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The Determinant Factors of Auditor Switch among Companies Listed on Tehran Stock Exchange

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Abstract

Regarding to the impact of auditor switching on auditor's independence, this issue become an important subject and widely studied in developed countries recently. In spite of the growing concerns of this issue, few studies have been done in Iran to investigate which factors influenced auditor switch. The aim of this research is to find major determinants of auditor switch among companies listed on Tehran stock exchange. In order to verify the determinants of auditor switch, logistic regression model is used in this study. The Sample consists of 182 companies that listed on Tehran Stock Exchange (TSE). From these 182 companies, 91 companies had auditor switch during 2003 till 2007 and 91 companies without auditor switch. The results indicate that between 6 factors that are analyzed in this research only auditor size is significantly related to auditor switch among companies listed on Tehran Stock Exchange. Furthermore, consistent with previous studies, this study showed that there is no significant relationship between receiving qualified audit opinion and auditor switch. Thus, this result suggests that opinion shopping is not a concern in TSE.

Keywords: Auditor Switch, Logistic Regression, Tehran Stock Exchange, Determinant Factors.

1. Introduction

Reliable financial reports provide required information for managers, investors, creditors and government. The financial reports comprising balance sheet, income statement, cash flow statement and notes to the financial statements (Bagherpour, Monroe and Greg, 2010). Financial statement users rely on this information only after the external auditor, who is independent, confirms the reliability of this information. Firms employ reputable auditors to assure outside investors the credibility of financial disclosures and hence mitigate the agency problems (Anderson, Kadous and Koonce, 2004). Thus auditors serve a corporate governance role in monitoring a firm's financial reporting process (Ashbaugh and Warfield, 2003). Independent audit reduces agency costs by verifying the truthfulness and completeness of the financial statements, thereby allowing more precise and efficient contracts to be based on the financial statements (Cohen, Kbrishnamoorhy and Wright, 2002). Auditors play a vital role in reducing information risk, which is the prime economic reason behind the demand for audit and auditing services. In performing their duty, auditors were said to face a substantial role conflict because they tried to maintain the professional norms and at the same time have to consider the managers wishes (chi, 1999). Therefore, if the auditors appear to have different opinion with the manager, it will lead to conflict of interest between them. As the result, the manager will decide to expunge the incumbent auditors and replaced it with a new one. Decision to switch auditors by client firm was due to the principle-agent problem in separation of ownership and control of a firm (Jensen and Meckling, 1972) and the separation of risk bearing, decision-making and control function in firms (Fama and Jensen, 1983).

Auditor switch decision involves change of incumbent auditor resulting in the choice of quality differentiated audit firms to realign the characteristics of the audit firm, with the growing need of clients under changing circumstances (Huson Joher, Shamsher and Annuar, 2000). Client may incur both direct and indirect costs when they decide to change auditors so question arise in the reasons behind auditor change when there are direct and indirect costs with it. Different factors may have impact on auditor switch such as disagreement about content of financial reports (Addams and Davis, 1994), disagreement about auditor opinion (Haskins and Williams, 1990), change of management (Beattie and Fearnley, 1995) and auditor fees (Addams and Davis, 1994). These factors may cause auditor switch and they may reduce the auditor's independence as well. Thus, the objective of this study is to find major determinants of auditor switch among companies listed on Tehran Stock Exchange. These factors were divided in two groups: 1) Factors related to auditors: Auditor fees, auditor opinion, audit quality and 2) Factors related to client: Client size, changing management, financial distress. The research question posed in this study concerns whether auditor related factors and client related factors influence auditor switch for companies in Iran.

The rising concern for auditor switch and auditor independence and the absence of relevant studies in Iran in this issue motivate us to do this research. To address the research question, logistic regression (maximum likelihood) method is used in this research. One major contribution of this research is the new categories of auditor switch factors that are more definable and relevant to the framework compared to the previous studies which delineates auditor related factors from client related factors that influence auditor switch among companies listed on Tehran Stock Exchange.

The rest of this paper is organized as follows: section 2 reviews theoretical framework and relevant prior studies while section 3 describes the methodology and section 4 reports on the result and conclusion.

