

## The Impact of Corporate Governance on Auditor Change Decision

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### Abstract

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Auditing plays a crucial role in corporate governance process and it has been shown to increase the reliability and quality of an organization's financial statements. Understanding the reasons why companies change their auditor is very important as it could inhibit the flow of capital in the securities markets and subsequently, increase the capital costs. The present study seeks to examine the impact of corporate governance on auditor change decision. Based on the analysis of 712 non-financial companies listed on Bursa Malaysia during the period from 31st December, 2009 to 2011, the results suggest that board independence, non-audit service, changes in management, company size and Big 4 are significant determinants of auditor change. The outcome of the study indicates the impact of sound governance on auditor change decision and might provide insightful knowledge which helps shareholders to realize the importance of having balance BODs.

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**Keywords:** Corporate governance; non-audit services; auditor change decision; Big 4; audit quality.

### 1. Introduction

The demise of Andersen and the collapse of Enron in the year 2002, have ignited intense debate regarding audit market competition and audit quality. Andersen ceased its business in August 2002, and was acquired by other firms. Although the US Supreme Court reversed Andersen's conviction in 2005, the audit market environment and structure had already changed. New legislation and corporate governance codes were proposed and introduced worldwide. The main focus was on improving corporate governance, which also includes the issue of auditor choice.



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The issue of auditor choice is not straightforward. Arguably, the biggest fallacy in corporate governance today is the premise that shareholders elect and appoint the auditor, when, in fact, shareholders (through proxy votes) have effectively handed over the control of auditor-related decisions (hiring, retention and compensation) to management (Abdel-Khalik, 2002). Therefore, the real motivation for auditor-client re-alignment might be known only to management.

Generally, evidence suggests that auditor changes could diminish users' confidence in the audited financial statements which further could inhibit the flow of capital in the securities markets and subsequently increased capital costs (Knap & Elikai, 1988). Despite the importance of understanding the motivations for, or determinants of, auditor change, little has been done to investigate the issue, particularly in emerging market such as Malaysia.

In Malaysia, studies on auditor change can be considered scanty. The most recent studies; Nazri, Smith and Ismail (2012a) and Nazri et al. (2012b) recommended that a study should be conducted on corporate governance characteristics such as board independence and CEO duality, so as to shed more light on this particular subject. Other prior Malaysian's studies (e.g. Ismail, Aliahmed, Nassir & Hamid, 2008) and, Joher, Ali, Mohd Ramidili and Nassir (2000), also do not address whether the auditor-client realignment decision is a function of company's corporate governance practices. The present study extends the auditor change studies by examining the possible influence of internal corporate governance mechanisms on auditor change decision. Thus, the purpose of this study is to provide an answer to this research question: *What is the effect of corporate governance on auditor change decision?*

Given how important corporate governance is in recent years and the recent reforms in the corporate governance code, the study hopes that more valuable findings could be revealed to help enrich the level of corporate governance agenda. The paper is organised as follows. The next section discusses prior relevant studies and outlines the development of hypotheses. Section 3 outlines the research methods and Section 4 presents the results of the study. Section 5 concludes the study.

## **2. Prior studies and hypothesis**

Most prior studies (Nazri et al., 2012a; 2012b; Ismail et al., 2008) on the auditor change decision in Malaysia have examined auditor change determinants such as change in management, audit opinion, client size. However, studies on corporate governance characteristics such as board independence, Chief Executive Officer (CEO) duality, are still lacking. Nazri et al. (2012a), investigated auditor choice issues, covering 18 years dataset period (1990-2008). The authors recommended that a study should be conducted on corporate governance characteristics so as to shed more light on this particular subject, and to include other variables that could affect the auditor choice decision such as audit opinion, audit fees and client firm size. Similarly, Nazri et al. (2012b) investigate the factors influencing auditor change. However, despite the findings providing invaluable evidence on the issue of auditor change in the country, they still recommended a replication of their study with other determinants of auditor change such as: audit tenure, Non-audit services, board independence, auditor-client relationship and CEO duality. Ismail et al. (2008) cover the period from 1997-1998. The study examined major determinants of auditor change; however, corporate governance variables were not

examined in the study as determinants of auditor change. Joher et al. (2000) cover a relatively old dataset (1986-1996). While providing invaluable evidence about the auditor change issue, the study focuses mainly on how the change could trigger market reaction.

