

Shedding New Light on Auditor Switching

*This article is based on a study supported by the
IMA® Foundation for Applied Research (FAR).*

By Joseph F. Brazel and Marianne Bradford, CPA

The demise of Arthur Andersen and the subsequent passage of the Sarbanes-Oxley Act of 2002 (SOX) had the inevitable result of prompting a large number of public and private companies to find new auditors. Some, of course, had no choice: They were clients of Arthur Andersen. Others decided they no longer needed the capabilities of a large firm, were dissatisfied with their auditor's service, or felt that the firm's fees were too high.

Not to be outdone, a good number of auditors decided to dump their clients, deeming them too risky, difficult to service, or not capable of meeting SOX Section 404 and Securities & Exchange Commission (SEC) accelerated filing deadlines. An auditor “resignation” can be especially problematic for a company that had depended on the firm’s grasp of its business, accounting issues, controls, and systems. It can take years for the new auditor to gain a full understanding of the company.

Despite the possible effects of these upheavals, the post-SOX trend has continued. One aspect that has received substantial attention is the high number of switches from Big 4 firms to non-Big 4 firms. For example, a 2008 study from researchers at Lehigh University and Virginia Commonwealth University reported that Big 4 public accounting firms had a net loss of 400 public clients in 2004 compared to 201 in 2003. Meanwhile, non-Big 4 firms had a net *gain* of 117 public clients in 2004, 87 more than in 2003. The study also noted that, on average, the Big 4 shed or lost larger clients. Audit fees rose substantially during this period, and the number of companies that switched auditors because of costs doubled.

Many experts have said that, in addition to fee increases, SOX has harmed the client-auditor relationship. Consider the scenario in which a manager wants to discuss an accounting issue with his or her auditor. Post-SOX, the manager must now be concerned that such a request may signal a lack of accounting competence or training within the company, giving the auditor a reason to become uneasy and drop the company as a client. From the auditor’s perspective, he or she must be careful not to provide consultation that may violate SOX Section 201. Moreover, the extra audit work required for compliance with SOX has stretched accounting teams at many audit firms very thin. Companies are responding by switching auditors to obtain more attention or higher quality of service.

What We Know about Auditor Switches

In the pre-SOX era, companies sometimes switched auditors to gain a fresh opinion on their financial statements. A 2002 study estimated that “opinion shopping” was behind 17% of auditor switches in the late 1990s, with most of these tending to occur later in the fiscal year. But companies also switched auditing firms at that time to evade anticipated bad news in the form of going-concern opinions.

Interestingly, another study of pre-SOX switches found that after companies changed auditors, their financial

Prior to December 2003, both switchers and nonswitchers were equally likely to have a Big 4 auditor. That’s no longer the case.

statements exhibited higher levels of earnings management. As you might expect, the very fact that a public company sought a new auditing partner sometimes had a significant, negative effect on its stock price because the change was interpreted as a sign of trouble. After the demise of Arthur Andersen, however, many former Andersen clients that were more visible in the capital markets switched auditors sooner (mostly to Big 4 firms) and experienced a more positive market reaction as a result. A 2007 study found that, after the collapse of Enron, higher-quality audit committees more quickly dismissed Andersen and chose a Big 4 firm as a successor. Not surprisingly, many ex-Andersen clients released more conservative financial statements after they switched to a new firm. (For more on this subject, see “Did Earnings Conservatism Increase for Former Andersen Clients?” in the Spring 2007 issue of the *Journal of Accounting, Auditing, and Finance*.)

There have been a few studies of recent auditor switches, but not many. One study found that non-Big 4 auditors have become more conservative and are more prone to constrain earnings management than in the past. Researchers have also concluded that more effective audit committees are more likely to recommend hiring new auditors if the present firm has received a deficient inspection report from the Public Company Accounting Oversight Board (PCAOB).

What Our Survey Revealed

Because of the dearth of research studying current perceptions of post-SOX/Andersen switches from the *client's* perspective, we set out to shed new light on this issue by asking the following questions:

- ◆ How are companies that experienced a voluntary, post-SOX/Andersen switch different from those that didn't?
- ◆ From the companies' perspective, is there a common explanation for these switches?
- ◆ Are companies that switched auditors happier with their current auditor?
- ◆ Are companies that switched auditors as happy as companies that have stuck with the same auditor since the passage of SOX?