2. Literature Review

2.1. Theory and Framework

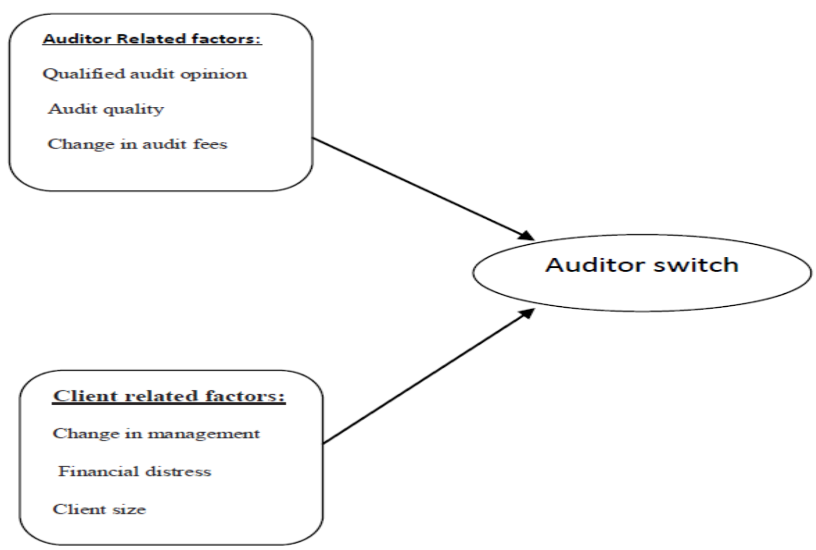
In addition to the legal requirement for listed companies to have their financial reports audited, there are also theoretical sources that generate demand for different levels of audit quality (Bagherpour, Monroe and Greg, 2010). The potential incentives include agency conflicts in the companies (Jensen and Meckling, 1976; Chow, 1982) or signaling quality by adding credibility to the financial statements (Jensen and Meckling, 1976). Auditing can reduce agency risks created by conflict of interests between managers and shareholders (Watts and Zimmerman, 1983); small and large shareholders (Fan and Wong, 2005); and shareholders and debt holders (Watts and Zimmerman, 1986). Jensen and Meckling (1976) suggest that auditing is one monitoring device that can mitigate agency costs, implying a need for an independent audit services. It is implied that auditors specialize in supplying various level of audit quality and audit firm size is an effective surrogate for audit quality. Firms change their auditors to ensure a desired quality of audit service. Decision to switch auditors by client firm was due to the principle-agent problem in separation of ownership and control of a firm (Jencen and Meckling, 1972) and the separation of risk bearing, decision-making and control function in firms (Fama and Jensen, 1983).

Most of past academic research focused on signaling theory or the information role of auditor choice to explain why a client switches auditors. Signaling theory states that clients switch auditors when they want to convey or signal to the public the quality or reliability of their financial statements and they do this through the type of auditor they engage (Bagherpour, Monroe and Greg, 2010). Both analytical and archival studies (Balvers, 1988; Willenborg, 1999) support the information or signaling role of auditor choice.

The privatization policy and the rapid increase in competition in the audit, managerial labor and capital markets increased agency costs and signaling incentives for Iranian listed companies, which can be linked to incentives for auditor switching. In an emerging securities market such as the TSE, the role of auditors as a means of reducing conflicts of interest in financial reporting decisions is potentially more important than in the case of developed markets. Consequently, investigating the factors that affect auditor change, which can impair auditor independence and ultimately audit quality, becomes very important.

Prior researches have shown that companies switch auditors due to factors such as change in management, audit quality, qualified audit opinion, change in audit fee and others (Ismail and Aliahmed, 2008). In this research, these factors were categorized in two groups: 1) auditor factors and 2) client factors. Qualified audit opinion, audit quality and change in auditor fees were considered as factors that related to auditor and change in management, financial distress and client's size as factors that related to the firm. So the theoretical framework of auditor switch for this study is shown in figure 1.

Figure 1: Research Model



2.2. Prior Researches

Some prior studies examine the association of one factor with auditor switch. Takiyah and Ghazali (1993) verified the association between qualified audit opinion and auditor switch but they do not find significant relationship between qualified report and auditor switch. In another research, Lennox (1999) examines the relationship between bankruptcy and auditor switch and the result shows that a switch is a weak signal of financial distress. Ismail and Aliahmed (2008) found that leverage, growth turnover, financing activities, longevity of audit engagement and audit fee are the significant determinants of auditor switch in Malaysian second board companies. They use William (1988) framework for audit switch that used 3 categories namely change in client contracting environment, client firm reputation and auditor effectiveness. Lin and liu (2010) examine other determinants of auditor switch by examining the association between firm's internal corporate governance mechanisms and auditor switch decision in China. Their study suggests that firms with weak internal corporate governance mechanism tend to switch to smaller or more pliable auditors. Bagherpour, Monreo and Shailer (2010) investigate how increased auditor competition and changes in corporate objectives and potential management agency costs affects auditor switching in Iran. However, they do not consider many important factors that were proven to have an effect on auditor switch like audit quality, change in management and audit fee. This warrants for this study that investigates these relevant factors into consideration.

