounting duties since the sale of their operating subsidiaries in April 2004. As a result, the part-time Chief Financial Officer has made all accounting entries, reviewed all accounting entries and reported on the financial results and (b) the Company had significant accounting adjustments for the year ended December 31, 2004 and the quarter end March 31, 2005 to the accounting records and financial reports.

Though this disclosure is significant and might very well represent the underlying reason for the change, the company sought to downplay the issue in the 8-K by prefacing it with the words "During the most recent fiscal year and through July 15, 2005, there have been no reportable events as outlined in Regulation S-B Item 304 (a)(1)(iv), other than ..." It is likely that the material internal control weaknesses documented in the company's 8-K, 10-K, and 10-Q resulted in the auditors attaching a high level of inherent risk and control risk to the audit, thereby increasing both the overall risk of the audit and the auditor's resource commitment to the audit.

Auditor Initiated Changes –Big4 To Non-Big4

Auditor initiated changes from Big4 to non-Big4 were relatively rare, with only 3.68 percent (39 cases) of the 1059 changes falling into this category. Contrary to the prior research findings on Big4 to non-Big4 auditor switches (Hackenbrack and Hogan 2002), none of the changes in our random sample of five companies appeared to be motivated by fee-related issues. Fees were not mentioned as a reason for the change in any of the 8-K reports we reviewed. A logical explanation is that these changes were initiated by the auditor rather than the client and issues related to audit risk and resource availability were more likely to be drivers of the auditor's decision to resign from an audit. In general, management used boilerplate language to communicate the auditor change in their 10-K reports, and the exact reasons for the auditor's resignation remain largely unclear.

The change was approved by the audit committee of the board in all five cases. As required by Regulation S-K (Item 304), the reports indicate that audit opinions for the two most recently completed fiscal years contained no qualifications or modifications; no adverse opinions or disclaimers; management had no disagreements with the auditors; and no reportable events occurred during the previous two year that could affect the outcome of the audit. Management also used boilerplate language to refer to the mandatory letter from the outgoing auditor regarding 8-K reported disclosures about the auditor switch. In general, the auditors' letters stated that they had no basis to agree or

disagree with management disclosures in the 8-K report. This language in itself is surprising, given the very broad scope of Regulation S-K, Item 304, particularly as it relates to disagreements between the auditor and management. A mere difference in opinion on a matter could constitute an item that must be disclosed under the regulation.

In order to address possible concerns about opinion shopping, one audit client in our sample departed from the usual boilerplate language, and used specific language to indicate that it was not seeking to influence the opinion rendered by the auditors. That client noted the following in its 8-K report:

Neither the Company nor anyone on its behalf has consulted Grant Thornton [the successor auditor] regarding (i) either the application of accounting principles to a specific completed or contemplated transaction or the type of audit opinion that might be rendered on the Company's financial statements; as such, no written or oral advice was provided, and none was an important factor considered by the Company in reaching a decision as to the accounting, auditing or financial reporting issues; or (ii) any matter that was a subject of a disagreement or reportable event with Deloitte [the predecessor auditor] (as there were none).

This disclosure is noteworthy because it represents the only case in our study where management departs from what seems like standard boilerplate language and specifically rules out opinion shopping as a reason for the change in auditors. Nonetheless, given that this case involves an auditor resignation, it seems surprising that management would be so deliberate in ruling out opinion shopping.

Auditor Initiated Changes – Non-Big4 To Non-Big4

Twenty-five percent of the total number of cases we examined fell into this category. Our detailed examination of cases in this category appears to confirm Chen, Gupta and Senteney (2004) finding of an association between auditor changes and impending client failure. Of the five cases we examined in this category, two of the clients received going concern audit opinions for fiscal years immediately preceding the auditors' resignations. The disclosures in both cases consist of a blend of boilerplate language and language that appears to downplay the significance of a going concern opinion. The fact that these companies had going concern problems which could prompt the auditors' resignation was mentioned as a minor conjunction to more prominently disclosed boilerplate language that shed little light on the reasons for the auditor change. For example, one of the companies in our sample used the following language:

Evans was the auditor for the Company for the year ended June 30, 2004. No accountant's report on the financial statements for either of the past two (2) years contained an adverse opinion or a disclaimer of opinion or was qualified or modified as to uncertainty, audit scope or accounting principles, except for a going concern opinion expressing substantial doubt about the ability of the Company to continue as a going concern. During the Company's two most recent fiscal years (ended June 30, 2004 and 2003) and from July 1, 2004 to the date of this Report, there were no disagreements with Evans on any matter of accounting principles or practices, financial disclosure, or auditing scope or procedure. There were no reportable events, as described in Item 304(a)(1)(iv)(B) of Regulation S-B, during the Company's two most recent fiscal years (ended June 30, 2004 and 2003) and from July 1, 2004 to the date of this Report.

