Sinteza
Međunarodna naučna konferencija Univerziteta Singidunum

Impact of Internet on Business Activities in Serbia and Worldwide
Uticaj Interneta na poslovanje u Srbiji i svetu

DOI: 10.15308/SINTEZA-2014-552-558

AUDITOR SWITCHING AND QUALIFIED AUDIT OPINION: EVIDENCE FROM SERBIA

Nemanja Stanišić, Zoran Petrović, Kosana Vićentijević, Vule Mizdraković
Singidunum University, Serbia

Abstract:
The awareness of association between auditor switching and the audit opinion is essential when legislation regarding mandatory audit practice is being done. To test the significance of the association, we collect data on audit opinion reports of a random sample that comprises 800 industrial entities from Republic of Serbia. Using Fisher's Exact Test, we conclude that companies that have received unqualified opinion in one period, and subsequently changed their auditor firm, were significantly less likely to receive unqualified opinion in the following period, when compared to companies that have not changed auditor.

Key words:
unqualified opinion,
industrial entities,
auditor switching.

INTRODUCTION

The causation between switching and the audit opinion is clearly important for policy decisions regarding both opinion shopping and auditor independence [13]. The practice of audit switching is generally considered advantageous and made mandatory in some countries, but its benefits are obtained only when it doesn't create financial incentives that might undermine auditor's independence. In a study by Carey et al. showed that auditors issuing first-time going-concern-modified audit opinions lost proportionately more fees by losing clients (through switching or company failure) than firms not issuing a going-concern-modified opinion to financially stressed clients [2]. This confirms that auditor independence is often challenged, a fact that is acknowledged in a rich body of research on this topic.

Nevertheless, to the best of our knowledge, no study on this subject has been conducted in Republic of Serbia. Therefore, for the purpose of this research, pairs of two consecutive annual audit reports issued to 800 randomly sampled medium and large size Serbian industrial companies are examined. Reports were issued by independent external auditor firm, and depending on availability of data, they were with reference to financial statements of companies for fiscal periods 2006 through 2010.

We divided the sample into two groups: companies that did not change auditor firm in period between issuance of these two reports (683 of them), and companies that did change auditor firm (117 of them). Based on opinions assigned in the paired reports, we constructed a transition matrix for each of the two groups. A sequence of tests for consistency of proportions of auditor's opinions types between these two groups of companies is performed.

Results indicate that among the companies that receive an unqualified audit opinion in one period, ones that subsequently change their auditor have significantly lower odds of receiving the same type of opinion in the following period. There was not sufficient evidence for inconsistency of proportions for companies that received qualified, adverse and declaimer of opinion type of reports in first periods. This however may be a consequence of relatively small frequency of reports with this type of opinion in the sample.

The results are consistent with those of other studies, and put forward that investors should be watchful of auditor switching practice, as it can timely indicate that reliability of financial reports is diminishing.

LITERATURE REVIEW

Previous studies have reported that auditor switching is positively associated with receipt of a going-concern-modified opinion [2]. A research by Krishnan et al. in which simultaneity-adjusted estimates were used confirmed a positive effect of a qualified opinion on switching found by Chow, Craswell and Citron & Taffler [13],[4],[6],[5]. Likewise, results from a random sample of SEC-registrants support the contention that firms switch auditors more frequently after receiving qualified opinions [13]. In addition, it appears that the probability of a switch increases with the severity of qualification [9].

However, it was not found that firms that have received qualified opinions switch systematically to audit firms with a history of rendering proportionally fewer qualified opinions. Results suggest that qualified firms which switch auditors are equally [13], or are even more likely to receive qualified opinions [12] and [13] subsequently. Analytical studies dealing with auditor independence issues Magee & Tseng, Dye and Teoh suggest an opposite causation, in which the auditor is less likely to qualify the opinion for a client who may switch auditors [18],[7],[23].