3. Hypothesis Development

Auditor switch decision involves change of incumbent auditor resulting in the choice of quality differentiated audit firms to realign the characteristics of the audit firm, with the growing need of clients under changing circumstances (Lin and liu, 2010). The two most prevalent reasons for an auditor change include perception that fees are too high and a lack of satisfaction with the services provided by the predecessor auditor (Bedingfield and Loeb, 1974). Firms switch auditors more frequently after receiving qualified opinion and subsequently do not receive any unqualified opinion (Chow and Rice, 1982). Failing firms have a great tendency to switch auditors than healthier firms (Schwartz and Menon, 1985). To address the research question, this study tests the relationship between auditor factors and client factors with auditor switch. In other words, the study seeks to determine whether these factors have impact on auditor switch among companies listed in Tehran Stock Exchange.

3.1. Change in Management

According to past studies, management influences auditor choice decision and have a motivation of switching auditor in order to pursue their own self interests (Williams, 1988). With changes in corporate managers and directors, new managers may prefer to switch auditors because they have a preferred working relationship with a particular auditor (Williams, 1988) they have a personal relationship with a particular auditor (Beattie and Fearnley, 1998) or they seek an auditor who is more accommodating with respect to their choice and application of accounting policies (Schwartz and Menon, 1985). The results of prior studies of the association between management changes and auditor switches are inconsistent. Some studies (Chow and Rice, 1982; Schwartz and Menon, 1985; Williams, 1988a) do not find any significant association, while others (Burton and Roberts, 1967, Carpenter and Strawser, 1971, Hudaib and Cooke, 2005) indicate that change in management is one of the main reasons for auditor switch. It is argued that change in management should be positively related to auditor switch. So the first hypothesis is:

H1: There is a positive relationship between change in management and auditor switch.

3.2. Qualified Audit Opinion

One very common reason cited for auditor switching is the qualification of auditor opinions. Prior research found that clients receiving an unclean audit report were likely to switch auditors (Chow and Rice, 1982; Geiger et al., 1998; Vanstraelen, 2003), perhaps because the management or the controlling shareholders believed that once an incumbent auditor was dismissed, the firm could find a more pliable auditor whose opinion would be more in line with the management's views (Chow and Rice, 1982; Vanstraelen, 2003). It is expected this variable positively related to switching of auditors.

Some prior studies report an increased likelihood of auditor changes following a qualified audit opinion (Chow and Rice, 1982; Teoh, 1992; Lennox, 2000; Hudaib and Cooke, 2005). Others report a negative association (Woo and Koh, 2001) or no association (Schwartz and Menon, 1985; Haskins and Williams, 1990). Therefore, following the arguments the second hypothesis is:

H2: There is a positive relationship between qualified audit opinion and auditor switch.

3.3. Client Size

Client size is another important explanatory variable because of the auditors' self-interest threat. Beatty (1993) reports that audit efforts and fees are found to increase with the size and complexity of the clients (Copley & Douthett, 2002). Willenborg (1999) suggest that large firms will be forced to hire or switch to large auditing firms as large firms were usually more complicated in operation and therefore, needed to hire auditors with more expertise which is associated with large audit firms. It has been argued that larger auditees, due to the complexity of their operations and the increased gap in the separation between management and ownership, demand highly independent audit firm to reduce agency costs (Watts and Zimmerman, 1986) and auditors' self-interest threat (Hudaib and Cooke, 2005). Furthermore, as the size of the companies increases, it is likely that the number of agency conflicts also increases and this might increase the demand for quality-differentiated auditors (Palmrose, 1984). Following Friedlan (1994) and Lennox (1999), the log of total assets is used to represent the size of the firms. Several studies have found that smaller companies are more likely to receive qualified audit opinions than larger auditees and subsequently change auditor (Gul et al., 1992; Krishnan et al., 1996). Following this argument, the third hypothesis is:

H3: There is a negative relationship between client size and auditor switch.

