

# Independent Auditor Switching And Changes In Corporate Bond Ratings

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## Abstract

*The creditability that independent audits add to financial reporting is undermined when clients change their independent auditors. Although the subject of numerous research studies there is a lack of definitive evidence concerning client motivation for switching independent auditors. This effort opens a new avenue of study and investigates the possible relationship between independent auditor switching and changes in corporate bond ratings. The findings suggest that clients are likely to experience decreasing bond ratings prior to and subsequent to switching independent auditors.*

## Introduction

In recent years the independent auditor - client relationship has been a concern of investors, lenders, and accounting policy makers. With the increasing complexity of financial reporting regulations, there is greater likelihood for conflict between independent auditors and their clients. In some cases, this reduces the audit to a bargaining process between the client and its independent auditor (Lev, 1979). A concern of financial statement users is that management can pressure the independent auditor into issuing a "clean opinion" by threatening to switch auditors. If management is dissatisfied with their current auditor's position on certain technical matters, they may select a new independent auditor to gain approval for desired financial reporting practices. This undermines auditor independence and, hence, the creditability of financial reporting.

A firm's financial reporting is reflected in its financial statements as well as related measures, such as corporate bond ratings. Although corporate bond ratings are determined independently of management, rating services make significant use of a firm's audited financial statements (Belkaoui, 1980). Bond ratings are important to investors and lenders because they signal a corporation's probability to default on its debt and because of their high correlation with debt security yields (Altman and Namacher, 1985; Foster, 1986).

An unfavorable bond rating may make it difficult for a firm to issue capital stock and to borrow funds at favorable interest rates. In response to an unfavorable bond rating change, management is likely to take action

to improve the firm's image in the financial community. In some cases the independent auditor may oppose such changes believing that management's justification is unreasonable. Switching independent auditors may be viewed by management as one means to gain approval for accounting treatments that may have favorable effects on the firm's financial reporting and, hence, corporate bond rating.

The purpose of this article is to examine the relationship between independent auditor switching and bond rating changes. Specifically, this study investigates the nature of corporate bond rating changes in the three year periods prior to and subsequent to independent auditor switches. Four questions are addressed: 1) Do firms switching independent auditors experience bond ratings decreases in the three year period prior to the switch?; 2) Do firms switching independent auditors experience bond ratings increases in the three year period subsequent to the switch?; 3) Do auditor switching firms choose a different type of independent auditor?; and 4) Are there significant differences in the patterns of independent auditor switching between higher and lower rated firms?.

The evidence generated from the study will enable us to better understand the motivations for and the consequences of independent auditor switching. It will allow investors and lenders to assess whether bond rating decrease portends a switch in independent auditors and whether a switch in auditors leads to a subsequent increase in bond ratings.

## Prior Research on Independent Auditor Switching

Numerous studies have investigated the rationale and consequences underlying independent auditor switches. An early study by Burton and Roberts (1967) surveyed 620 firms listed on the Fortune 500 during the 1955 to 1963 period. Although their results were generally inconclusive, they found that management change was the most frequently cited reason for auditor switches. In more recent studies Bedingfield and Loeb (1974) and Eichenseher and Shields (1983) identified audit fees as a major reason for switching independent auditors but were unable to provide definitive evidence concerning other possible relevant factors.

In an analysis of 8-K statements filed with the SEC McConnell (1984) investigated the relationship between auditor switching and technical disagreements. Auditor-client disputes was cited as a reason for auditor switching in only a limited number of the cases. However, McConnell qualified his finding indicating that auditor-client disputes often involve matters that are sensitive to both parties and, therefore, may not be made public in 8-K statements.

Schwartz and Menon (1985) investigated the relationship between auditor switching and the client's financial distress. Their study compared a matched sample of healthy firms with firms that filed for bankruptcy. The results indicate that failing firms are more likely to switch independent auditors relative to healthy firms. Schwartz and Menon attribute the results to the fact that failing firms need to reduce their audit cost and management's desire to conceal financial problems.

Qualified audit opinions are widely believed to a major factor for switching independent auditors. A qualified opinion is perceived to have an unfavorable effect on the firm's stock price and its ability to borrow funds. Chow and Rice (1982) investigated the relationship between auditor switching and qualified audit opinions for a sample of SEC registrants over a two-year period. Their findings indicate that firms switch independent auditors more frequently after receiving qualified opinions. However, Chow and Rice also determined that firms that have received qualified opinions do not select new independent auditors having a history of rendering proportionately fewer qualified opinions. Furthermore, their results indicate that firms that have switched independent auditors following a qualified opinion tend not receive clean audit opinions in the subsequent year.