Evidence is found of both familiarity and intimidation threats [9]. With aim of loosening potentially hazardous relationship between auditor and company management, auditor rotation is made mandatory in some countries. A study conducted by Lu advocates that successor auditor's audit quality exceeds the predecessor auditor's audit quality, and that the successor auditor's reactions to auditor switching reduce the benefits of opinion shopping to companies [16]. However, majority research studies conducted on this topic point out that once the cost of auditing firm rotation is taken into the account, it outweighs its potential benefits [10] and [22]. Even when mandatory rotation legislation is in place, it appears that switching of auditors at the end of the mandatory term is linked to type of received opinion [24].

Arguments are made that, as a potential solution, limitation of managerial influence over auditor switching should be imposed [15]. However, in addition to receiving an unqualified opinion report, fee reduction is a major motivation for auditor switching. There is a strong evidence that a change of auditor is associated with a fee reduction of 5% to 7%, although this fee discount does not persist over time [11]. Another study showed the tendency of companies with high audit fees to dismiss their auditor after a year [22].

Pricing factor might be even related to macroeconomic cycles, which may have consequence on a collective level. Numerous studies have found that large audit firms with international reputations earn fee premiums due to their perceived higher quality [20]. Therefore, in periods of economic prosperity, a trend of switching towards large audit firms is observed. Finding of a study by Richardson draws our attention to the fact that the similar pattern of auditor switching has been observed prior to the Great Depression [21]. However, as he reports, during the crisis, this flow of clients is reversed with large international firms losing clients through switches, on average, to domestic and smaller audit firms. Similarly, after the demise of Arthur Andersen and enactment of the Sarbanes-Oxley Act of 2002, a significant migration of public clients to second-tier and smaller third-tier audit firms has been witnessed [3]. As a consequence, during the 2003-2004 period, auditor switching was more likely to result in lost clients for large accounting firms and a net gain in clients for smaller ones [1].

A recent study by Luypaert & Van Caneghem described another important factor that influences decisions on auditor change [17]. Namely, in the takeover processes, the majority of acquired firms switch to the auditor of the acquiring firm regardless of similarity of their activities.

In this paper, we will focus on the association between auditor switching and subsequent change in received opinion, and try to provide further evidence on this concern.

METHODOLOGY

Due to characteristics of the data (small sample size for certain audit opinion types), we use Fisher's exact method in order to test associations between nominal variables. Although exact results are always reliable, some data sets are too large for the exact p value to be calculated, yet they do not meet the assumptions necessary for the asymptotic method. In this situation, the Monte Carlo approximated calculation method provides an unbiased estimate of the exact p value, without the requirements of the asymptotic method [19]. Accordingly, we construct 99% confidence intervals for p values with 10000 samples.

With the aim of controlling for family wise errors, we use Holm's sequentially rejective procedure [8]. The steps in the aforementioned procedure are, as described in Lehmann&Romano, along these lines [14]:

Let k = 0

1. If $\hat{p}_{(k+1)} > \frac{\alpha}{s-k}$, go to step 2. Otherwise set $k = k + 1$ and repeat step 1.
2. Reject $H_{(j)}$ for $j \leq k$ and accept $H_{(j)}$ for $j > k$, where $\hat{p}_1 \ldots \hat{p}_s$ are p values of s individual tests, ordered p values are denoted by $\hat{p}_{(1)} \leq \cdots \leq \hat{p}_{(s)}$, and the associated hypotheses by $H_{(1)} \ldots H_{(s)}$.

RESULTS

The results of analysis of the sample are summarized in form of two transition matrices.

TABLE I. TRANSITION MATRIX FOR COMPANIES THAT DID NOT CHANGE AUDITOR

	Unqualified opinion	Qualified opinion	Disclaimer of opinion	Adverse opinion
Unqualified opinion	93.57%	5.36%	0.71%	0.36%
Qualified opinion	42.42%	51.52%	3.03%	3.03%
Disclaimer of opinion	10.00%	35.00%	55.00%	0.00%
Adverse opinion	75.00%	0.00%	25.00%	0.00%

TABLE II. TRANSITION MATRIX FOR COMPANIES THAT DID CHANGE AUDITOR

	Unqualified opinion	Qualified opinion	Disclaimer of opinion	Adverse opinion
Unqualified opinion	86.32%	7.37%	5.26%	1.05%
Qualified opinion	35.29%	52.94%	11.76%	0.00%
Disclaimer of opinion	75.00%	0.00%	25.00%	0.00%
Adverse opinion	100.00%	0.00%	0.00%	0.00%

In order to test for statistical significance of observed difference in the proportions between the two groups, we state four pairs of hypotheses, each pair for a distinct initial auditor opinion type.

