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# The impact of mandatory versus voluntary auditor switches on stock liquidity: Some Korean evidence

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ABSTRACT

Using Korean listed firms subject to the auditor "designation rule", this paper shows that (1) firms that switch auditors exhibit lower stock liquidity than firms that do not switch auditors, and (2) the negative liquidity effect of auditor switches is concentrated in firms that switch to low-quality auditors. Meanwhile, firms that switch auditors under the auditor designation system do not exhibit lower stock liquidity, consistent with audit designation mitigating the concerns about audit quality deterioration around auditor changes. Furthermore, we find that foreign ownership has a mitigating impact on the negative relation between auditor switches and stock liquidity, suggesting that investors are less concerned about auditor switches when an alternative monitoring mechanism exists.



## 1. Introduction

In a recent report published by the Competition Commission (CC), barriers to the switching of auditors are identified as one of the major factors restricting competition in the UK audit market, thereby leading to higher prices and lower audit quality (CC, 2013a). To ensure greater audit independence and a fresh approach to audits, the CC suggests mandatory tendering and rotation of audit firms as one possible remedy (CC, 2013b) that will lead to frequent auditor changes. However, other types of problems can arise as a result of frequent auditor switches and increased market competition. For example, companies can use auditor changes to obtain a favourable audit opinion (i.e. opinion shopping). In addition, increased competition in the audit market has brought about the practice of low-balling (i.e. setting audit fees below costs on initial engagements) and tendering, which can impair auditor independence (e.g. CAJEC, 1992). Thus, it is *ex ante* unclear whether frequent audit changes will improve audit quality.

In this paper, we examine the effect of auditor switching on stock liquidity to provide evidence on the consequences for the capital market. As auditors play an important role in determining the quality of financial reporting and the cost of capital (Balvers, McDonald, & Miller, 1988; DeAngelo, 1981; Fortin & Pittman, 2007; Pittman & Fortin, 2004), a firm's decision to change its incumbent auditor provides important information to the capital market regarding the quality of financial reporting. However, as the underlying reasons for auditor changes are generally unobservable to firm outsiders, it is difficult

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for investors to evaluate their effects. Prior studies that examine the stock price reactions to news of an auditor change provide mixed evidence; some find positive or non-negative stock market reactions (Sankaraguruswamy & Whisenant, 2004; Whisenant, 2006), while others find negative price reactions (Beneish, Hopkins, Jensen, & Martin, 2005; Knechel, Naiker, & Pachecko, 2007; Smith, 1988; Shu, 2000; Wells & Loudder, 1997; Whisenant, Sankaraguruswamy, & Raghunandan, 2003). Departing from the stock market reaction approach of prior studies, we focus on the effect of auditor changes on stock market liquidity. Stock liquidity reflects the degree of information asymmetry between potential buyers and sellers (Glosten & Milgrom, 1985), which should be affected by firms' financial reporting quality (Healy, Hutton, & Palepu, 1999; Leuz, 2003; Leuz & Verrecchia, 2000). Thus, the stock market's overall assessment of the effect of auditor switches on firms' financial reporting quality will be captured by the stock liquidity around such switches. In particular, the liquidity effect has important implications for firms because higher stock liquidity is associated with a lower cost of capital and higher firm valuation (Amihud & Mendelson, 1986; Lang, Lins, & Maffett, 2012).

