

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

Arezoo Aghaei chadegani<sup>1+</sup>, Zakiah Muhammaddun Mohamed<sup>2</sup> and Azam Jari<sup>3</sup>

<sup>1</sup>Islamic Azad University, Mobarake Branch, Isfahn, Iran.

<sup>2</sup>University kebangsaan Malaysia

<sup>3</sup>Islamic Azad University, Mobarake Branch, Isfahn, Iran.

**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.

**Key words:** Auditor Switch, Tehran Stock Exchange, Logistic Regression, Determinant Factors.

### 1. Introduction

Financial reporting provides required information for managers, investors, creditors and government. This financial reporting has done by providing financial statement like balance sheet, income statement, cash flow and financial statement's notes (Bagherpour, Monroe & Greg, 2010). The users of financial statement can rely on this information only when someone who is independent confirms the reliability of this information. Firms can employ reputable auditors to assure outside investors of the credibility of financial disclosures and hence mitigate the agency problems (Anderson, Kadous & Koonce, 2004). Thus auditors serve a corporate governance role in monitoring a firm's financial reporting process (Ashbaugh & Warfield, 2003). 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 & Meckling, 1972) and the separation of risk bearing, decision-making and control function in firms (Fama & 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, Shamsheer & 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

---

<sup>+</sup> Corresponding author. Tel.: 0060173191093 E-mail address: [arezooaghaie2001@yahoo.com](mailto:arezooaghaie2001@yahoo.com)

about content of financial reports (Addams & Davis, 1994), disagreement about auditor opinion (Haskins & Williams, 1990), change of management (Beattie & Fearnley, 1995), auditor fees (Addams & Davis, 1994). These factors may cause auditor switch and they may reduce the auditor's independence as well. In this research we want to know if these factors have relationship with auditor switch in TSE. Thus, the objective of this study is to find major determinants of auditor switch among companies listed on TSE. We divided these factors in two groups: 1) Factors related to auditors: Auditor fees, auditor opinion, auditor size and 2) Factors related to client: Client size, changing management, financial distress. The research question is: RQ: which auditor related factors and client related factors influence auditor switch in TSE?

The importance of auditor switch and auditor independence and absence of enough studies in Iran in this issue motivated us to do this research. To address the research question we used logistic regression (maximum likelihood) method in this research. One contribution of this research is the new categories of auditor switch factors that is more definable and relevant to the framework of this issue compare the previous ones and our study contributes to the body of knowledge on auditor switch issue by examining auditor related factors and client related factors for the first time among companies listed on TSE. 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 (agency and signaling) that generate demand for different levels of audit quality (Bagherpour, Monroe & Greg, 2010). The potential incentives include agency conflicts in the companies or signaling quality by adding credibility to the financial statements (Jensen & Meckling, 1976). 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 (Jensen & Meckling, 1972) and the separation of risk bearing, decision-making and control function in firms (Fama & Jensen, 1983). Much of the 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 & Greg, 2010). The rapid increase in competition in the audit, managerial labor and capital markets increased agency costs and signaling incentives for Iranian listed companies, which we link to incentives for auditor switching. Specifically, we investigate the association between factors related to client and auditor characteristics and auditor switches by companies listed on the TSE. Prior researches have shown that companies switch auditors due to factors such as change in management, auditor size, qualified audit opinion, change in audit fee and others (Ismail & Aliahmed, 2008). In this research we categorize these factors in two groups: 1) client factors and 2) auditor factors. We consider change in management, financial distress and client's size as factors that related to the firm and qualified audit opinion, auditor size and change in auditor fees as factors that related to auditor.

### **2.2. Prior Researches**

Some studies in the past examined the association of one factor with auditor switch. Takiyah & Ghazali (1993) verified the association between qualified audit opinion and auditor switch but they did not find significant relationship between qualified report and auditor switch. In another research, Lennox (1999) examined the relationship between bankruptcy and auditor switch and the result showed that a switch is a weak signal of financial distress. Maybe one of the reasons that these relationship have not supported was that the samples were small and they did not consider the other factors related to auditor switch. Ismail & Aliahmed (2008) find out why Malaysian second board companies switch auditors? They found that leverage, growth turnover, financing activities, longevity of audit engagement and audit fee were the significant determinants of auditor switch. They accepted the William's framework for audit switch that used 3 categories namely change in client contracting environment, client firm reputation and auditor effectiveness. We used other simple categories for factors that affect auditor switch to show the simple relationship. Lin & Liu (2010) investigated the association between firm's internal corporate governance mechanisms and

auditor switch decision in China. This 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 did not consider many important factors that in previous studies have proven that had effect on auditor switch like auditor size, change in management and audit fee that we try to investigate in this research.