The first pair of hypotheses:

H(1O): Among the companies that have been given unqualified auditor's opinion in one year, proportions of audit opinions given to these companies in the following year are equal regardless of whether auditor firm is changed in the interim or not.

H(1A): Among the companies that have been given unqualified auditor's opinion in one year, proportions of audit opinions given to these companies in the following year are different, depending on whether audit firm has changed in the interim or not.

The second pair of hypotheses:

H(2O): Among the companies that have been given qualified auditor's opinion in one year, proportions of audit opinions given to these companies in the following year are equal regardless of whether auditor firm is changed in the interim or not.

H(2A): Among the companies that have been given qualified auditor's opinion in one year, proportions of audit opinions given to these companies in the following year are different, depending on whether audit firm has changed in the interim or not.

The third pair of hypotheses:

H(3O): Among the companies that have been given disclaimer of opinion in one year, proportions of audit opinions given to these companies in the following year are equal regardless of whether auditor firm is changed in the interim or not.

H(3A): Among the companies that have been given disclaimer of opinion in one year, proportions of audit opinions given to these companies in the following year are different, depending on whether audit firm has changed in the interim or not.

The fourth pair of hypotheses:

H(4O): Among the companies that have been given adverse auditor's opinion in one year, proportions of audit opinions given to companies in the following year are equal regardless of whether auditor firm is changed in the interim or not.

H(4A): Among the companies that have been given adverse auditor's opinion in one year, proportions of audit opinions given to companies in the following year are different, depending on whether audit firm has changed in the interim or not.

After stating the hypotheses, we proceed to Holms sequentially rejective procedure for hypotheses testing.

TABLE III. HOLMS SEQUENTIALLY REJECTIVE PROCEDURE FOR HYPOTHESES TESTING

Row pairs ordered by sig.	Fisher's Exact Test Significance (2-sided)	Adjusted α level	H_o hypothesis status
First pair of TM rows - $H_{(1O)}$	0.0037	0.0125	Rejected
Third pair of TM rows - $H_{(3O)}$	0.0220	0.0167	Not rejected
Second pair of TM rows - $H_{(2O)}$	0.3340	0.0250	Not rejected
Fourth pair of TM rows - $H_{(4O)}$	1.0000	0.0500	Not rejected

The procedure has been stopped after the first step, since the condition

$$\hat{p}_{(2)} > \frac{0.05}{4-1}$$

is met in the second step, and we conclude that there is no enough evidence to reject hypotheses H2O, H3O and H4O.

CONCLUSIONS

In this paper, we have tested consistency of two transition matrices of two consecutive annual auditor's opinion reports: one based on data collected on companies that have changed auditor firm and one based on companies that have not changed auditor firm. This has been accomplished by sequential testing of four pairs of hypotheses on homogeneity of proportions of audit opinions received in later period, each for a distinct opinion type received in initial period (a row in matrix). Results show that the only significant difference in proportions is the

one within the companies that received unqualified audit opinion in initial periods. Out of these companies, ones that subsequently change their auditor firm have significantly lower odds of receiving the same type of opinion in the following periods. This supports findings of research studies that have been previously conducted in the field [12],[13]. Hypotheses that differences in proportions exist when qualified opinion, adverse opinion or disclaimer of opinion are received in initial periods have been rejected. Partially, failing to reject these hypotheses might be a result of the relatively small statistical power, which is in turn consequence of small sample size for given opinion types in initial periods. Therefore we recommend further research be undertaken.

REFERENCES

[1] J.F. Brazel and M. Bradford, „Shedding New Light on Auditor Switching," Strategic Finance, vol. 92, No.7, pp. 49–53, 2011.

[2] P. J. Carey, M. A. Geiger and B. T. O'Connell, „Costs Associated With Going-Concern-Modified Audit Opinions: An Analysis of the Australian Audit Market," Abacus, Vol. 44, No.1, PP.61–81. doi:10.1111/j.1467-6281.2007.00249.x, 2008.