3.4. Audit Quality

Selecting an audit firm that suits the company's or managers' needs may be a function of many factors but audit quality is known to be an important determinant of auditor choice in developed markets (Dopuch and Simunic, 1982). There is substantial evidence internationally that large companies are more likely to be audited by the large audit firms. Auditing large clients requires more resources (human and technical), which are usually provided by large audit firms (Dopuch and Simunic, 1982). Large audit firms are generally perceived as the provider of high audit quality and enjoy a high reputation in the business environment (DeAngelo, 1981). In Iran two groups of audit firms exist: one group comprises auditors authorized by Tehran Stock Exchange which are perceived as higher quality auditors and the second group comprises auditors who are not authorized by Tehran Stock Exchange, hence purported as lower quality auditors. Audit quality is a binary variable which takes the value of 1 if auditor is from first group and 0 otherwise. Therefore, the fourth hypothesis is:

H4: There is a negative relationship between audit quality and auditor switch.

3.5. Financial Distress

The financial position of client has important implications on decisions in retaining the audit firm. Clients who are insolvent and experiencing unhealthy financial position are more likely to engage auditors having high independence to boost the confidence of shareholders and creditors as well as to reduce the risk of litigation (Francis and Wilson, 1988). In addition, financially stressed clients are more likely to replace their audit firms compared to their healthier counterparts due to the reason that these types of companies need to hire a higher quality of auditor compared to the previous one

(Schwartz and Menon, 1985; Hudaib and Cooke, 2005). In Iran financial distressed firms are those firms that are subjected to Business Law par. 141[1]. Therefore, the fifth hypothesis is:

H5: There is a positive relationship between financial distress and auditor switch.

3.6. Audit Fees

Reduction in audit fee has been identified by prior literature as a primary reason for auditor switching. Eichenseher and Shields (1983) find that audit fees and good working relationships are the two most important determinants affecting auditor selection decision. When managers are not comfortable with audit fees they try to switch auditors in an effort to find a better offer. Accordingly, positive relationship between auditor switch and change in audit fees is expected. Thus the last hypothesis is:

H6: There is a positive relationship between change in audit fees and auditor switch.

4. Research Methodology

4.1. Sampling

In this study secondary data is used to investigate the relationship between independent and dependent variables. The sample consists of 182 companies that listed in Tehran Stock Exchange from the period of 2003 to 2007. From these 182 companies, 91 companies had auditor switch and 91 companies had no auditor switch. The sample firms are limited in this period because of availability of data in this period. The samples are compiled according industry and size. The relevant data had been collected from the annual general meeting, companies' financial statements and notes. The dependent variable is auditor switch and independent variables are change in managements, audit quality, qualified audit opinion, client size, change in auditor fees and financial distress.

4.2. Logistic Regression Model

Since the dependent variable (auditor switch) is a binary variable, the stepwise logistic regression technique is used to confirm the relationship between auditor switch and independent variables. The following logistic regression model is run to concurrently test the 6 hypotheses in this study:

$$\mathbf{ASW = \beta_0 + \beta_1 LOGA + \beta_2 CHM + \beta_3 AQ + \beta_4 AFE + \beta_5 QO + \beta_6 FD + \varepsilon}$$

ASW= auditor switch that takes 1 if firms switches auditor and 0 otherwise.

LOGA= log of assets that is used for client's size.

CHM= change in management that takes 1 if firms change the managers and 0 otherwise.

AQ= audit quality that takes 1 if auditor is confirmed by TSE and 0 otherwise.

AFE= change in audit fee that takes 1 if audit fee has changed and 0 otherwise.

QO= qualified audit opinion that takes 1 if firms received qualified opinion and 0 otherwise.

FD= financial distress that takes 1 if firm is financial distressed firms and 0 otherwise.

Change in management is a binary variable which takes the value of 1 if the firm changes managers and 0 otherwise. Qualified audit report is a binary variable which takes the value of 1 if auditor issued qualified report and 0 otherwise. Financial distress is also a binary variable which takes the value of 1 if firms is financial distressed and 0 otherwise. For client size log of assets is used and audit fees is also a binary variable which takes the value of 1 if auditor changes the fees and 0 otherwise. Audit quality also is binary variable that takes 1 if auditor is confirmed by TSE and 0 otherwise.