One of the difficulties in studies on auditor changes is that both the decision to change the current auditor and the selection of a new auditor are endogenous choices of the firm (Francis & Wilson, 1988). To overcome this problem, we utilise a unique situation in South Korea (hereafter Korea), provided by the “auditor designation” rule. Specifically, the Korean Securities and Futures Commission (SFC) designates external auditors for some firms that are likely to have strong incentives for opportunistic earnings management, such as firms that are subject to accounting enforcement actions or firms with excessive debt-to-equity ratios.[1] The SFC requires these firms to replace their incumbent auditor with a designated new auditor. Thus, this regulatory designation forces firms that would not otherwise do so to switch auditors. Furthermore, as the new auditors are selected through a pre-set procedure by the SFC, investors can rule out the possibility of opinion shopping and the low-balling practice in the case of designated auditor changes (Bae, Kallapur, & Rho, 2012; Jeong, Jung, & Lee, 2005; Kim & Yi, 2009). We take advantage of this unique institutional feature to compare the stock liquidity impacts of voluntary auditor changes initiated by the client firms and mandatory auditor changes due to the auditor designation practice. We also utilise a regulatory change to draw implications about the causality of the effect of auditor designation on stock liquidity. Specifically, information on designated auditors was publicly available until 2004, but after that the SFC stopped making the designation list public. The stock market will incorporate information about designated auditors into stock liquidity only when it can access such information. We would therefore expect the relation between auditor designation and stock liquidity to disappear, or at least be weakened, in the later period.

Using data from Korean listed firms for the period between 1995 and 2011, we first document that firms that have switched auditors are associated with lower stock liquidity than those that have not. This finding is consistent with the notion that stock investors view auditor switches as reflecting lower audit quality due to the possibility of opinion shopping and auditors' low-balling/tendering practice. Additional analyses reveal that this effect is concentrated among firms that switch to non-Big 4 auditors, providing further evidence that investors' concerns are related to deteriorating audit quality.

Using the sub-period in which auditor designation information was publicly available (1995–2004), we document that the negative impact of auditor switches on stock liquidity is significantly mitigated when they are imposed on the firms by the regulatory body. More specifically, we do not find any significant difference in stock liquidity between switchers under the designation system and non-switchers, a finding in sharp contrast to the significantly lower liquidity associated with voluntary auditor switching. When we re-estimate the model for the sub-period in which auditor designation information is not publicly disclosed (2005–2011), we find no evidence that auditor designation affects the relation between a change of auditor and stock liquidity. In so doing, we demonstrate that the effect of designated auditor changes on stock liquidity in the earlier period is attributable to the market's reaction to auditor designation news.

Next, we examine the role of foreign ownership in mitigating the negative impact of voluntary auditor switches. Since foreign investors play an active role in pushing for high-quality auditors and better firm-level governance (Baek, Kang, & Park, 2004; Ferreira & Matos, 2008; Leuz, Lins, & Warnock, 2009), a high degree of foreign ownership could signal rigorous monitoring to the stock market and thus mitigate the concerns about opinion shopping when switching auditors. We find that the low level of stock liquidity associated with auditor switches is not observed for firms with high foreign ownership, suggesting that a strong governance mechanism (i.e. high foreign ownership) mitigates the negative liquidity effect of voluntary auditor switches. We also provide supplementary evidence on the effect of auditor switches on the relation between earnings and returns (i.e. earnings response coefficients (ERCs)). We find that firms that switch auditors have lower ERCs than non-switchers, consistent with our findings on stock liquidity. Our empirical findings are robust to the endogenous auditor selection.

This study makes several important contributions to the related literature and debates on auditor changes. First, it is the first to analyse the stock liquidity effect of auditor switches. Our finding that a switch of auditors has a negative liquidity consequence corroborates studies on the relation between transparency and liquidity (Healy et al., 1999; Lang et al., 2012; Leuz, 2003; Leuz & Verrecchia, 2000). Second, our paper adds to the general body of knowledge on the role of high-quality audits in reducing information asymmetry in the capital market, by documenting that a switch to a low-quality auditor is perceived to lead to lower financial reporting quality (Autore, Billingsley, & Schneller, 2009; Pittman & Fortin, 2004). Thus, our finding on the negative liquidity effect of a voluntary auditor change has important implications for the CC's recommendation that auditor changes should be made more frequently in the UK. Third, our study makes a novel

[1] Please see Section 2.3 for further information on the auditor designation system in Korea.