[3] H. Chang, C.S.A. Cheng and K. J. Reichelt, „Market Reaction to Auditor Switching from Big 4 to Third-Tier Small Accounting Firms," Auditing: A Journal of Practice & Theory, Vol. 29, No. 2, pp. 83–114. doi:10.2308/aud.2010.29.2.83, 2010.

[4] C.W.R. Chow, „Qualified Audit Opinions and Auditor Switching," Accounting Review, Vol. 57, No. 2, pp. 326–336, 1982.

[5] D. B. Citron and R. J. Taffler, „The Audit Report under Going Concern Uncertainties: An Empirical Analysis," Accounting and Business Research, Vol. 22, No. 88, pp. 337–345, doi:10.1080/00014788.1992.9729449, 1992.

[6] A. T. Craswell, „The Association Between Qualified Opinions and Auditor Switches," Accounting and Business Research, Vol. 19, No. 73, pp. 23–31. doi:10.1080/00014788.1988.9728832, 1998.

[7] R. A. Dye, „Informationally motivated auditor replacement," Journal of Accounting and Economics, Vol. 14, No. 4, pp. 347–374, 1991.

[8] S. Holm, „A simple sequentially rejective multiple test procedure," Scandinavian Journal of Statistics, Vol. 6, No. 2, pp. 65–70, 1979.

[9] M. Hudaib and T. E. Cooke, „The Impact of Managing Director Changes and Financial Distress on Audit Qualification and Auditor Switching," Journal of Business Finance & Accounting, Vo. 32, No.9-10, pp. 1703–1739, doi:10.1111/j.0306-686X.2005.00645.x, 2005.

[10] A. B. Jackson, M. Moldrich and P. Roebuck, „Mandatory Audit Firm Rotation and Audit Quality," SSRN Electronic Journal, doi:10.2139/ssrn.1000076, 2007.

[11] T. Kittsteiner and M. Selvaggi, „Concentration, Auditor Switching and Fees in the UK audit market," Report from LSE Enterprise, 2008.

[12] J. Krishnan, „Auditor Switching and Conservatism," The Accounting Review, Vol. 69, No. 1, pp. 200–215, 1994.

[13] J. Krishnan, J. Krishnan and R. G. Stephens, „The Simultaneous Relation Between Auditor Switching and Audit Opinion: An Empirical Analysis," Accounting & Business Research, Vol. 26, No. 3, 224–236, 1996.

[14] E. L. Lehmann and J.P. Romano, „Generalizations of the familywise error rate," The Annals of Statistics, Vol. 33, No. 3, pp. 1138–1154, 2005.

[15] C.S. Lennox, „Audit Quality and Auditor Switching: Some Lessons for Policy Makers," SSRN Electronic Journal, doi:10.2139/ssrn.121048, 1998.

[16] T. Lu, „Does Opinion Shopping Impair Auditor Independence and Audit Quality?," Journal of Accounting Research, Vo. 44, No. 3, pp. 561–583, doi:10.1111/j.1475-679X.2006.00211.x, 2006.

[17] M. Luypaer and T. Van Caneghem, „An empirical analysis of factors related to auditor switching after corporate takeovers," Working Papers, retrieved from http://ideas.repec.org/p/hub/wpecon/201203.html, 2012.

[18] R. P. Magee and M.C. Tseng, „Audit Pricing and Independence," The Accounting Review, Vol. 65, No. 2, 315–336, 1990.

[19] C.R. Mehta and N. R. Patel, „IBM SPSS Exact Tests," IBM Software Group, retrieved from ftp://public.dhe.ibm.com/software/analytics/spss/documentation/statistics/20.0/en/client/Manuals/IBM_SPSS_Exact_Tests.pdf, 2005.

[20] L. Niemi, L. „Auditor Size and Audit Pricing: Evidence From Small Audit Firms," European Accounting Review, Vol. 13, No. 3, pp. 541–560. doi:10.1080/09638180420002371151, 2004.

[21] A. J. Richardson, „Auditor Switching and the Great Depression," The Accounting Historians Journal, Vol. 33, No. 2, p. 39, 2006.

