

Changing Auditors and the Influence of Client Specific Attributes: An Analysis

Dr. Ram S. Sriram, Accounting, Louisiana State University

Abstract

This article examines certain client specific attributes of a group firms to ascertain whether some of these attributes are more closely associated with firms switching auditors. The results indicate that firms receiving a qualified opinion and small firms and those listed in over the trading counter to be more likely to change auditors. Firms audited by bigger audit firms appear to be less likely to switch auditors.

Introduction

The autonomy of auditors in the performance of their professional duties has always been considered a cornerstone of the profession [Mautz and Sharaf, 1961]. The increase in audit failures combined with allegations of "opinion shopping" by clients, have raised serious concerns about auditors' independence. Some fear that unbridled competition enables clients to switch auditors whenever a disagreement occurs and that threat of loss of clients will undermine auditor's independence [Goldman and Barlev, 1974]. The Securities and Exchange Commission (SEC) has expressed its concern by issuing a number of Accounting Series Releases (e.g., SEC ASR No. 165 [1974]; No. 194 [1976]; No. 247 [1978]) requiring disclosures about auditor and client disagreements when a corporation changes its auditors. The SEC believes that the disclosures might discourage management from shopping for auditors whenever a disagreement occurs over accounting or reporting issues.

There is no question that disagreements over the appropriateness of accounting treatments or audit qualification, strain the auditor and client relationship. Management assumes responsibility for the content of financial statements, but auditors can make users aware of any disagreements by issuing a qualified or adverse opinion. Since an auditor's report is used by stockholders, creditors and others to evaluate the firm, management would be concerned with the type of report issued by the auditors. When management is dissatisfied with the auditor's report, it may initiate search for other auditors, whose views on reporting issues are consistent with management or accommodating to management.

In the past, several researchers have examined the

association between one or more client and audit related attributes and the auditor change process [Burton and Roberts, 1967; Carpenter and Strawser, 1967, Bedingfield and Loeb, 1974; Schwartz and Menon, 1985; Williams, 1988]. These studies identified some of the variables associated with auditor changes and generally contributed to an understanding of auditor and client relations. This study improves on these previous studies by collectively examining some of the attributes to find answers to some of the following questions: (1) Do firms with certain attributes are more likely to change auditors? and (2) Can these client and specific attributes be used to discriminate between clients likely to change auditors and clients less likely to change auditors? and (3) What are some of the compelling reasons that may induce a firm to change auditors? Finding answers to some of these questions may improve our understanding of auditor and client relations and can aid other researchers engaged in building a theoretical framework of auditor changes.

The research presented explores whether five specific attributes are related to a change of auditors. These attributes are: latest audit opinion, size of the client company, size of the audit firm, exchange on which the client is listed, and a change in management (change in the company's CEO). Reasons such as need for additional services, disputes over accounting principles or audit fees or dissatisfaction with services provided by current auditors also have been found to influence a change of auditors. But, these other reasons have not been included in this study because of the difficulty in obtaining this information for firms that did not change auditors. The study uses a sample of 200 firms, among

whom, 100 changed auditors during 1985-86 and 100 did not change auditors. The year 1985 was chosen because, according to the Public Accounting Report, the year 1985 represents one of the greater number of auditor changes in the U.S.

Review of Prior Research

Previous studies have offered several explanations for why corporations change auditors. Studies by Burton and Roberts [1967], Carpenter and Strawser [1967], Bedingfield and Loeb [1974], Chow and Rice [1982], Schwartz and Menon [1985], and Williams, [1988] examined the reasons corporations switch auditors and found that auditor changes were either dependent on or associated with attributes such as type of opinion last issued by the displace auditors, the audit fees, the size of the audit firm, the disputes over accounting principles and a client's financial condition. A few other studies examined the reaction of the market to auditor switches [Fried and Schiff, 1981; and Smith and Nichols, 1982]. The market based studies indicated that the market does not react to information on auditor switches or conflict with auditors.

Some studies used a different approach to study the auditor selection problem and tested the association between agency cost variables and auditor quality [Frances and Wilson, 1976; Healy and Lys, 1984; Eichenseher and Shields, 1986; Simunic and Stein, 1986; and Johnson and Lys, 1986]. Frances and Wilson [1986] suggested that firms that issue debt change from high quality auditors once debt was issued. The study did not directly examine the differences in attributes between firms that changed auditors and firms that did not change auditors. Eichenseher and Shields [1986] primarily examined the preferences of Big Eight auditors for certain clients and found leverage and presence of audit committees to be significantly associated with Big Eight preference for clients. Simunic and Stein [1986] examined the tendency of firms offering securities to the public for the first time to switch between Big Eight firms and local audit firms. The study found association between switching auditors and certain agency cost variables, such as book value of client's assets, leverage, location etc. The results of some of these studies were either inconclusive or differed from one another.