This study extends prior research and investigates the possible link between bond rating changes and auditor switching. The evidence generated from the study adds to our understanding of the impact of auditor switching on the firm as well as for investors and creditors.

## Conduct of The Study

Information on auditor switches occurring during the 1983 - 1987 period was gained from *Who Audits America*. Corporations switching independent auditors which have an outstanding bond issue listed and rated in *Moody's Bond Record* during the three year periods prior to and subsequent to the switch are included in this study. A total of 133 firms meeting these criteria are included in the analysis.

The Moody rating system provides investors and lenders with a simple system of gradation of corporate bonds. Moody's presents nine basic corporate bond ratings ranging from Aaa (highest) to C (lowest). For purposes of analysis the nine ratings were aggregated into three categories: A (includes Aaa, Aa, and A), B (includes Baa, Ba, and B), C (includes Caa, Ca, and C). The bond rating at the time of auditor switch is used to classify the firms into the three categories. The direction of any bond rating changes occurring in the three year periods prior to and subsequent to the auditor switch is captured for each firm.

Additionally, four types of independent auditor firm switches are captured in the study, including Big 8 to Big 8, Non-Big 8 to Big 8, Big 8 to Non-Big 8, and Non-Big 8 to Non-Big 8. It should be noted that as the result of recent mergers the "Big 8" public accounting firms have been reduced to the "Big 6." However, this reduction in the number of firms should not have a significant effect on the nature of the study's results.

## Results

### *Effect Of Bond Rating Changes Prior To And Subsequent To Auditor Switches*

Table 1 presents evidence concerning the direction of the bond rating changes occurring in the three year periods prior to and subsequent to the auditor switches for all 133 firms. Tables 2, 3, and 4 present this evidence disaggregated on the basis of corporate bond rating at the time of the independent auditor switch.

### Aggregated Firm Analysis:

It is apparent from Table 1 that relative to non-switching firms auditor switching firms are more likely to experience a negative prior or subsequent trend in their bond rating. Prior to the switch 47 firms had a decrease, while 12 experienced an increased rating. After the switch 40 firms exhibited a negative trend and 18 had an increase in their bond rating. However, these results do not indicate whether there are significant differences in auditor switching patterns between higher and lower rated firms.

**Table 1**  
Bond Rating Trends Prior to  
and Subsequent to Auditor Switch

Prior Trend	Subsequent Trend			Total
	Increase	No Change	Decrease	
Increase	1	8	3	12
No Change	12	46	16	74
Decrease	5	21	21	47
Total	18	75	40	133

**Table 2**  
Bond Rating Trend Prior to and Subsequent to Auditor Switch:  
A Rated Bonds

Prior Trend	Subsequent Trend			Total
	Increase	No Change	Decrease	
Increase	0	6	1	7
No Change	2	18	7	27
Decrease	0	5	2	7
Total	2	29	10	41

**Table 3**  
Bond Rating Trend Prior to and Subsequent to Auditor Switch:  
B Rated Bonds

Prior Trend	Subsequent Trend			Total
	Increase	No Change	Decrease	
Increase	1	2	2	5
No Change	8	27	9	44
Decrease	3	12	14	29
Total	12	41	25	78

**Table 4**  
Bond Rating Trend Prior to and Subsequent to Auditor Switch:  
C Rated Bonds

Prior Trend	Subsequent Trend			Total
	Increase	No Change	Decrease	
Increase	0	0	0	0
No Change	2	1	0	3
Decrease	2	4	5	11
Total	4	5	5	14

### A Rated Bonds:

For A rated bonds there does not appear to be a significant relationship between the prior trend in bond ratings and independent auditor switching. An equal number of firms experienced an increase or decrease in bond ratings prior to switching independent auditors. Furthermore, only 12 of the 41 A rated firms had a bond rating change subsequent to their auditor switch. However, ten of these firms had a decrease in their bond rating. This lack of significance is also reflected in the results of a chi-square analysis of the data.

### B Rated Bonds:

The results are more definitive for firms with B rated bonds. There is greater likelihood that firms with a negative prior or subsequent trend in bond ratings switch independent auditors. Five auditor switching firms experienced an increasing prior bond rating while 29 switching firms had a decreasing trend. Subsequent to the auditor switch 25 B rated firms had a negative trend and 12 experienced an increase in bond ratings.