[22] C. M. R. Stefaniak, „The Causes and Consequences of Auditor Switching: A Review of the Literature," Journal of Accounting Literature, Vol. 28, pp. 47–121, 2009.

[23] S. H. Teoh, „Auditor Independence, Dismissal Threats, and the Market Reaction to Auditor Switches," Journal of Accounting Research, Vol. 30, No. 1, pp. 1–23, 1992.

[24] A. Vanstraelen, „Going-Concern Opinions, Auditor Switching, and the Self-Fulfiiling Prophecy Effect Examined in the Regulatory Context of Belgium". Open Access publications from Maastricht University, retrieved from http://ideas.repec.org/p/ner/maastr/urnnbnnlui27-18435.html, 2003.

APPENDIX

TABLE IV. CROSS TABULATION OF AUDITOR'S OPINION TYPE CHANGE WITH AUDITOR FIRM CHANGE FOR COMPANIES THAT HAVE RECEIVED UNQUALIFIED OPINION IN INITIAL PERIOD

			Opinion				Total
			Unqualified opinion to Unqualified opinion	Unqualified opinion to Qualified opinion	Unqualified opinion to Disclaimer of opinion	Unqualified opinion to Adverse opinion	
Audit firm change	**No**	Count	524	30	4	2	560
		Expected Count	518.1	31.6	7.7	2.6	560.0
	Yes	Count	82	7	5	1	95
		Expected Count	87.9	5.4	1.3	.4	95.0
Total		Count	606	37	9	3	655
		Expected Count	606.0	37.0	9.0	3.0	655.0

TABLE V. CHI-SQUARE TESTS FOR COMPANIES THAT HAVE RECEIVED UNQUALIFIED OPINION IN INITIAL PERIOD

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)	Point Probability
Pearson Chi-Square	14.133[a]	3	.003	.007		
Likelihood Ratio	9.875	3	.020	.016		
Fisher's Exact Test	11.573			.006		
Linear-by-Linear Association	9.866[b]	1	.002	.004	.004	.002
N of Valid Cases	655					

a. 3 cells (37.5%) have expected count less than 5. The minimum expected count is .44.

b. The standardized statistic is 3.141.

TABLE VI. ESTIMATES OF EFFECT SIZE OF AUDITOR SWITCHING ON OPINION RECEIVED IN LATER PERIOD THE FOR COMPANIES THAT HAVE RECEIVED UNQUALIFIED OPINION IN INITIAL PERIOD

		Value	Approx. Sig.	Exact Sig.
Nominal by Nominal	**Phi**	.147	.003	.007
	Cramer's V	.147	.003	.007
N of Valid Cases		655		

TABLE VII. CROSS TABULATION OF AUDITOR'S OPINION TYPE CHANGE WITH AUDITOR FIRM CHANGE FOR COMPANIES THAT HAVE RECEIVED QUALIFIED OPINION IN INITIAL PERIOD

			Opinion				Total
			Qualified opinion to Unqualified opinion	***Qualified opinion to Qualified opinion***	***Qualified opinion to Disclaimer of opinion***	***Qualified opinion to Adverse opinion***	
Audit firm change	**No**	***Count***	42	51	3	3	99
		Expected Count	41.0	51.2	4.3	2.6	99.0
	Yes	***Count***	6	9	2	0	17
		Expected Count	7.0	8.8	.7	.4	17.0
Total		***Count***	48	60	5	3	116
		Expected Count	48.0	60.0	5.0	3.0	116.0

TABLE VIII. CHI-SQUARE TESTS FOR COMPANIES THAT HAVE RECEIVED QUALIFIED OPINION IN INITIAL PERIOD

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)	Point Probability
Pearson Chi-Square	3.267[a]	3	.352	.327		
Likelihood Ratio	3.045	3	.385	.455		
Fisher's Exact Test	2.866			.334		
Linear-by-Linear Association	.301[b]	1	.583	.700	.350	.125
N of Valid Cases	116					

a. 4 cells (50.0%) have expected count less than 5. The minimum expected count is .44.

b. The standardized statistic is .549.