Further, the client in this case sought to emphasize the auditor's desire to discontinue services to public companies as the reason for the auditor's resignation. Thus, the 8-K report states that the auditor resigned "for reasons related to the firm's decision to cease providing auditing services to public companies" rather than communicating that the auditor change was most likely due to the increased audit and business risk associated with a client that has going concern challenges.

Only one of the 8-K reports in our sample stated that the company did not consult with the successor auditor prior to the predecessor auditor's resignation. In addition, the language used in the 8-K reports suggests auditors in four of the five cases did not file a letter with the SEC to confirm the client's disclosures about the reasons for the auditor changes. In one of the cases, the 8-K report erroneously suggests that the *successor auditor* must file a letter

with the SEC to comment on the client's disclosures regarding the auditor change. Actually, the Regulation requires the *outgoing auditor* to file a letter with the SEC.

Client-Initiated – Big4 To Big4

Client initiated auditor changes from Big4 to Big4 were relatively rare, with only 1.89 percent (20 auditor changes) of the total audit changes in our sample is represented in this category. The change was approved by the audit committee of the board in all five cases we selected for detailed study. In each of the five cases, the client reported no disagreements with the auditor; no issues related to the scope of the audit and the ability to express an opinion; and no consultation with the successor auditor for two years prior to the engagement on matters related to the financial statements. As required by the regulation, each client provided the auditor with a copy of its 8-K disclosures and the auditor complied with the request to furnish the SEC with a statement concurring with the client's disclosures. Four of the five clients in this category indicated no reportable events.

One of the companies disclosed a material weakness in the internal control. The company disclosed in its December 2004 Form 10-K that its auditors determined a material weakness existed in its internal control over financial reporting. Those weaknesses pertained to the company's sale and leaseback accounting procedures. The specific disclosure, which is reproduced below, hints at a degree of discord between the auditor and the client:

In connection with the audit of the Company's financial statements for the fiscal year ended December 31, 2004, it was determined that we had a deficiency in internal control over financial reporting related to the application of lease accounting to a sale leaseback transaction ... The error in ... resulted in us restating our balance sheet for the third quarter ended October 2, 2004. We and our independent auditors have concluded that the error was a result of a material weakness in our internal control over financial reporting as it relates to the application of sale leaseback accounting. ...

Our internal control process had included consultations with third-party advisors, as deemed necessary, relative to understanding and properly applying generally accepted accounting principles for the sale leaseback transaction, which for us is not a regularly recurring transaction. However, for the transaction in question, the third-party reviews did not report, and our other internal controls over the application of accounting policies did not detect, that the presence of certain forms of continuing involvement in the leased property by us which precluded the use of sale leaseback accounting. As a result, the property in question and the related financing liability should have continued to be recorded on the financial statements.

We will remediate this weakness by increasing the knowledge of our employees responsible for reviewing and approving the accounting for leasing transactions, including the review of the conclusions reached by qualified third parties.

Notwithstanding the above 10-K disclosure, the 8-K report downplays the significance of the issue as a reportable event, and management actually reported the dismissal of the auditor for economic reasons. The language used in the client's Form 8-K seems intended to suggest that the company had no reportable events. The internal control deficiency is reported as an aside and there is no disclosure in the 8-K report that the auditors required the company to make a significant restatement of its financial statements because of the material internal control weakness. It seems plausible that the auditor's noncommittal letter in response to the 8-K disclosure pursuant to the Regulation S-K 304 is related to this incident.

Client Initiated Changes – Non-Big4 To Big4

Client initiated auditor changes from non-Big4 to Big4 were relatively rare. This category consisted of only 17 cases or 1.60 percent of the overall sample of 1059 auditor changes. The change was approved by the audit committee of the board in all five cases we selected for detailed study. In each of the five cases, the client reported no disagreements with the auditor; no issues related to the scope of the audit and the ability to express an opinion; and no consultation with the successor auditor for two years prior to the engagement on matters related to the financial

statements. As required by the regulation, each client provided the auditor with a copy of its 8-K disclosures and the auditor complied with the request to furnish the SEC with a statement concurring with the client's disclosures. Four of the five clients in this category indicated no reportable events.

