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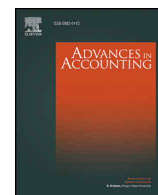

Auditor search periods as signals of engagement risk: Effects on auditor choice and audit pricing☆

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ABSTRACT

We examine the effect of auditor search periods (time taken from the dismissal/resignation of the old auditor to the appointment of the new auditor) on successor auditor choice and audit fees. Using a sample of auditor changes during the period 2002–2012, we find that clients associated with long search periods are less likely to be accepted by Big N auditors. Our results also show that successor auditors charge their clients higher initial audit fees following lengthier searches. Finally, we document that delays in appointing successor auditors following resignations are associated with a significantly negative stock market response. Our results suggest that investors, regulators and academics should be heedful of lengthy auditor search periods in their evaluations of audit quality and client risks.

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1. Introduction

How auditors manage risks associated with auditing their clients is a topic of great interest to investors, regulators and academics (Johnstone, 2000, 2001). Studies show that auditors evaluate their own firms' business risks, and their clients' business and audit risks in client acceptance decisions (Ayers & Kaplan, 1998; Cohen & Hanno, 2000; Johnstone, 2000, 2001; Asare, Cohen, & Trompeter, 2005; Schroeder & Hogan, 2013).[1] Once a client is accepted, audit firms actively manage their client portfolio risk, shedding risky clients when necessary (Johnstone & Bedard, 2003). They also implement other risk-management strategies, for example, assigning specialists and/or charging higher audit fees for their riskier clients (Johnstone & Bedard, 2004).

Khalil, Cohen, and Schwartz (2011) examine whether a client's engagement risk is positively related to the time taken to find a new auditor following an auditor change (hereafter auditor search period (*ASP*)). In support of their hypothesis, they find that *ASP*s are positively associated with client-risk factors such as internal control weaknesses and illegal acts by top management. It is not clear from their study, however, whether long *ASP*s proxy for a "new" or unreported risk factor(s), since the authors only demonstrate a positive association of *ASP*s with "known" risk factors identified by prior research. Khalil et al. (2011) also do not examine whether lengthy *ASP*s in turn impact auditors' decisions.

Unlike Khalil et al. (2011) we examine whether *ASP*s signal the presence of new or unreported risk factors that actually influence auditors' decisions. Specifically, we test whether lengthy *ASP*s have an incrementally significant impact over and above the known risk factors documented by prior work in influencing the choice of a new auditor and initial auditor fees. There has been no research that we are aware of, that has examined the impact of audit search periods on auditor choice and initial audit fees.

Khalil et al. (2011) exclude auditor dismissals from their sample because they argue that lengthy *ASP*s have an association with risk factors only in the case of auditor resignations. However, because management reports whether an auditor was dismissed or resigned, some resignations may have been reported as dismissals

☆ Data Availability: Data are available from public sources identified in the paper.

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[1] These risks are defined in Johnstone and Bedard (2004) as follows. Client business risk is "the risk that a potential client's economic condition will deteriorate in either the short term or long term". Audit risk is "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated". Auditor business risk is "the risk that the audit firm will suffer a loss resulting from the engagement".

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to avoid a negative investor reaction (Lee, Mande, & Ortman, 2004; Griffin & Lont, 2010). Our results indicate that dismissals involving positive search periods are possibly de-facto resignations. Specifically, we find that dismissals accompanied by appointment delays are associated with the same high risk client-factors observed with resignations. Turner, Williams, and Weirich (2005) also report that auditor dismissals occur more often when there are concerns about internal control weaknesses and the reliability of financial reporting.

As in Khalil et al. (2011), we measure *ASP*s by counting the number of days between the termination date of the predecessor auditor and the engagement date of the successor auditor. Although companies usually appoint new auditors on the old auditors' termination dates, there are at least two reasons for why high risk firms can have non-zero search periods (i.e., positive *ASP*s). First, auditors are known to take a longer time in their client acceptance decisions when they solicit or are solicited by high risk clients. A more complex and time-consuming process is involved before auditors can justify profitability when accepting a risky engagement. In some cases, a second review of a prospect by risk management partners is necessary (Johnstone & Bedard, 2003; Ayers & Kaplan, 1998) which in turn delays client acceptance.[2] Second, a high risk client may have previously solicited and been rejected by another audit firm(s) which can lengthen the firm's search for an auditor. In general, we expect that the longer it takes for a client-firm to conclude its search for a new auditor, the more likely that there are risk factors present in that firm.