We surveyed 175 IMA® members by requesting data describing their company's auditor relationship(s) post-SOX/Andersen. If respondents were unable to provide us with this data, they could opt out of the survey at any time. None did. Respondents represented both publicly traded and privately held companies. Of the 175 respondents, 51 reported an auditor switch sometime after December 31, 2003. A switch after this date would be both post-SOX and voluntary (in other words, not mandatory because of Andersen's demise in 2002). We

included the 124 respondents who reported no auditor switch to compare the current levels of satisfaction among switchers to those of companies that stayed put throughout the post-SOX era. Information about our

Table 1: Survey Respondents' Job Titles and Experience

JOB TITLE	NUMBER OF RESPONDENTS
Chief Financial Officer	19
Vice President	13
Controller	6
Assistant Controller	34
Manager/Supervisor of Accounting	11
Director of Accounting	29
Internal Audit	10
Accounting Staff/General Accounting	25
Chief Information Officer	23
Other	5
Total Number of Participants	175

Table 2: Demographic Data for Surveyed Companies

RESPONSES	SWITCHERS (AVERAGE)	NONSWITCHERS (AVERAGE)	DIFFERENCE STATISTICALLY SIGNIFICANT?
Percentage of public firms	37%	46%	No
Percentage in manufacturing	27%	39%	No
Scope of operations ¹	2.76	3.01	No
Effectiveness of internal controls (pre-SOX) ²	6.03	6.50	No
Years in business ³	3.35	4.32	Yes
Revenue (in millions)	\$725	\$4,602	Yes
Number of employees ⁴	3.80	5.02	Yes
Number of internal auditors ⁵	2.09	2.57	Yes
Percentage with Big 4 auditor pre-12/31/03	67%	63%	No
Percentage currently with Big 4 auditor	40%	63%	Yes
Percentage who are a busy-season client	69%	53%	Yes

¹ Responses were measured on a scale where: 1 = based in one state, 2 = regional, 3 = national, 4 = international.

² Responses were measured on a scale where: 1 = ineffective, 9 = extremely effective.

³ Responses were measured on a scale where: 1 = 0-10 years, 2 = 11-20 years, 3 = 21-30 years, 4 = 31-40 years, 5 = >40 years.

⁴ Responses were measured on a scale where: 1 = <100; 2 = 101-250; 3 = 251-500; 4 = 501-1,000; 5 = 1,001-2,500; 6 = 2,501-5,000; 7 = 5,001-10,000; 8 = >10,000.

⁵ Responses were measured on a scale where: 1 = 0, 2 = 1-5, 3 = 6-10, 4 = 11-15, 5 = >15.

survey respondents' job titles is presented in Table 1. As you can see, we obtained insights from IMA members who held mostly senior positions at their companies and typically had between 16 and 20 years of accounting and/or finance-related experience.

We analyzed the data and found that switchers and nonswitchers are just as likely to be publicly traded, in the manufacturing industry (no other industry was represented as substantially as manufacturing, although this could be because of the makeup of IMA membership), and have widespread operations (see Table 2). Also, you would expect that switchers had less effective internal controls pre-SOX either because an auditor resigned as a result of frustration over lax controls or because the company sought a firm that would accept a lower threshold for effectiveness. Whichever was the case, the switchers in our sample didn't report a significantly lower level of pre-SOX diligence.

What differs between switchers and nonswitchers? Companies that jumped ship appear to be younger and

Table 3: Reasons for Auditor Switch

RESPONSES	NUMBER
Audit fees were too high	16
Not satisfied with service	15
Auditor resigned	8
Merger or acquisition	5
Company grew and needed a larger audit firm	5
Internal control disagreement	1
Financial accounting disagreement	0
Other	7
Total	57*

*Number exceeds the sample size of switchers (51) because some respondents provided more than one reason for their switch.

Table 4: Are Switchers Happy?

RESPONSE ¹	SWITCHERS			NONSWITCHERS	
	PRIOR AUDITOR	CURRENT AUDITOR	CHANGE STATISTICALLY SIGNIFICANT?	CURRENT AUDITOR	CURRENTLY DIFFERENT FROM SWITCHERS?
Mutual cooperation	5.38	6.50	Yes	6.52	No
Positive financial statement negotiations	5.67	6.60	Yes	6.44	No
Positive internal control negotiations	5.44	6.15	Yes	6.22	No
Quality of informal consultation	5.35	6.53	Yes	6.18	No
Satisfaction with level of service	4.85	6.29	Yes	6.40	No

CURRENT INTERNAL CONTROL COSTS ²	SWITCHERS	NONSWITCHERS	DIFFERENCE STATISTICALLY SIGNIFICANT?
Total internal control costs as a percentage of revenue	0.92%	1.12%	No
Accounting staff	5.31	5.09	No
Internal audit staff	3.31	3.39	No
External consultants	4.64	4.56	No
New information systems	4.29	3.94	No
Reconfiguration of existing systems	4.29	3.84	No
Documentation of internal controls	4.52	4.53	No
Testing of internal controls	4.48	4.77	No
Maintaining internal controls	4.79	4.94	No

¹ Responses were measured on a scale where: 1 = very low, 9 = very high.