One of the cases involved a going concern opinion. The client's disclosure in this case begins by indicating that the company's audited financial statements did not contain an adverse opinion, disclaimer, or modification as to audit scope or accounting principles. The client then proceeds to indicate at the end of the disclosure, almost as an after-thought, that the auditor's report contained a modification related to the company's ability to continue as a going-concern.

A second case involved a client with a material weakness in internal control. The internal control issue involved the company's consolidated financial statements for the first quarter of 2004. The weakness included inadequate staffing and supervision which led to untimely identification and resolution of certain accounting matters, failure to perform timely reviews and evaluation of general ledger account balance, lack of procedure or expertise needed to prepare required disclosures, and evidence that the employees lacked the qualification and training needed to fulfill their responsibilities. Unlike other 8-K disclosures, the disclosures in this 8-K are comprehensive and do not required the reader to locate and review the relevant 10-Q in order to understand the nature of the material weakness. However, the material weakness was identified by the auditor and the language used to describe the weakness is very forthright and candid. It seems intuitive that the nature of the disclosure would produce disquiet among employees and officers of the company thereby contributing directly to a separation. At the same time the situation described by the auditors suggests a very high-risk audit. Thus, it is somewhat puzzling that the auditor did not withdraw from the audit.

Client Initiated Changes –Big4 To Non-Big4

There were 220 auditor changes in this category, comprising 20.77% of the 1059 changes in the sample. However, one "switch" involved only a change in the auditors for the "Firm's Employee Savings and Investment Plan". There was no change in the firm's independent registered public accounting firm. It is interesting to note that in four of the five cases in this group, there was no clear reason given for the switch. In the remaining case, the termination of the auditor was attributed to "economic reasons", which is consistent with observation from the literature.

In none of the cases was an adverse opinion/qualified opinion/disclaimer of opinion issued by the departing auditors in the two years prior to the auditor switch. Similarly, in none of the cases was there a disagreement between the firm and the departing auditor on any matter of accounting principles, practices, or financial statement disclosure, or auditing scope or procedure which, if not resolved to the satisfaction of the departing auditor, would have caused it to make references thereto in its report on the financial statements of such years.

Four of the 5 firms had no reportable events as defined in Item 304(a)(1)(v) of Regulation S-K. The one exception was a "reportable event" arising from a material weakness because the company did not maintain effective controls over the reporting of quarterly pro-forma net income and earnings per share (EPS) in relation to the fair value recognition provisions of SFAS 123. This material weakness resulted in a restatement of the client's financial statements. While such restatements often lead to litigation, it is puzzling that the company in its 8-K disclosures indicates that "there have been no reportable events" and treated the exception as a benign issue. Another striking observation related to this case is that the 10-Q report in which management disclosed this material weakness emphasizes management's role in detecting and correcting the weakness. Yet it is evident that the weakness was discovered subsequent to a prior disclosure when the error was made and that there ought to have been an external auditor's involvement in the discovery and correction of this issue. It is possible that the prior period adjustment was mandated by the auditors and could have been a contentious issue in the client-auditor relationship.

As required, the Registrant provided the departing auditor with a copy of its disclosures and requested the departing auditor to provide a letter addressed to the SEC stating whether it agreed with the disclosures. In each of the 5 cases, these conditions were met, and the auditor's letter was filed. In every case, the auditors agreed that they have

resigned, which is a statement of fact, but they consistently indicated that they had no basis to agree or disagree with management's disclosures in the 8-K report.

Client Initiated Changes –Non-Big4 To Non-Big4

There were 479 auditor switches in this group, making up 45.23% of the 1059 auditor switches identified. These client-initiated changes were the most prevalent of all auditor changes we investigated. The next closest change was auditor initiated change from non-Big4 to non-Big- 4. Considering the conjecture that non-Big4 firms are increasingly removing themselves from SEC audits, these statistics are surprising particularly when one considers that the reality appears to be a movement from non-Big4 back to non-Big4 auditors.