Our sample consists of auditor switching firms in the years beginning after SOX and ending in 2012, as reported in *Audit Analytics*. Using both dismissal and resignation samples, we first investigate whether Big N audit firms are more or less likely to accept clients with long search periods than non-Big N audit firms. As Big N auditors have more to lose from audit failures (Jones & Raghunandan, 1998), we could expect that Big N auditors will be less likely to accept risky clients as proxied by long search periods. However, it is also possible that Big N auditors are more capable of accepting high-risk new clients because the auditors are able to diversify client-risk over a larger client portfolio (Simunic & Stein, 1990; Francis & Krishnan, 2002). Our empirical results, however, support a strategy of risk avoidance by Big N auditors. Specifically, we find that auditor search periods are negatively associated with the likelihood of subsequent acceptance by a Big N auditor (see also Shu, 2000; Catanach, Irving, Williams, & Walker, 2011).

Second, we investigate whether a lengthy auditor search period is positively associated with the initial pricing of an audit following an auditor change. If lengthier search periods proxy for higher levels of engagement risk, successor auditors can be expected to exert more effort and/or charge a higher hourly rate for auditing their new risky clients. In support, we find that the length of the audit search period has an incrementally significant and positive association with audit fees after controlling for other known risk factors. This finding is noteworthy. Firms with long *ASP*s are not only less likely to be accepted by Big N auditors but they also face higher audit fees. In tests performed separately by Big N and non-Big N auditors, we find that even non-Big N auditors are able to charge a fee premium that increases with the duration of the search period.

Finally, we examine whether the search periods are associated with the stock market reaction to auditor changes. After controlling for other determinants, we find that firms having positive search periods and whose auditors have resigned experience a significantly greater negative market reaction. Overall, therefore, the results suggest that long auditor search periods reflect risk factors that are considered by both markets and auditors in their decision making. Investors, policy makers and academics should be heedful of auditor search periods because their durations convey useful incremental information about client-firms' risks.

Knowing whether an auditor resigned or was dismissed is a matter of great interest to investors, regulators and academics. Although auditors do not resign from their engagements very often, their resignations trigger a large negative reaction from market participants (Shu, 2000; Raghunandan & Rama, 1999; Krishnan & Krishnan, 1997). There is great interest in understanding what risk factors are being signaled to markets by an auditor resignation. Griffin and Lont (2010), for example, demonstrate that the stock market response to auditor resignations is largely driven by fundamental risk factors such as litigation and bankruptcy, while Ghosh and Tang (2015) find that resignations portend negative events for firms in the following three years such as internal control weaknesses, litigation and delistings. Our study contributes to this literature by showing that among the firms whose auditors have resigned, those experiencing delays in finding a new auditor are viewed by auditors and investors as being associated with significantly higher risk factors. We present supporting evidence indicating that appointment delays are associated with future adverse events such as delistings and litigation. Interestingly, we find that auditor dismissals are also associated with downward auditor changes and higher successor auditor fees, although the association is not statistically significant in sub-sample tests.

The remainder of the paper is organized as follows. In the next section, we discuss prior literature and our hypotheses. This is followed by a discussion of the sample, empirical models and results. Our conclusion is in the final section.

2. Literature review and hypotheses development

2.1. Client-risk management by auditors

Using proprietary pre-SOX data, Johnstone and Bedard (2004) examine client acceptance decisions of a large audit firm during 2000–2001 and provide evidence of active risk management that includes the shedding of riskier clients and acceptance of less risky clients. Pratt and Stice (1994) survey 243 auditors and report that the auditee's financial condition is of paramount importance in the decision to accept or continue with a client. Johnstone (2000) develops a model showing in an experimental setting that client-business risk, audit risk and auditor-business risk are all evaluated in client acceptance and continuance decisions. Using proprietary data for 1997–1998, Johnstone and Bedard (2003) provide evidence that auditors adopt a variety of strategies that include assigning specialist personnel and billing higher rates to manage risks in their client portfolios.

Studies suggest that auditor changes reflect information about client risk factors more strongly post SOX than pre-SOX. Landsman, Nelson, and Rountree (2009), for example, demonstrate that in the periods immediately following SOX, the Big 4 auditors very aggressively managed their client portfolios by dropping risky clients (see also Griffin & Lont, 2010). They attribute these risk-based realignments to a reduced supply of auditor services (demise of Arthur Andersen) and a higher demand for those services (SOX requirements). Rama and Read (2006) also find that there were more Big 4 auditor resignations in 2003 than in 2001. Using post-Auditing Standard No. 5 (AS 5) data, Schroeder and Hogan (2013) document that the Big 4 continued to rebalance their client-portfolios by shedding high risk clients well beyond the early post-SOX years. This is interesting because resource capacity had increased at the Big 4 firms as there was a lower level

[2] Risk management partners are often more conservative than engagement partners (Ayers & Kaplan, 1998).

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