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Research Report

Does information about auditor switches affect investing decisions?

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ABSTRACT

This study examines the impact of auditor dismissals and resignations on investing decisions. The study also aims to ascertain whether these decisions differ due to a reason given for the dismissal or resignation. Participants were given a scenario involving an investing decision and were first asked to assess the level of risk associated with investing in the company. Next, they were asked to allocate $10,000 between investing in the company versus a money market account. Five different questionnaires were created by varying information about an auditor switch and the reason for the switch. Results indicated that auditor switches produce higher investment risk assessments and marginally lower amounts invested than no auditor switches. Furthermore, the effects of resignations were not significantly different from the effects of dismissals. Also, disclosure of a disagreement as a reason for an auditor switch had no impact.

Introduction

Auditor switches occur when companies either dismiss their auditors or when auditors resign from engagements. Dismissals involve company-initiated changes of auditors, while resignations are initiated by the auditors. The purpose of this research is to ascertain whether knowledge about auditor switches affects investing decisions, and if so, whether the effect is different for dismissals versus resignations. This study, which focuses on individual investors using an experimental approach, also addresses whether a reason given for the auditor switch impacts investing decisions. Companies may or may not disclose the reasons for auditor switches. Common reasons include the disagreements between the client and its auditor, client's business strategy, going concern issues, management's reputation, reputation/experience of the auditor, scope limitations, independence impairment, and clients seeking audit fee savings or better services (Calderon & Ofobike, 2008; Chang, Cheng, & Reichelt, 2010; Turner, Williams, & Weirich, 2005).

In recent years, the number of auditor resignations and client dismissals has grown significantly (Owens-Jackson, Robinson, & Shelton, 2008). Prior research documents an increase in auditor resignations beginning in the 1990s (Catanach, Irving, Williams, & Walker, 2011). "The growth in the number of resignations is presumably an effort by audit firms to reduce their exposure to client risk and litigation" (Catanach et al., 2011, 269).

The Securities and Exchange Commission (SEC) requires registrants to report in its Form 8-K filing any change in auditor as well as whether the change was client-initiated or auditor-initiated (SEC, 1988, 1989).[1] The registrant need not disclose the reason for an auditor change, but disclosure about accounting disagreements is required when accompanied by auditor changes (SEC, 1988). The reason for the auditor change may be attributable to the client (e.g.,

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[1] Prior to 1988, registrants were required to disclose auditor changes in 8-K filings, but they did not need to indicate whether the change was due to a resignation or dismissal.

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client–auditor disagreements) or to the auditor (e.g., impaired independence).

Prior studies

A number of studies have examined the effects of auditor switches on investing decisions.[2] Some studies have focused on resignations while others have focused on dismissals. Several do not differentiate whether the changes are resignations or dismissals, while some compare the effects of dismissals and resignations.

Dismissals

Asthana, Balsam, and Krishnan (2010) find that clients switching from Arthur Andersen just prior to its demise experienced positive abnormal returns during the three-day window surrounding the announcement of the switch. The authors attribute this positive response to the reduction in uncertainty associated with the cost of finding a new auditor. Sankaraguruswamy and Whisenant (2004) show that abnormal stock returns are positively associated with the disclosure of non-verifiable reasons for auditor dismissals, but are unrelated to disclosures of verifiable reasons.

Resignations

Unlike for auditor dismissals, research has generally found negative market reactions to auditor resignations (DeFond, Ettredge, & Smith, 1997; Dunn, Hillier, & Marshall, 1999; Khalil, Cohen, & Trompeter, 2011; Shu, 2000). Two studies involving auditor resignations address disclosure of reasons for the resignations. Wells and Louder (1997) find that reasons provided for resignations or other information related to resignations provide no additional information to the market. Beneish, Hopkins, Jansen, and Martin (2005) demonstrate that when resignations are accompanied by disclosures about auditor–client disagreements over accounting treatment or over the adequacy of internal controls, the resignations are associated with negative abnormal returns for the former client. However, when resignations are not accompanied by explanations, there is no stock market effect.

Undifferentiated auditor switches

Several studies do not distinguish between the effects of resignations and dismissals and the results of these studies are quite mixed. Some find negative stock price reactions or decreased trading volume due to auditor switches (Cullinan, Du, & Zheng, 2012; Eichenseher, Hagigi, & Shields, 1989; Hagigi, Kluger, & Shields, 1993). Others report either no stock price reaction (Johnson & Lys, 1990; Klock, 1994) or combinations of positive, negative, or no reactions that depend on various circumstances (Chang et al., 2010; Knechel, Naiker, & Pacheco, 2007).

Some studies involving undifferentiated auditor switches address disclosure of reasons for the switches. While Fried and Schiff (1981) do not find a difference in market reactions to auditor switches accompanied by disagreement disclosures versus those without such disclosures, other studies report that disclosures of disagreements with auditor switches result in adverse market reactions (Dhaliwal, Schatzberg, & Trombley, 1993; Hackenbrack & Hogan, 2002; Smith & Nichols, 1982).

Comparing dismissals and resignations

A few studies have compared auditor resignations with auditor dismissals. These studies have generally found that resignations are more likely to be associated with indicators of risk than are dismissals (Catanach et al., 2011). Whisenant, Sankaraguruswamy, and Raghunandan (2003) show that disclosure of auditor resignations together with reportable events dealing with financial statement reliability issues is associated with negative returns above and beyond the effect of the resignation disclosure itself. Disclosure of auditor dismissals together with those reportable events is associated with negative returns above and beyond the effect of the dismissal disclosure itself for a seven-day trading period, but not for a three-day trading period surrounding the disclosure date. Griffin and Lont (2010) find that investors react negatively to resignation announcements, but the reaction to dismissals is largely insignificant. The negative reaction is explained mostly by two reportable event disclosures – auditor–client disagreements and nonreliance on management.

All of these prior studies on auditor switches use archival data and focus on stock markets as a whole. The current study focuses on stock market investing decisions of individual investors rather than market-based analyses. Individual investors merit study for several reasons. First, the SEC is concerned about the welfare of individual investors. Second, knowledge about decision-making by individual investors is useful for developing theoretical models dealing with investment markets (Daniel, Hirshleifer, & Subrahmanyam, 1998). Third, individual investors do bear the consequences of the stock prices that evolve from the actions of institutional investors (i.e., the price makers).

This study uses an experimental approach to investigate the effects of auditor switches on individuals' judgments about investments. The use of an experimental approach allows one to completely control the information available to participants. The study is able to control for factors that can cause confounding in archival studies, including concurrent information disclosure, firm-specific characteristics, and self selection.

Hypotheses

An analytical model by Lu (2006) demonstrates that auditor switching sends a negative signal to capital market participants that can result in stock price declines for the client. Possible underlying reasons for the negative signal include that the new auditor selected would be less critical of management (i.e., opinion shopping), managers may be maximizing their own utility rather than shareholders'

[2] For a recent review of studies dealing with various aspects of auditor changes, including effects on investment decisions, see Stefaniak et al. (2009).