### C Rated Bonds:

Although there are fewer C rated bonds, the effect of the prior trend is more pronounced. Eleven C rated auditor switching firms experienced a negative ratings trend prior to the switch, while there were no firms that had a positive prior trend. After the switch the trend is less apparent with four firms having increasing and five experienced a decreasing bond rating.

Furthermore, a chi-square analysis of the prior trends indicates that there are significant differences among the three ratings categories of firms. It is apparent that lower rated firms are more likely to switch independent auditors when there is a negative prior bond rating trend. Relative to A rated firms lower rated firms may have more difficulty in gaining and maintaining the confidence of the financial community. Therefore, in the event of a negative change in their bond rating lower rated firms are more likely to engage in actions to improve their financial reporting. Switching independent auditors may be perceived by lower rated firms as one means to gain approval for accounting treatments that have a favorable effect on their financial statements.

The beneficial effect of an independent auditor switch on the subsequent bond rating trend is less apparent. In each of the three categories more firms experienced a decrease than an increase in bond rating subsequent to switching independent auditors.

### Effect of The Type of Independent Auditor Switch

Table 5 presents the type of independent auditor switch classified on the basis of the bond rating at the time of the switch. The evidence indicates that "Big 8" firms are the dominate group of prior and subsequent independent auditors. The "Big 8" firms were the subsequent independent auditors in 124 of the 133 switches. This finding is not surprising. "Big 8" firms are perceived by many individuals in the financial community to possess greater technical accounting and auditing expertise relative to "Non Big 8" firms. Therefore, corporations desiring to enhance their creditability with the financial community often select "Big 8" firms.

**Table 5**  
Bond Rating and Type of Auditor Switch

Bond Rating At Date of Switch	Type of Switch			
	8 to 8	N to 8	8 to N	N to N
A	35	3	2	1
B	62	11	5	0
C	9	4	1	0
Total	106	18	8	1

8 to 8: From Big 8 auditor to Big 8 auditor.  
 N to 8: From Non-Big 8 auditor to Big 8 auditor.  
 8 to N: From Big 8 auditor to Non-Big 8 auditor.  
 N to N: From Non-Big 8 auditor to Non-Big 8 auditor.

Evidence is presented in Table 6 concerning the relationship between the type of independent auditor switch and the prior and subsequent bond rating trends. The results indicate a lack of significant differences among the four types of independent auditor switches. It does not appear that the type of independent auditor switch has a significant impact on the bond rating trend.

**Table 6**  
Type of Auditor Switch and Bond Rating Trend Prior to  
and Subsequent to Auditor Switch

Type of Switch	Trend of Bond Rating Prior to Switch			Trend of Bond Rating Subsequent to Switch		
	+	0	-	+	0	-
8 to 8	9	60	37	14	61	31
N to 8	2	11	5	2	12	4
8 to N	0	3	5	1	3	4
N to N	0	1	0	0	0	1
Total	11	75	47	17	76	40

8 to 8: From Big 8 auditor to Big 8 auditor.  
 N to 8: From Non-Big 8 auditor to Big 8 auditor.  
 8 to N: From Big 8 auditor to Non-Big 8 auditor.  
 N to N: From Non-Big 8 auditor to Non-Big 8 auditor.

### Conclusions

The auditor acts as an independent objective referee of corporate financial statements. By adding creditability to the financial reporting process the auditor plays an important role in our economy. This creditability can be undermined when corporations switch independent auditors. Investors and creditors may question the reasons for independent auditor switching and whether it affects the reliability of reported financial results. Recent studies have attempted to capture and explain the rationale for and consequences of independent auditor switching.

The current study sheds light on the link between independent auditor switching and the trend in corporate bond ratings. The results suggest that client managements are sensitive to bond rating changes. Auditor switching firms are likely to experience decreasing prior and subsequent bond rating trends. Furthermore, this relationship is more pronounced for lower rated firms. Switching independent auditors may be viewed by management as one means of gaining greater control over the financial reporting process. Yet, the evidence indicates that most firms switch to similar independent auditors and do not necessarily improve their bond rating trend.

### Suggestions for Future Research

The increasing public concern over auditor independence makes independent auditor switching a fertile area for research. Based on the findings of this study there are several avenues of suggested future research. Although most prior research has focused on the reasons for switching independent auditors there has been relatively little evidence generated concerning the subsequent effects on clients, stockholders, and independent auditors. Additional effort is needed to gain an understanding of the short-run and long-run implications of independent auditor switching on corporate earnings, liquidity, financing, and stock market prices. Further study is needed to gain evidence concerning client industry differences and why independent auditor switching occurs more frequently for certain firms.

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