The client received a going concern opinion in all 5 cases in this group, confirming Chen, Gupta and Senteney (2004) findings of an association between auditor changes and impending client failure. In none of the cases was an adverse opinion, qualified opinion, or disclaimer of opinion issued by the auditor. Furthermore, there was no disclosure in any of the five 8-Ks with regard to internal control deficiencies as required by Regulation S-K 304. A logical explanation is that because of their size, none of the entities involved was required at the time to certify the effectiveness of their internal control systems. There was also no disclosure with regard to available information that might prevent the auditor from expressing an opinion or that might make the auditor unwilling to be associated with the financial statements.

All five clients indicated no disagreements with the auditor. Notwithstanding the going concern uncertainties in all five audit reports, the clients consistently indicated that there were no reportable events. This suggests a check-the-box orientation to compliance with the regulation rather than an interest in transparency related to matters that are pertinent to the relationship with the auditor.

In each of the 5 cases the registrant requested from the auditor, and received the mandatory letter addressed to the SEC concerning any new information, clarifying the registrant's disclosure, or stating any reasons why the auditor does not agree with any statements made by the Registrant in the report. In every case, the auditors agreed that they had resigned, which is a statement of fact, but they consistently indicated that they had no basis to agree or disagree with management's disclosures in the 8-K report.

DISCUSSION

Our study suggests that registrants are not complying with the spirit of regulation S-K, Item 304. Presumably, the regulation is intended to promote transparency and disclosure about material events that could affect the efficacy of the audit report. Yet, we observe that companies use a "check the box" approach to disclosing the reasons for auditor changes. This seems to be a cynical approach to compliance. By providing the minimum required information related to several of the required disclosures, management may indicate that they are complying because they fulfill specific disclosure requirements. However, their disclosures are inadequate for one to fully understand the rationale for the auditor change. This is further compounded by the content of the required auditor compliance letter. The auditors invariably indicate in the compliance letter that they have no basis to agree or disagree with management's disclosures.

Although the regulation specifically requires registrants to disclose disagreements and opinion differences (whether or not they were resolved to the auditors' satisfaction), none of the disclosures we examined mentioned any disagreements with the auditors. Auditors also refrain from commenting on any type of disagreement with their clients and instead use non-committal language in their letters to the SEC. This appears to be a conflict avoidance strategy that auditors use systematically. It also suggests a strategic hedging posture to minimize litigation risk and assure good relationships with former clients over the long term.

There is a consistent pattern of auditor changes when a client receives a going concern opinion. Clients in our small sample invariably dismissed their non-Big4 auditors and switched to another non-Big4 auditor when they received a going concern opinion. While not as consistent, there are similar switches to non-Big4 auditors from Big4

auditors who issue going concern opinions. Our observations are supported by Chen, Gupta and Senteney (2004) who suggest an association between auditor changes and impending company failure.

We did not observe the type of relationships that Sankaraguruswamy and Whisenant's (2004) documented. These authors found that "clients are more likely to cite service-related reasons when dismissing large predecessor auditors, and are more likely to cite fee-related reasons when choosing small-successor auditors." If the market does indeed penalize companies for disclosing fee-related issues as the reason for an auditor's dismissal (Hackenbrack and Hogan 2002), then it seems plausible that management deliberately avoids identifying audit fees in their 8-K reports as a possible reason for dismissing their auditors. Furthermore, such a disclosure might be interpreted adversely by the market as a signal of management's willingness to sacrifice service for reduced fees (Hackenbrack and Hogan 2002). While there are logical explanations for not observing the fee-related issues as a documented reason for auditor switches, we are surprised that there is very little mention of fees in the disclosures particularly in the context of the growing cost of audit services and the findings of Sankaraguruswamy and Whisenant (2004).

Although all companies used boilerplate language that offers little clarity for their auditors' dismissals or resignations, we observed that at least one registrant in each of our small samples disclosed a material internal control weakness which sometimes led to a financial statement restatement, a going concern opinion, or both. This observation is consistent with prior empirical findings that auditor changes are related to the existence of reportable events (Chen, Gupta and Senteney 2004; Woo and Koh 2001).