### **3. Hypotheses Development**

To address the research question, we intended to test the relationship between client factors and auditor factors with auditor switch. In other words, we want to know whether these factors have impact on auditor switch among companies listed on TSE or not?

#### **3.1. Change in Management, Financial Distress and Client Size**

According to literature review a firm's management would like to influence auditor choice decision and have a motivation of switching auditor in order to pursue their own self interests. 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) or they seek an auditor who is more accommodating with respect to their choice and application of accounting policies (Schwartz & Menon, 1985). The financial position of client has important implications on decisions in retaining the audit firm. Clients who are insolvent and are experiencing an 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 & 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 new quality of auditor compared to the previous one (Schwartz & Menon, 1985; Hudaib & Cooke, 2005). In Iran financial distressed firms are those firms that are subjected to Business Law par. 141. Client size is another important explanatory variable because of the auditors' self-interest threat. 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 & Zimmerman, 1986) and auditors' self-interest threat (Hudaib & Cooke, 2005). Following Friedlan (1994) and Lennox (1999), the log of total assets to control the size effect of the firms is used in this research. Following this argument, the client factors hypotheses are:

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

H2: There is a positive relationship between financial distress and auditor switch.

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

#### **3.2. Auditor Size, Qualified Audit Opinion and Audit Fees:**

Selecting an audit firm that is suited to a company or managers' needs may be is a function of many factors but auditor size is known to be an important determinant of auditor choice in developed markets (Dopuch & Simunic, 1982). There is substantial evidence internationally that the 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 & Simunic, 1982). In Iran we have two groups of audit firms, one group are auditors who are confirmed by TSE and the second group are auditors who are not confirmed by TSE. In this research we consider the first group as a higher prestige auditor (big size) and the second group as a small size. Another 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 & 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 & Rice, 1982; Vanstraelen, 2003). We expected this variable should be positively related to switching of auditors. Audit fee reduction has been identified by prior literature as a primary reason for auditor switching. Eichenseher & Shields (1983) found 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. Following this argument, the auditor factors hypotheses are:

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

H5: There is a positive relationship between qualified audit opinion and auditor switch.

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

## 4. Research Methodology

### 4.1. Sampling

In this study we used secondary data to investigate the relationship between independent and dependent variables. The sample consists of 182 companies that listed on TSE. From these 182 companies, 91 companies had auditor switch during 2003 until 2007 and 91 companies without auditor switch. We limit the sample firms 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 the independent variables are change in managements, auditor size, qualified audit opinion, client size, change in auditor fees and financial distress.

### 4.2. Logistic Regression Model

Due to our dependent variable (auditor switch) that is a binary variable, we used the stepwise logistic regression technique to confirm the relationship between auditor switch and independent variables. We run the following logistic regression model to test our 6 hypothesis:

$$ASW = \beta_0 + \beta_1 LOGA + \beta_2 CHM + \beta_3 ASI + \beta_4 AFE + \beta_5 QO + \beta_6 FD + \varepsilon$$

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

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

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

ASI= auditor size 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.

## 5. Results

### 5.1. Descriptive Analysis

The samples of this research consist of 182 companies that 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 choose from different industries because we have to find firms that had auditor switch as a sample. Fig 1 presents the T-test results on the variables in client firms that switched and not switched auditors. We had 182 companies totally that the result shows that auditor size is most important factors based on t value.

variables	N	MAX	MIN	SUM	MEAN	S.D	T VALUE	SIG
ASW	182	1	0	91.00	0.50	0.50	13.454	0.00
LOGA	182	7.40	4.28	1.96	1.078	71424	2.036	0.04
CHM	182	1	0	48.00	0.2637	0.44187	8.052	0.00
ASI	182	1	0	172.00	0.9451	0.22850	55.796	0.00
AFE	182	1	0	168.00	0.9231	0.26720	46.605	0.00
QO	182	1	0	137.00	0.7527	0.43261	23.474	0.00
FD	182	1	0	41.00	0.2253	0.41892	7.255	0.00

Fig. 1: Descriptive Results

Fig 2 presents the correlation co efficient matrix for the variables used in the regression model. It indicates no multi co linearity problem between variables. Fig 3 presents the results of testing normality of data.

