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Government and managerial influence on auditor switching under partial privatization

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ABSTRACT

We investigate how auditor switching is affected by government influence, misalignment between type of auditor (government vs. private) and type of controlling shareholder (government vs. private), and misalignment between an incumbent auditor and imputed preferences of managers in a market characterized by continued substantial government ownership in listed entities. We exploit a natural policy and regulatory experiment in Iran that allows us to investigate what happens when previously government-owned entities are partially privatized as listed entities where, in many cases, the government retains significant ownership interests. At the same time, there were significant changes in the audit market, resulting in large increases in the number of private sector auditors competing for previously state-administered audits. We find the likelihood of auditor switches is strongly associated with measures of misalignment between type of auditor and type of controlling shareholder and auditor–managerial misalignment, but these associations are constrained by significant government influence. Exposing the constraining effect of significant government influence on auditor switching is an important contribution to our understanding of privatizations, government shareholder influence and auditor choice. These results have implications for policy development in other emerging and transition

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economies where privatization remains largely partial, and competition among private sector auditors is still emergent.

1. Introduction

The link between political economy and auditor choice is an important policy question in emerging and transition markets where privatization has been a significant phenomenon (Guedhami et al., 2009). Privatizing corporate ownership raises the risks of serious agency conflicts between minority investors and politically connected managers or continuing government ownership, with significant implications for auditor choice (Chan et al., 2007; Wang et al., 2008; Guedhami et al., 2009). The risk of expropriation of minority shareholders by large shareholders is higher in emerging markets than in developed markets (Claessens et al., 2000; Claessens and Fan, 2002) and this may be reflected in financial reporting decisions. Therefore, the role of auditors in reducing conflicts of interest in financial reporting decisions is potentially more important in emerging markets than in developed markets. Consequently, factors that affect auditor changes, and may impair auditor independence and ultimately, audit quality, can have significant policy relevance in emerging and transition markets.

Where there is significant government influence through retained ownership in partially privatized companies, managers may prefer auditors who are more aligned with government interests. The widespread phenomena of privatizations and economic liberalization in several emerging markets have been accompanied by rapid growth in audit suppliers as governments have licensed more private sector audit firms. While there has been some research on auditor choice following privatizations, emphasizing auditor size differences (e.g., Chan et al., 2007; Wang et al., 2008; Guedhami et al., 2009), there is little examination of what happens when previously state-administered audits are relocated to a market governed by competition and demand (Mennicken, 2010). We contribute to the public policy literature concerned with auditing by addressing this issue.

We complement and extend the existing literature by investigating the effects of significant government influence on incentives for auditor switching in an immature audit market in which auditor competition is increasing, alongside an emerging equity market. We focus on incentives arising from misalignments between type of auditor (government vs. private) and type of controlling shareholder (government vs. private), and between auditor and imputed preferences of managers. Hereafter, we refer to these two types of misalignment as "auditor–controlling shareholder misalignment" and "auditor–managerial misalignment". We do this in a market characterized by continued substantial government ownership in listed entities and rapid growth in the number of competing audit firms separated from government control. In particular, we examine whether government influence prevails over the switching incentives arising from auditor–controlling shareholder misalignment and auditor–managerial misalignment.

We examine auditor–controlling shareholder misalignment from a perspective that is different to the prevailing emphasis on "Big N" vs. "non-Big N" as the auditor choice, relative to client interests.[1] We consider whether auditor switches are driven by government control of listed corporations and audit firm ownership (i.e., government or private sector auditors). We examine auditor–managerial misalignment in more traditional terms by focusing on conditions that have the potential to create conflict between auditors and client management; these include changes in management, discretionary accrual preferences and audit qualifications.

Our study exploits a natural experiment concerning auditor switching that was generated by policy and regulatory changes in Iran. The policy changes involve: (1) the incremental partial privatization of government corporations; (2) removal of the government auditor's monopoly over the audit of

[1] Chan et al. (2007) find that a decrease in government shareholdings leads to an increased demand for higher-quality audits in China. In a comparison of auditor choice by privatized firms across 32 countries, Guedhami et al. (2009) reveal that privatized firms are less likely to appoint a Big Four auditor.