² Responses were measured on a scale where: 1 = none, 10 = very high.

smaller (in terms of sales and number of employees/internal auditors) than companies that didn't switch. (Again, these breakups travel a two-way street: Auditors may be abandoning younger and smaller companies because they perceive them as riskier.) Prior to December 2003, both switchers and nonswitchers were equally likely to have a Big 4 auditor. That's no longer the case. Companies now tend to switch to a non-Big 4 auditor. As Table 2 shows, only 40% stuck with one of the Big 4 after December 2003, as opposed to 67% before. The reasons that companies gave for seeking out a smaller audit firm included "switched back to a local firm" and "we're too small; not enough fees for them." Another respondent commented, "Big 4 firm was too busy w/SOX clients; we were no longer a priority."

Switchers were also more likely to have a December fiscal year-end, which represents the busy season for audit firms. With their audit teams stressed to opine on both financial statements and internal controls for SOX-bound public clients, audit firms may have had to shed some busy-season clients in order to serve their remaining ones effectively.

Searching for a Common Thread

Our survey found that the most common reasons why survey respondents switched auditors after December 2003 were that the company wasn't satisfied with the audit firm's level of service and that audit fees were deemed too high. (See Table 3 for additional reasons.) The first reason appears clear-cut. The latter could be because of the company shopping for a lower fee or the auditor politely backing out of a risky engagement by citing a fee that was much higher than what the company was willing to pay. Our data doesn't show much evidence of explicit auditor resignations, as only eight companies cited this reason. Oddly enough, only one switch was attributed to a disagreement over financial accounting or internal control matters. Thus, there appears to be very little opinion shopping (if any) occurring post-SOX.

Are Switchers Satisfied with Their Current Auditor?

We asked switchers if they feel better about their current auditor than their previous one on a number of factors. Next, to provide some perspective to the data, we compared the current perceptions of switchers to companies that didn't hire new auditors after the passage of SOX. Then we determined whether companies that switched auditors post-SOX were able to elude costly internal control expenditures. We focused on internal control costs because even private

companies began expanding these activities post-SOX.

On many factors (for instance, mutual cooperation and satisfaction with service), switchers are more pleased with their new auditor than they were with their former one, as shown in Table 4. Regardless of who initiated the switch, it seems that companies are currently better off overall since they changed auditors. But are switchers as happy as companies that have engaged the same auditor for the entire post-SOX era (the nonswitchers)? Our evidence suggests that they are. Nevertheless, while switchers are as happy as nonswitchers, they also appear to be experiencing the same internal control costs as a percentage of revenue. In short, despite whatever expectations they may have had, these companies didn't save any money by switching auditors.

Where Does Your Company Fit In?

In this article, we've briefly summarized research related to auditor switches and have attempted to shed new light on the topic through a recent survey of IMA members. We specifically sought to examine voluntary, post-SOX/Andersen switches and to obtain perceptions about these decisions from the company's perspective.

Our survey results provide a number of interesting findings: First, we found that companies that switched firms tended to be younger, smaller, and more likely to be a busy-season audit than nonswitchers. Moreover, many of the switches in our sample were a move from a Big 4 firm to a non-Big 4 firm. Second, the two primary reasons for post-SOX switches were a lack of client service from the auditor and high audit fees. Third, even though they might not have reduced their costs, companies that switched auditors seem to be more pleased with their new firm, and their current satisfaction levels are equivalent to those of nonswitchers. **SF**

The authors want to thank IMA for providing a grant that helped to fund their research.

Joseph F. Brazel, Ph.D., is an associate professor of accounting at North Carolina State University's College of Management in Raleigh, N.C. You can reach Joe at (919) 513-1772 or joe_brazel@ncsu.edu.

Marianne Bradford, Ph.D., CPA, is an associate professor of accounting at North Carolina State University and is a member of IMA's North Carolina Triangle Area Chapter. You can reach Marianne at (919) 513-1436 or marianne_bradford@ncsu.edu.