[1] According to Business law par.141, if the firm had net losses equal to half of the firm's equity, the board of directors is required immediately to invite shareholders to decide about survival or dissolution of the company. These companies are known as financial distressed companies according to this law.

5. Results
5.1. Descriptive Analysis

The samples of this research consist of 182 companies that are divided into two groups. The first group consists of 91 firms with auditor switch and the second group (control) consists of 91 firms without auditor switch. The samples are chosen from different industries to represent the population of listed firms in TSE. Table 1 presents the frequencies of binary variables in this research. Table 2 presents the descriptive statistics of all variables in the study.

Table 1: Frequency of variables

Variables in 182 firms	1	0	total
CHM	48	134	182
AQ	172	10	182
AFE	168	14	182
QO	137	45	182
FD	41	141	182

Table 2: Descriptive Results

variables	N	MAX	MIN	MEAN	S.D
ASW	182	1	0	0.50	0.50
LOGA	182	7.40	4.28	1.078	71424
CHM	182	1	0	0.2637	0.44187
AQ	182	1	0	0.9451	0.22850
AFE	182	1	0	0.9231	0.26720
QO	182	1	0	0.7527	0.43261
FD	182	1	0	0.2253	0.41892

Table 3 presents the correlation co efficient matrix for the variables used in the regression model. It indicates no multi co-linearity problem between variables since all of the coefficients are less than 0.8.

Table 3: Correlation Co Efficient Matrix

	CONSTANT	LOGA	CHM	AQ	AFE	QO	FD
COSTANT	1						
LOGA	-0.729	1					
CHM	-0.016	-0.074	1				
AQ	-0.630	0.065	0.105	1			
AFE	-0.256	-0.021	-0.176	-0.45	1		
QO	-0.171	-0.015	0.031	-0.010	0.085	1	
FD	0.729	-0.00	0.074	-0.065	0.021	0.015	1

Significant at 5% level

Table 4 presents the results of testing normality of data. Since the figures for skewness and kurtosis is below 1.96 the distribution of all variables are normal.

Table 4: Testing Normality of data

	Skewness	Kurtosis
Auditor Switch	0.00	0.02
Qualified Audit Opinion	1.18	0.061
Log of Assets	0.98	0.18
Change in Management	1.08	0.84
Auditor Fee	0.00	0.18
Audit quality	0.98	0.01
Financial Distress	1.32	0.24

Significant at 5% level

5.2. Logistic Regression Analysis

The result of logistic regression model is presented in Table 4. Six independent variables were analyzed using maximum likelihood estimation procedure in stepwise logistic regression based on all data of 182 firm-year observations from 2003 to 2007. Results indicate that Client Size and Audit Quality factors have negative relationships with auditor switch. Financial Distress and Change in Management respectively have positive relationship with auditor switch as predicted. But Qualified Audit Opinion and Auditor Fees that were predicted to have negative relationships with auditor switch, yield positive relationships. The overall correct percentage of this logistic regression model is 75.3%. The result indicates a significant positive relationship between Audit Quality and Auditor Switch at 5% confidence level.

Table 4: Logistic Regression Results

Variables	Predicted sign	B	S.E	Wald	df	sig	EXP(B)
LOGA	-	-0.236	0.230	1.050	1	0.306	0.790
CHM	+	0.518	0.457	1.282	1	0.258	1.678
AQ	-	-2.191	1.124	3.798	1	0.05**	0.112
AFE	+	-0.433	0.605	0.512	1	0.474	0.649
QO	+	-0.274	0.409	0.450	1	0.502	0.760
FD	+	1.74	1.7	1.05	1	0.306	0

**Significant at 5% level

6. Conclusion

In this research the relationship between auditor switch and six independent variables (log of assets, change in management, client size, audit quality, qualified audit opinion and financial distress) as determinants of auditor switch in Tehran Stock Exchange are examined. The sample consists of 91 firms with auditor switch and 91 firms without auditor switch. The stepwise logistic regression model is used for determining the factors that affect auditor switch. Logistic regression analysis has shown that only audit quality is significantly related to auditor switch in TSE. Previous studies had different result and in some research audit fee and change in management were found as important factors of auditor switch. Furthermore, consistent with most previous studies, this study showed that there is no significant relationship between receiving qualified audit opinion and auditor switch. Thus, this result suggests that opinion shopping should not be of concern in TSE.

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