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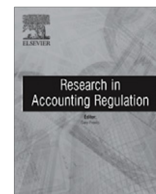

Determinants of auditor changes for non-accelerated filers ☆

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ABSTRACT

Significant accounting scandals and the imminent collapse of Arthur Andersen in 2001 precipitated a period of heightened regulatory response, most notably the enactment of the Sarbanes–Oxley Act of 2002. In the years that followed, the Securities and Exchange Commission created a separate class of non-accelerated filers (companies with public float of up to $75 million) and provided these companies with significant regulatory relief from certain financial reporting disclosure and auditing requirements, including the extension of scaled disclosure to these companies in 2007. Over the period of 2001 through 2007, as non-accelerated clients anticipated and responded to their different and evolving regulatory regime, audit firms were adjusting to the increased concentration in their market, a new monitoring structure, and significant changes to the scope of their work. We examine whether auditor–client misalignment is a significant determinant of auditor change during this period, particularly for non-accelerated filers, as large auditors sought to rebalance their client portfolios. We find evidence that auditor–client misalignment increases the likelihood of auditor change (resignation and dismissal) for non-accelerated, but not accelerated, filers. We also find that auditor–client misalignment increases the likelihood of downward changes to third-tier auditors for non-accelerated, but not accelerated, filers.

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Introduction

The audit literature on determinants of auditor changes has included the impact of certain regulatory and structural changes in the auditor industry (e.g., Choi, Doogar, & Ganguly, 2004; Hogan & Martin, 2009; Landsman, Nelson, & Roundtree, 2009; Shu, 2000). However, the events of the past decade have also created a rapidly changing regulatory environment that has divided the levels of corporate disclosures and audit requirements into two rather distinct groups of companies – accelerated filers and non-accelerated filers. The impact that a different regulatory regime has on non-accelerated filer auditor changes warrants examination. Non-accelerated filers are essentially companies that have a common equity public float of less than $75 million. The implementation of the Sarbanes–Oxley Act of 2002 (SOX) and other rulings by the Securities and Exchange Commission (SEC) have differentially applied higher standards (i.e., more timely and extensive) to "accelerated" filers, while keeping prior standards or allowing regulatory easing for "non-accelerated" filers.

We believe the emergence of this class of non-accelerated filer companies played an important role in the audit market and auditor changes during the period 2001 through 2007. The collapse of Arthur Andersen, along with increased regulations and auditing requirements, particularly for accelerated filers, caused a significant shift in the composition of large/small auditor client portfolios. By 2006, the remaining four largest audit firms (the Big 4) audited approximately 98% of the largest public companies,

☆ *Data availability:* Data are publicly available from the sources identified in this paper.

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while their audit share of smaller public companies fell from 44% to 22% during the period of 2002 to 2006.[2] During the period 2003–2006, the auditor turnover rate for companies with a market capitalization of less than $75 million was 63% (Grothe & Weirich, 2007).

As described in more detail in the next section, smaller companies, whom the SEC defined as non-accelerated filers, operate under increasingly different financial reporting regimes than do accelerated filers. Further, changes in the auditor market and the potential impact of SOX on non-accelerated filers prompted considerable discourse by regulators and capital market participants.[3] The ensuing recommendations highlighted continuing uncertainty around Section 404 requirements (management and auditor reports on effectiveness for internal controls over financial reporting) for non-accelerated filers and the potential for additional regulatory easing for smaller public companies. We believe that a series of events from 2001 through 2007, starting in late 2001 with the commencement of an SEC investigation of Arthur Andersen and the bankruptcy of Enron, created an environment in which both audit firms and their non-accelerated clients were considering changes that would best position their resources and needs with regard to regulatory changes affecting financial reporting and auditing. Therefore, in this study we examine the impact of auditor–client misalignment on auditor changes for non-accelerated filers from 2001 through 2007.