	Constant	LOGA	CHM	ASI	AFE	QO	FD
COSTANT	1						
LOGA	-0.729	1					
CHM	-0.016	-0.074	1				
ASI	-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

Fig. 2: Correlation Co Efficient Matrix

	Skewness	Kurtosis
Auditor Switch	0.00	2.02
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
Auditor Size	0.98	0.01
Financial Distress	1.32	0.24

Significant at 5% level

Fig. 3: Testing Normality of data

Variab les	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
ASI	-	-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	0.750
FD	+	1.74	1.7	1.05	1	0.306	0

Fig. 4: Logistic Regression Results

## 5.2. Logistic regression analysis

The result of logistic regression model have presented in Fig 4. Six independent variables were analyzed using maximum likelihood estimation procedure in stepwise logistic regression based on all data of 182 firm-year observations during 2003 until 2007. Result indicated that as we predicted Log of Assets and Auditor Size have negative relationships with auditor switch. Financial distress and Change in management have positive relationship with auditor switch as we predicted. But Qualified Audit Opinion and Auditor Fees that we predicted to have negative relationships with auditor switch, yield positive relationships. The overall correct percentage of this logistic regression model is 75.3% and only Auditor Size significantly related to Auditor Switch at 5% level of significant.

## 6. Conclusion

In this research the relationship between auditor switch and six independent variables (log of assets, change in management, client size, auditor size, qualified audit opinion and financial distress) as determinants of auditor switch on TSE are examined. Our sample consists of 91 firms with audit switch and 91 firms without auditor switch. We used stepwise logistic regression model for determining the relationship between auditor switch and independent variables. Analysis the findings have shown that only auditor size is significantly related to auditor switch in TSE. 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 can support that opinion shopping should not be of concern in TSE.

## 7. Acknowledgement:

I would like to thank my supervisor, Dr Zakiah Muhammaddun Mohamed for her patient guidance and advices.

## 8. References:

- [1] Anderson, U., Kadous, K., & Koonce, L. The role of incentives to manage earnings and quantification in auditors' evaluations of management-provided information. *Auditing: A Journal of Practice & Theory*. 2004, 23(1): 11–27.
- [2] Bagherpour, M and Monroe, G. Auditor Switching in an Increasingly Competitive Audit Market. W.papers. 2010.
- [3] Chow, C and Rice, S. Qualified audit opinions and auditor switching. *The Accounting Review*. 1982, 5(2): 326-35.
- [4] Dopuch, N. and Simunic, D. Competition in Auditing: An Assessment. In *Symposium on Auditing Research IV*. Urbana: University of Illinois. 1982: 401-450.
- [5] Fama, E.F and Jensen, M.C. Auditor change: A joint test of theories relating to agency cost and auditor differentiation. *accounting review*.1988: 663-683.
- [6] Hudaib, M. and Cooke, T.E. The impact of managing director changes and financial distress on audit qualification and auditor switching. *Journal of Business Finance & Accounting*. 2005, 32 (9/10): 1703-39.

- [7] Ismail, SH. Aliahmed, H. Why Malaysian Second Board Companies Switch Auditors: Evidence of Bursa Malaysia. *International Research Journal of Finance and Economics*. 2008, 13: 123-130.
- [8] Jensen, M. C. & Meckling, W. H. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics*. 1972, 3: 305-360.
- [9] Lennox, C. Audit Quality and Auditor Size: An Evaluation of Reputation and Deep Pockets Hypotheses. *Journal of Business Finance & Accounting*. 1999, 26(7/8): 779-805.
- [10] Lin, Z. Jun and Liu, M. The determinants of auditor switching from the perspective of corporate governance in china. *Advances in Accounting, incorporating advances in international accounting journal*. 2010, 26: 117-127.
- [11] Takiah, M.I and Ghazali, S.M. Incidence of Qualified Opinions and the Effects on Auditor Switching : an empirical study in Malaysia. *Management Journal (December)*. 1993: 53-63.
- [12] Vanstraelen, A. Going-concern opinions, auditor switching, and self-fulfilling prophecy effect examined in the regulatory context of Belgium. *Journal of Accounting, Auditing and Financ*. 2003, 18: 231–253.
- [13] Williams, D. D. The potential determinants of auditor change. *Journal of Business Finance & Accounting*. 1988, 15: 243–261.