### *2.1 Hypothesis 1: Board independence*

The distribution of power among corporate managers, shareholders and directors is set when shareholders nominate a board of directors to represent and protect their interest (O'Neill, Pouder & Buchholtz, 1998). A major role of a company's board is its control function, which includes monitoring top management actions to ensure that executives fulfil their responsibilities to the company (Fama & Jensen, 1983).

It is believed that the effectiveness of the board in monitoring the decisions of managers is often associated with its composition. Board composition refers to the distribution of members according to their primary allegiance, which may be either to the shareholders (outside) or to the managers (inside). Outside directors generally are viewed as professional referees who unbiasedly protect the shareholders' interests, helping to prevent or detect any management opportunistic behaviour [8]. Non-executive Directors (NEDs) who are independent from management could limit the opportunity of the board to become 'an instrument of top management' by serving to limit top management's discretionary decisions (Beasley & Petroni, 2001). Thus, the larger the proportion of independent NEDs on the board, the more effective it will be in monitoring managerial opportunism [Fama et al., 1983].

Empirical studies have shown that when boards of directors are more independent, they tend to act in the best interests of shareholders (Dechow, Sloan & Sweeney, 1996). NEDs are expected to place a greater emphasis (than executive directors) on the extent and quality of the audit rather than on its cost, thereby seeking to reduce informational asymmetries between themselves and inside (executive) directors (Beasley et al., 2001). The presence of NEDs is expected to increase auditor independence since the external auditor is able to discuss matters arising from the audit process with non-executive directors free from managerial influence. The development of audit committees has further enhanced the role of NEDs in this respect. In light of the above arguments, it is expected that, in the event of auditor change, companies with a greater proportion of NEDs on the board would provide a better monitoring on the management action. Given the bad effects of auditor change on users' perception, the company with better directors' independence will be less likely to change auditor.

H1: Board of directors' independence is negatively associated with auditor change.

### *2.2 Hypothesis 2: The existence of a dominant personality (duality)*

Besides the composition of outside directors on the board, the separation of the roles of the chairman of the board and the chief executive officer (CEO) can also affect the independence of the board. The Cadbury Report and the Combined Code in the UK suggest that the roles of the chairman and CEO should be separated. A separate chairman, who is more likely to monitor the interests of the shareholders, can countervail CEO power. Whenever the same person acts as both chairman and CEO

(i.e. duality), the CEO will have greater stature and political influence over board members and this has the potential to undermine the independence of the board (Jubb, 2000). As the duality implies influence by an insider on the board, then it can be expected that auditor change would be more likely in the presence of chairman and CEO duality than in its absence.

In light of the above discussion, it is expected that the presence of a dual chairman/CEO is positively associated with the propensity to change auditor. Further as duality decreases the level of a board's independence, it is expected that the presence of dual chairman/CEO is negatively associated with higher quality new auditor selection.

H2: The presence of a dual chairman/CEO is positively associated with auditor change.

### 3. Methods

#### 3.1 Sample selection

Initial annual listings of all companies were obtained from the official list of companies listed on Bursa Malaysia, as on 31st December of 2007 to 2011. This source contains comprehensive entries of all companies and securities listed on the Main Market or ACE Market (prior to 2010, the list includes Second Board and MESDAQ market). As extracted from Datastream on 2nd September, 2015, 763 companies were continuously listed on Bursa Malaysia from the period of 2007 to 2011. Twenty five companies were excluded from the total population due to incomplete data (annual report not available). Furthermore, 26 companies were similarly excluded since the said companies changed auditor more than once during that period. The total sample size became 712 companies, which included 191 auditor-changed companies, and 521 non-auditor changed companies.

#### 3.2 Model estimation

The logistic model to estimate the auditor change was developed to include potential determinant variables. The estimation is as below.

$P(\text{audchg}=1) = f(\text{nedbod}, \text{dual}, \text{nas}, \text{nasaudfee}, \text{mgtchg}, \text{levtdta}, \text{sizeasset}, \text{growth}, \text{lgaud fee}, \text{opinion and big4})$ .