Qualified Opinions and Disagreements Over Reporting Matters

The management of a corporation generally decides

the kind and quality of information that it will provide to users of financial statements. Management controls the auditors' access to information and personnel of the organization and it is possible for management to report misleading and false information. If auditors disagree with the management over the quality of reporting, they can qualify their audit opinion. The qualified opinion may be used as a means to bringing the management into order. Since a qualified opinion may reflect negatively on the management's financial reporting practices, management naturally prefers to receive a "clean" opinion [Schwartz and Menon, 1985]. Managers may believe that receiving a qualified opinion could adversely affect the price of the firm's securities and the perception of stockholders and others about the reliability of management's financial representations. Management may attempt to influence the auditors by threatening to change to other auditors to avoid a qualified opinion.

Chow and Rice [Chow and Rice, 1982] found evidence of corporations changing auditors after receiving a qualified opinion. They contend that these corporations may have changed auditors to seek a more amenable auditor and to obtain a more favorable report. If a corporation switches to a new audit firm immediately after receiving a qualified opinion, it is possible that the qualified opinion influenced the decision to change auditors. Since corporations may change auditors for a variety of reasons, such as savings in audit fees, mergers of their company or the audit firm, or need for bigger auditors, we cannot assume a one to one relationship between auditor changes and issuance of a qualified opinion. For example, a company may be facing financial distress and creditors may insist on the financial statements being audited by a different audit firm that can provide greater credibility and insurance [Schwartz and Menon, 1985]. Since, it is difficult to ascertain the real intent behind a management's decision to change auditors or auditors' decisions to give a qualified opinion, this study stops short of examining the motives behind auditor changes. This study only posits that a corporation receiving a qualified opinion will have a higher propensity to change auditors in the following year than a corporation receiving a clean opinion.

To test whether corporations receiving qualified opinions have a greater propensity to change auditors, the type of opinion given in the year preceding the auditor change was cross tabulated with the changers and non-changers (see Table 1). The study classified audit opinions as (1) unqualified and (2) qualified for

reasons other than consistency in application of accounting principles. The results show that 38 of the 200 corporations received qualified opinions and that 35 of these firms changed auditors the following year.¹ The evidence suggests that a qualified opinion provides an incentive for management to change auditors.

Client and Audit Firm Size

The decision to change auditors also can be influenced by the size of a corporation and the audit firm which audits the corporation. There are several reasons why a corporation may prefer a large audit firm. Carpenter and Strawser [Carpenter and Strawser, 1982] found that corporations going public changed from small to large nationally known audit firms. Because of significant growth, these corporations may have outgrown the small audit firm. Corporations facing financial distress also changed from smaller to larger audit firms to provide more assurance to its investors and creditors [Schwartz and Menon, 1985]. A corporation's size also may influence and limit selection of an audit firm. For example, in the case of General Motors, only a few audit firms could perform the audit, and General Motor's size restricts its choice of audit firms.

Likewise, audit firms may prefer clients who are large and have substantial operations and revenue. Auditors usually derive more revenue from the audit of big corporations and consider association with large corporations prestigious. Size may give a competitive advantage to big and nationally known audit firms, seeking new clients. Size becomes important also because of artificial barriers existing in the audit services market. Underwriters, bankers and audit committees often recommend large audit firms because of the greater confidence they place in the reports produced by large audit firms. Restrictions imposed by the Securities and Exchange Commission, creditors and others induce corporations to seek auditors who are more familiar with and capable of handling such restrictions (for example, auditors who can audit corporations registered with the SEC).

To test whether the size of a corporation influences auditor changes, a chi-square test was performed (See Table 2). The results show that 97% of corporations that changed auditors were small corporations (corporations were categorized as big or small based on their sales revenue).¹ To examine whether audit firm size influences auditor changes, audit firm size and auditor changers and non-changers was cross tabulated (See

Table 3). Audit firms were categorized as Big Eight or non-Big Eight. The results indicate that Big Eight auditors audited 91% of the corporations that did not change auditors, while non-Big Eight auditors audited only 9% of such corporations. The chi-square statistic of 23.05 is statistically significant at the 0.05 level. The audit firm size appears to be an important attribute influencing the selection of auditors and small audit firms appear to be affected by changes more frequently. The extent of changes within the Big Eight tier was not examined.