TABLE IX. ESTIMATES OF EFFECT SIZE OF AUDITOR SWITCHING ON OPINION RECEIVED IN LATER PERIOD THE FOR COMPANIES THAT HAVE RECEIVED QUALIFIED OPINION IN INITIAL PERIOD

		Value	Approx. Sig.	Exact Sig.
Nominal by Nominal	**Phi**	.168	.352	.327
	Cramer's V	.168	.352	.327
N of Valid Cases		116		

TABLE X. CROSS TABULATION OF AUDITOR'S OPINION TYPE CHANGE WITH AUDITOR FIRM CHANGE FOR COMPANIES THAT HAVE RECEIVED ADVERSE OPINION IN INITIAL PERIOD

			Opinion			Total
			Disclaimer of opinion to Unqualified opinion	*Disclaimer of opinion to Qualified opinion*	*Disclaimer of opinion to Disclaimer of opinion*	
Audit firm change	**No**	***Count***	2	7	11	20
		Expected Count	4.2	5.8	10.0	20.0
	Yes	***Count***	3	0	1	4
		Expected Count	.8	1.2	2.0	4.0
Total		***Count***	5	7	12	24
		Expected Count	5.0	7.0	12.0	24.0

TABLE XI. CHI-SQUARE TESTS FOR COMPANIES THAT HAVE RECEIVED ADVERSE OPINION IN INITIAL PERIOD

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)	Point Probability
Pearson Chi-Square	8.760[a]	2	.013	.022		
Likelihood Ratio	8.013	2	.018	.022		
Fisher's Exact Test	6.377			.022		
Linear-by-Linear Association	4.626[b]	1	.031	.038	.038	.031
N of Valid Cases	24					

a. 4 cells (66.7%) have expected count less than 5. The minimum expected count is .83.

b. The standardized statistic is -2.151.

TABLE XII. ESTIMATES OF EFFECT SIZE OF AUDITOR SWITCHING ON OPINION RECEIVED IN LATER PERIOD THE FOR COMPANIES THAT HAVE RECEIVED ADVERSE OPINION IN INITIAL PERIOD

		Value	Approx. Sig.	Exact Sig.
Nominal by Nominal	**Phi**	.604	.013	.022
	Cramer's V	.604	.013	.022
N of Valid Cases		24		

TABLE XIII. CROSS TABULATION OF AUDITOR'S OPINION TYPE CHANGE WITH AUDITOR FIRM CHANGE FOR COMPANIES THAT HAVE RECEIVED DISCLAIMER OF OPINION IN INITIAL PERIOD

			Opinion		Total
			Adverse opinion to Unqualified opinion	*Adverse opinion to Disclaimer of opinion*	
Audit firm change	**No**	Count	3	1	4
		Expected Count	3.2	.8	4.0
	Yes	Count	1	0	1
		Expected Count	.8	.2	1.0
Total		Count	4	1	5
		Expected Count	4.0	1.0	5.0

TABLE XIV. CHI-SQUARE TESTS FOR COMPANIES THAT HAVE RECEIVED DISCLAIMER OF OPINION IN INITIAL PERIOD

	Value	df	Asymp. Sig. (2-sided)	Exact Sig. (2-sided)	Exact Sig. (1-sided)	Point Probability
Pearson Chi-Square	.313[a]	1	.576	1.000	.800	
Continuity Correction[b]	.000	1	1.000			
Likelihood Ratio	.505	1	.477	1.000	.800	
Fisher's Exact Test				1.000	.800	
Linear-by-Linear Association	.250[c]	1	.617	1.000	.800	.800
N of Valid Cases	5					

a. 4 cells (100.0%) have expected count less than 5. The minimum expected count is .20.

b. Computed only for a 2x2 table

c. The standardized statistic is -.500.

TABLE XVI. ESTIMATES OF EFFECT SIZE OF AUDITOR SWITCHING ON OPINION RECEIVED IN LATER PERIOD THE FOR COMPANIES THAT HAVE RECEIVED DISCLAIMER OF OPINION IN INITIAL PERIOD

		Value	Approx. Sig.	Exact Sig.
Nominal by Nominal	**Phi**	-.250	.576	1.000
	Cramer's V	.250	.576	1.000
N of Valid Cases		5		