



Voluntary disclosure of reasons for auditor changes and the capital market reaction to information disclosure [☆]

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ABSTRACT

This study examines the association between firm attributes and management's voluntary disclosure of the reason(s) for auditor changes and evaluates the capital market reaction to information disclosure of the auditor change events accompanied by preexisting red flag and non-red flag issues. We find that managers are more likely to disclose the reason(s) for auditor changes when those changes occurred because of benign business reasons or if the reasons do not indicate the presence of any underlying operating or financial reporting problem. On the other hand, managers are less likely to disclose the reason(s) for auditor changes when those changes are preceded by red-flag situations. Furthermore, auditor changes accompanied by preexisting red-flag situations are viewed negatively by the capital market, implying that the full disclosure of reasons for auditor changes is informative to investors. This observation is supported further by our market-based analyses, which consistently show that auditor changes accompanied by prevailing red flag issues are valued incrementally in the market above and beyond the reportable events (under FRR No. 31) and auditor-initiated changes. The study contributes to the recent policy debate related to mandating the disclosure of the reason(s) for auditor switches. Specifically, the results support the recent debates that the current voluntary disclosure regime results in selective disclosure practices that are likely to contribute to the general lack of transparency with respect to auditor changes.

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1. Introduction

Under the current Securities and Exchange Commission (SEC) form 8-K disclosure rules relating to auditor changes,

firms are required to file Form 8-K notifying investors of a change in the firm's external auditor. While the SEC encourages firms to disclose the reason(s) for all auditor changes, companies are not mandated to disclose the reasons for changing their auditors.³ Companies are required only to

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³ Form 8-K is required to be filed by SEC registrants if certain significant events occur, including auditor changes. In (SEC, 1977), the SEC issued Release No. 34-13989 to amend form 8-K filing requirements to mandate that registrants be required to disclose the reason(s) for auditor changes. However, after due deliberation, the SEC decided not to incorporate the proposed amendment when the final rules were issued in Securities Exchange Act Release No. 34-14808 (SEC, 1978). As a result, the decision as to whether or not to disclose the reason(s) for an auditor change continued to be in the hands of management.

disclose the reason(s) for an auditor change in limited circumstances where such a change is associated with auditor–client disagreements over certain reportable issues.⁴ This reporting flexibility has led to inconsistencies among firms in their disclosure practices relating to auditor switches, and in the absence of an SEC mandate, an overwhelmingly large proportion of companies that switched auditors chose not to disclose the reason(s) for the changes.⁵ Only a small fraction of companies (hereinafter, disclosing firms) voluntarily disclosed the reasons for their auditor changes.

Investor advocacy groups have long expressed dissatisfaction with the current rules relating to firms' disclosure of the reason(s) for auditor changes. For example, in its most recently adopted “best practices” policies for corporate governance and disclosure, the Council of Institutional Investors (CII), an investor advocacy group, includes the following recommendation (12g) relating to the disclosures they recommend that firms provide in the case of auditor changes:

The audit committee should publicly provide to shareholders a plain-English explanation of the reasons for a change in the company's external auditors. At a minimum, this disclosure should be contained in the same Securities and Exchange Commission (SEC) filing that companies are required to submit within four days of an auditor change. (Recommendation No. 12g; CII, 2007, p. 6)

Accounting firms have also expressed dissatisfaction with the current regulations relating to firms' disclosures of the reason(s) for auditor changes. For example, in a March 2006 press release, Grant Thornton urged the SEC to revise its form 8-K disclosure rules requiring firms to specifically disclose the reason(s) for auditor changes in their 8-K filings. In its press release, Grant Thornton argued that mandating such disclosures would serve to improve transparency surrounding the event of auditor changes for outside stakeholders (Grant Thornton, 2006).

The U.S. Treasury Department's *Advisory Committee on Auditing Profession* has recently added fresh impetus to this disclosure policy debate. Among its many recommendations, the Treasury Department's *Advisory Committee on*

Auditing Profession recommended that the SEC amend its disclosure of auditor change requirements to mandate that all firms be required to disclose the reason(s) for all auditor changes (see Treasury Department, 2008). In response to this recommendation, in a *Petition for Rulemaking*, the CII has twice written to the SEC (CII, 2008a, 2008b) urging the Commission to “pursue rule-making that require public companies to . . . provide shareowners with a plain-English descriptive narrative of the reasons for a change in external auditors *in all cases of such a change* [emphasis added]” (CII, 2008a, p. 1). In its letters to the SEC, the CII expresses the view that the current voluntary disclosure regime fails to provide investors with adequate information associated with auditor changes. In particular, the CII observed that there are potentially worrisome reasons for auditor changes but, because of the lack of disclosure, investors find it challenging to identify such auditor changes. To date, the SEC has not proposed new rules to enact this recommendation of the Treasury Department's report.

As evident from their comments, the CII believes that the current selective disclosure practice in this setting contributes to the lack of transparency with respect to firms' auditor changes. This could arise, in part, if firms are selective in making their disclosures, i.e., the firms make these disclosures only when it is convenient for them to do so. In this study, we evaluate this presumption and examine the relationship between various firm characteristics indicating the presence of red-flag and non red-flag situations and the firm's voluntary disclosure of reasons for their auditor changes. Specifically, in the first stage, we investigate if the switching firm's attributes that indicate serious underlying issues accompanying auditor changes (i.e., so called “red-flag” issues), are associated with a decreased likelihood that management voluntarily discloses the reason(s) for auditor changes. In the second stage, we examine stock market reaction to auditor change events when they are associated with pre-existing red flag or non-red flag issues. These analyses may potentially provide new insights to the current policy debate as to whether the SEC should expand its current form 8-K disclosure requirements with the additional mandate that firms report the reason(s) for all auditor changes. The study thus adds to the growing disclosure literature that examines the relationship between firm characteristics and voluntary disclosure decisions, and how the capital market participants factor the information in pricing stock in absence of inadequate disclosures.

The disclosure of reasons for auditor changes is not mandated by the SEC except for its enacted Financial Reporting Release No. 31 of 1988 (FRR 31), which requires that certain reportable events about internal control quality and financial statement reliability issues be disclosed in the 8-K filings relating to auditor changes.

Three types of information are to be furnished to the 8-K filings with the SEC:

- 1) Initiating party to auditor change;
- 2) Auditor–client disagreement; and
- 3) Reportable events concerning internal control weakness and financial reporting quality issues.

⁴ In 1988, the SEC enacted Financial Reporting Release (FRR) No. 31, in which certain reportable events about internal control and financial statement reliability issues became mandatory disclosures to be included in 8-K filings relating to auditor changes. In terms of FRR No. 31, the reportable events are as follows: the internal controls necessary for the registrant to develop reliable financial statements do not exist; information has been obtained that suggests that the auditor can no longer rely on management's representations or has made the auditor unwilling to be associated with the financial statements prepared by management; information that potentially impacts the reliability of financial statements requires an expansion of audit scope; information materially impacts the fairness and reliability of prior or current financial statements. The SEC (1988) notes that reportable events and auditor–client disagreement that are mandated to be disclosed in the 8-K filings for auditor changes are “similar in that each involves situations where the position of management may be considered to be generally at odds with that of the auditor.”

⁵ During the period 2003–2006, almost 65-percent of the firms that changed auditors did not disclose the reason(s) for their auditor switches (e.g., Grothe & Weirich, 2007; Turner, Williams, & Weirich, 2005).

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