Stock Exchange Listing and The Regulatory Environment

Preferences of parties other than auditors and clients sometimes influence audit firm selections. Regulation and reporting requirements imposed by the SEC, Financial Accounting Standards Board, and the stock exchanges induce management to select auditors who are familiar with specific reporting requirements of the corporation. When the regulation and reporting rules increase and when less flexible standards are available, it may constrain management's choice of audit firms. Management may find it difficult to shop for auditors who would be willing to violate clear standards and expose themselves to litigation and loss of reputation.

The stock exchange is one among the many monitoring and regulating agencies that restricts management's choice of auditors. As a precondition for listing, companies listed on New York Exchange (NYSE) and American Exchange (AMEX) are subject to regulations such as existence of outside directors and audit committees. Participation by outside directors or audit committees might limit a management's role and power to change auditors. Also, regulation and reporting requirements differ between firms registered with the NYSE/AMEX and OTC firms. Because of the differences in reporting procedures, the number of qualified audit firms may be limited since audit firms incur significant costs in developing expertise related to particular regulatory requirements. Once such expertise has been acquired, the cost to serve additional clients subject to such requirements are lowered. Because of the benefits of using an experienced auditor, the corporation also will seek an audit firm that is familiar with the its reporting requirements. McConnell [1983] found that Big Eight accounting firms audited most corporations listed on New York or American exchanges. When NYSE/AMEX listed corporations changed auditors, the change was made within the Big Eight audit firm tier.

To test, whether the attribute stock exchange listing differs between corporations that changed auditors and corporations that did not change auditors, stock exchange listing was cross tabulated with changers and non-changers (See Table 4). The results indicate that 96% of the corporations that changed auditors were listed on the OTC markets. In contrast, 93% of the corporations that did not change auditors were listed on NYSE/AMEX. Stock exchange listing appears to be a factor influencing the selection of auditors. The findings indicate that corporations listed on OTC make more auditor changes than corporations listed on New York or American Exchanges. Since OTC firms are subjected to less sophisticated reporting requirements than NYSE/AMEX firms, managers of OTC firms may have greater flexibility in deciding to change auditors than accept unfavorable auditing judgments.

Summary and Conclusions

The purpose of this paper was to determine if certain attributes are related to a change of auditors. The results indicate that type of opinion issued by the auditors, size of the corporation and audit firm, and the exchange on which the corporation is listed impact auditor changes.

This study examined whether small corporations subjected to less reporting requirements and public scrutiny make more auditor changes. The propensity of corporations listed on certain stock exchanges and corporations that received a qualified opinion from their auditors to switch auditors more frequently were discussed. The results show that small corporations and those listed on OTC make more frequent auditor changes than large corporations and those listed on NYSE/AMEX. The regulatory constraints imposed by the stock exchanges appears to decelerate the rate of auditor changes. Many firms reacted negatively to qualified opinions issued by their auditors by changing to a different audit firm in the following year. The frequent changes appear to affect small audit firms more than Big Eight audit firms.

The study examined a few factors present during a change of auditors. How these factors affect auditor's independence and how auditor and client relationships could be improved were not examined. Additional studies of the theoretical basis underlying auditor and client relationships, using other variables such as mergers and acquisitions, role of financial institutions and other regulatory bodies may enhance such an understanding.

FOOTNOTES

1. The chi-square statistic of 33.27 is significant at the 0.05 level.
2. The chi-square statistic of 169.29 indicates that size is an important attribute. However, the large value of chi-square may indicate a skewed and non-normal distribution.

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TABLE 1
AUDIT FIRM CHANGES AND AUDIT REPORT QUALIFICATION

<u>Audit Report Qualification</u>			
	<u>Not-Qualified</u>	<u>Qualified</u>	<u>Row Total</u>
<u>Audit Firm</u>			
Not-Changed	97	3	100
Changed	65	35	100
Column Total	162	38	200

TABLE 2
AUDIT FIRM CHANGES AND CLIENT SIZE

<u>Client Corporation's Size</u>			
	<u>Big</u>	<u>Small</u>	<u>Row Total</u>
<u>Audit Firm</u>			
Not-Changed	96	4	100
Changed	3	97	100
Column Total	99	101	200

TABLE 3
AUDIT FIRM CHANGES AND AUDIT FIRM SIZE

<u>Audit Firm Size</u>			
	<u>Non-Big Eight</u>	<u>Big Eight</u>	<u>Row Total</u>
<u>Audit Firm</u>			
Not-Changed	9	91	100
Changed	39	61	100
Column Total	48	152	200

TABLE 4
AUDIT FIRM CHANGES AND STOCK EXCHANGE MEMBERSHIP

<u>Stock Exchange Membership</u>			
	<u>NYSE</u>	<u>OTC</u>	<u>Row Total</u>
<u>Audit Firm</u>			
Not-Changed	93	7	100
Changed	4	96	100
Column Total	97	103	200