Where;

- audchg = The estimated conditional probability of auditor change
- nedbod = A proxy for BODs independence as measured by the percentage of non-executive directors on BODs. Equal '1' if the ratio of NED on BODs equal or higher than the sample median, '0' otherwise.
- dual = Equals '1' if the chairman is also the MD/CEO during the year preceding auditor change or '0' otherwise.
- nas = Equal '1' if NAS provided to client is higher the sample median or '0' otherwise.

<i>nasaudfee</i>	=	A proxy auditor independence as measured by the ratio of non-audit services fee paid to the auditor to the total audit fee during the year of auditor change.
<i>mgtchg</i>	=	Equals '1' if the company had change managing director or CEO during the year of auditor change or '0' otherwise.
<i>levtdta</i>	=	Total debt/total assets
<i>lgsizeasset</i>	=	Natural log of total assets
<i>growth</i>	=	Percentage change in sales
<i>lgaud fee</i>	=	Audit fee paid to auditor fee during the year of auditor change.
<i>opinion</i>	=	A qualified opinion indicator variable, coded '1' if the company was issued with qualified audit opinion during the year of auditor change or '0' otherwise
<i>big4</i>	=	Equals '1' if the company's auditor was a big4 during the year preceding auditor change or '0' otherwise

#### **4. Results**

Table 1 presents the results for the auditor change model. Based on the results of this study, board independence is significant at the p-value of 0.072. The finding is contradicted to H1. This suggests that the greater the percentage of independent board members, the more likely a company will change auditor. This is possibly due to demand by independent directors for the company to change to a higher quality auditor. Another explanation is that the change was initiated to avoid auditor's familiarity threat.

However, CEO duality was found to be not significant. This finding does not support H2 which stated that the presence of dual chairman/CEO is positively associated with auditor change. The result supports the findings of O'Sullivan (1999), which revealed that there is no significant relationship between the two variables. Hence, in respect to the above assertion, a company that is being run by a chairman who is also the Chief Executive Officer (CEO) does not seem to influence auditor change decision.

Other significant determinants include a change in management, size and brand name auditor. The findings document a p-value of 0.077, indicating that management changes could influence auditor change decision. The result is consistent with the findings of Nazri et al. (2012). The study also documents a strong association between size and auditor change decision. This finding is supported by prior studies such as Nazri et al. (2012), Ismail et al. (2008), Hudaib and Cooke (2005) and Huson, Ali, Anuar, Ariff and Shamsheer (2000). Additionally, the brand name auditor (i.e. Big 4) was also found to be a significant determinant, indicating a negative association between the two variables. A company seems less likely to change auditor if its current auditor is one of the Big 4.

**Table 1.** Results of Auditor Change Model

Variables	Coef.	Std. Err.	z	p>z
nedbod	1.3275	0.7390	1.8000	0.0720*
dual	-0.2977	0.2471	-1.2100	0.2280
nas	-0.3945	0.1990	-1.9800	0.0470**
nasaudfee	-0.0077	0.0422	-0.1800	0.8550
mgtchg	0.5336	0.3017	1.7700	0.0770*
levtdta	0.0003	0.0003	0.8200	0.4110
lgsizeasset	-0.4884	0.2016	-2.4200	0.0150**
growth	0.0001	0.0002	0.6200	0.5350
lgaud_fee	0.4928	0.3060	1.6100	0.1070
opinion	0.2785	0.5268	0.5300	0.5970
big4	-1.1852	0.2056	-5.7600	0.0000***
cons	0.7607	0.8666	0.8800	0.3800

Notes: The dependent variable (audchg) is 1 for auditor-changed companies. The p-values are based on two-tailed tests.  
 \*, \*\*, \*\*\* denotes significance at 10%, 5% and 1% level, respectively.

## 5. Conclusion

The research objective of the study is to investigate the impact of corporate governance on auditor change decision. Based on a sample size of 712 non-financial companies, the results suggest board independence as one of the determinant factors of auditor change. Other significant determinants include the provision of non-audit service, changes in management, size and Big 4. The outcome of the study indicates the impact of sound governance on auditor change decision and might provide insightful knowledge which helps shareholders to realize the importance of having balance BODs. The study recommends that future studies should include additional corporate governance variables such as the effectiveness of audit committee, management ownership and ownership concentration. Lastly, a longer period of years could be covered to have a true reflection on the issue.

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