CONCLUSION

This study finds that SEC registrants use boilerplate language that generally offers little insight into the underlying reasons for auditor resignations and dismissals. It is seldom that management offers clear and forthright disclosures about issues that could have influenced auditor change decisions. The disclosures we examine suggest an auditor change pattern that mirrors such reportable events as going concern uncertainties and material internal control weaknesses. In particular, all client-initiated auditor changes from non-Big4 to non-Big4 followed a going concern audit opinion on the financial statements. Additionally, two of the five cases of management initiated changes from Big4 to non-Big4 auditors were preceded by going concern opinions. Despite this observed disclosure pattern, most management 8-K disclosures tend to marginalize the effects of reportable events on the auditor change decision. In fact, management disclosures offer insufficient insight into the underlying reasons for auditor changes and contribute little to transparency in corporate governance. In the context of the cases that we studied, the auditor's compliance letter required by the SEC makes virtually no contribution to transparency and disclosure as the letters are generally non-committal and uninformative.

Readers should be aware that our study is based on a small but representative sample of cases that were randomly selected to include five cases from each category in our auditor change typology. We expressly selected a small sample in order to assure that the study was manageable and that we were able to review all 8-K disclosures in detail. Despite the small sample size, we observed several of the patterns reported in prior studies.

Our study has important implications for future research and for practice. First, future researchers should be aware of the differences between client-initiated and auditor initiated auditor changes. The client initiated changes we examined were most likely to involve non-Big4 to non-Big4 auditor switches, which invariably involve a going concern opinion on the financial statements. Auditor initiated changes tended to be less prevalent (particularly those that involve a switch to a Big4 auditor). Such differences need to be further examined in the literature. Second, future research must attempt to address the underlying reasons for the persistent use of non-committal language by auditors in complying with registrants' request to confirm the 8-K disclosures. Such non-committal language perpetuates game-playing and a lack of clarity in management disclosures. Finally, our findings suggest a need for additional study to examine management's motivation for the use of boilerplate language and disclosures in the 8-K reports. It seems evident that companies are using a "check-the-box" approach to compliance with Item 304 of Regulation S-K without really adhering to its spirit and intent to promote transparency and clarity in the market for auditors. Auditors, on the other hand, are not forthright in their letters to the SEC and it appears that the SEC does not vigorously pursue cases where the evidence points to obfuscation of the underlying reasons for auditor changes. One might hypothesize

that the potential for costly litigation and damage to possible future relationships are significant motivations for the status quo in the market for auditors.

REFERENCES

1. Chen, Y., A. Gupta and D. Senteney. 2004. Predicting Impending Bankruptcy Using Audit Firm Changes. *The Journal of American Academy of Business, Cambridge* (March): 423-433
2. Chow, C. and S Rice. 1982. Qualified audit opinions and auditor switching. *Accounting Review* 57 (April): 326-335
3. Controller's Report. 2006. Audit Fees Increase 292% Since 2001 for S&P Small-Cap. *Controller's Report* 2006 (9): 1-3.
4. DeFond, M. L. 1992. The association between changes in client firm agency costs and auditor switching. *Auditing: A Journal of Practice & Theory* 11: (Spring): 16-31.
5. Eichenseher, J. and D. Shields. 1989. Corporate capital structure and auditor "fit". *Advances in Accounting* 7 (Supplement 1): 33-56
6. Hackenbrack, K. E. and C. E. Hogan. 2002. Market Response to Earnings Surprises Conditional on Reasons for Auditor Change. *Contemporary Accounting Research* 19 (2) (Summer): 195-223
7. Haskins, M and D. Williams. 1990. A contingent model of intra-Big 8 auditor changes. *Auditing: A Journal of Practice & Theory* 9 (Fall): 55-74
8. Healy, P. 1985. The impact of bonus schemes on the selection of accounting principles. *Journal of Accounting and Economics* 9 (April): 85-107
9. Johnson, B. and T. Lys. 1990. The market for audit services: Evidence from voluntary audit changes. *Journal of Accounting and Economics* 12 (January): 281-308.
10. Palmrose, Z. 1984. The demand for quality-differentiated audit services in an agency-cost setting: an empirical investigation. Auditing Research Symposium (University of Illinois)
11. Sankaraguruswamy, S. and J. S. Whisenant. 2004. An empirical analysis of voluntarily supplied client-auditor realignment reasons. *Auditing: A Journal of Practice & Theory* 23(1): 107-121.
12. Woo, E. and H.C. Koh. 2001. Factors associated with auditor changes: a Singapore study. *Accounting and Business Research* 31(2): 133-144.

NOTES