We posit that auditor–client misalignment has a significant influence on auditor changes for non-accelerated filers for both auditor resignations and client dismissals. We estimate a multinomial logistic regression model allowing us to examine the influence of auditor–client misalignment on auditor resignations and client initiated changes (dismissals) for both groups of companies (non-accelerated and accelerated filers) using a reference group of companies that did not change auditors. We examine the pooled time series of 2001 through 2007 in which significant changes affecting non-accelerated filers and their auditors occurred. Consistent with our hypotheses, and controlling for other documented determinants of auditor change, we find that auditor–client misalignment is a significant determinant for non-accelerated filers for both resignations and dismissals. We find a different relation for accelerated filers. Auditor–client misalignment is insignificantly related to auditor resignation from accelerated filers and negatively related to accelerated filers dismissing their auditors.

We also examine the choice of successor auditor, and posit that auditor–client misalignment has a significant influence on non-accelerated filer downward (but not lateral/upward) change outcomes. We estimate a multinomial logistic regression to examine the influence of auditor–client misalignment on downward and lateral/upward auditor changes for both groups of companies compared to the reference group of companies that did not change auditors. We define downward changes as a company with a large predecessor auditor changing to a third-tier auditor. We define lateral/upward changes as all other changes.[4] Our empirical implementation of downward changes follows recent studies examining differences in quality, if any, between Big 4 and second-tier audit firms (e.g., Boone, Khurana, & Raman, 2010; Cassell, Giroux, Myers, & Omer, 2011; Jenkins & Velury, 2011). Considering the same control variables as in the case of resignation or client dismissal, we find that auditor–client misalignment is positively related to the likelihood of downward changes and insignificantly related to all other types of changes by non-accelerated filers (lateral/upward). This result is consistent with our hypothesis. We find a different relation for the types of changes by accelerated filers in that auditor–client misalignment is insignificantly related to the likelihood of downward changes and negatively related to the likelihood of all other types of changes. We conduct sensitivity analyses to determine the robustness of our primary results. First, we substitute alternative measures for discretionary accruals and auditor tenure in our models. Second, we add a control variable for a sub-set of our sample years (2003–2007) to proxy for audit risk that we define as ineffective disclosure controls under Section 302 of SOX. Finally, we implement two alternative measures of "large" auditor based upon a related body of literature on auditor quality.[5]

We contribute to the literature in several ways. First, we focus on auditor changes by non-accelerated filers during a time period in which regulatory changes occurred that increasingly differentiated their auditing, reporting, and disclosure requirements from those of accelerated filers. The body of research that examines auditor changes in the context of regulatory and structural changes in the market for auditor services (e.g., Choi et al., 2004; Hogan & Martin., 2009; Landsman et al., 2009; Shu, 2000) uses pooled samples across both categories of accelerated and non-accelerated clients, and focuses primarily on Big 4 and non-Big 4 auditors (or omits non-Big 4 entirely). Their findings may reflect the inclusion of "smaller" companies in their samples, but do not permit inferences about this distinct class of companies or this aspect of regulatory

[2] GAO-08-163 Audits of Public Companies Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action, January 2008. This report defines the largest public companies as those with revenues exceeding $1 billion and smaller public companies as those with revenues under $100 million.

[3] GAO-06-361 SARBANES-OXLEY ACT, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, April 2006; Final Report of the Advisory Committee on Smaller Public Companies To the United States Securities and Exchange Commission, April 2006; COSO Internal Control over Financial Reporting—Guidance for Smaller Public Companies (2006).

[4] We define large auditors to include Big 4 audit firms (Deloitte Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers) and second-tier audit firms (Grant Thornton, BDO Seidman, McGladrey & Pullen, Crowe Chizek). Our definition of second-tier auditors follows that of the Government Accountability Office (2008) and some prior research studies (e.g., Hogan and Martin, 2009; Carver et al., 2011; Cullinan, Du, & Zheng, 2012). Third-tier auditors include all other audit firms.

[5] In our sensitivity analysis, we implement two alternative definitions of large auditors. First, we follow Landsman et al. (2009) and define large auditors as only Big 4 auditors. In this case, downward changes consist of change from Big 4 to second-tier auditors and Big 4 to third-tier auditors. Second, we define large auditors as Big 4 auditors and two other audit firms, Grant Thornton and BDO Seidman. As in the case of our primary analysis, downward changes consist of Big 4 and second-tier (now Grant Thornton and BDO Seidman) to third-tier. Third-tier auditors include all other audit firms.

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