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INTERNATIONAL JOURNAL OF ECONOMICS AND FINANCIAL ISSUES
EJ EconJournals
ISSN: 2146-4138

International Journal of Economics and Financial Issues

ISSN: 2146-4138

available at http: www.econjournals.com

EJ EconJournals

International Journal of Economics and Financial Issues, 2016, 6(S7) 77-80.

Special Issue for "International Soft Science Conference (ISSC 2016), 11-13 April 2016, Universiti Utara Malaysia, Malaysia"

The Association between Corporate Governance and Auditor Switching Decision

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ABSTRACT

The purpose of this study is to examine the association between corporate governance and the propensity of auditor switching. In particular, the study seeks to investigate whether board independence and Chairman - Chief Executive Officer (CEO) duality, influence the auditor-client realignment exercise. Understanding the reasons why companies switch auditor is very important as auditor switching could inhibit the flow of capital in the securities markets, and subsequently, increase the capital costs. 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 the companies with higher non-executive directors than the sample median tend to switch auditor. The Chairman-CEO duality, however, has no effect on the decision. The results also suggest that the provision of non-audit service, changes in key management, company size and Big 4 are significant determinants of auditor switch decision. The outcome of the study indicates the importance of sound governance on auditor switch decision and might provide insightful knowledge which helps shareholders to realize the importance of having balance BODs.

Keywords: Auditor Switch, Audit Market, Auditor Change, Corporate Governance, Malaysia
JEL Classifications: M41, M43, M49

1. INTRODUCTION

In the middle of year 2002, Andersen, one of the top five audit firms in the world, was convicted of obstruction of justice for shredding documents related to the failed US energy giant, Enron. Andersen ceased its business in August 2002, and its business was acquired by other firms. The demise of Andersen and the collapse of Enron have ignited intense debate regarding audit market competition and audit quality. 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.

The issue of auditor choice is not straightforward. According to Abdel-Khalik (2002), 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. Therefore, the real motivation for auditor-client re-alignment might be known only to management.

Generally, evidence suggests that auditor switches 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 (Knapp and Elikai, 1988). Despite the importance of understanding the motivations for, or determinants of, auditor switch, little has been done to investigate the issue, particularly in emerging market such as Malaysia.

In Malaysia, studies on auditor switch can be considered scarce. The most recent studies; Nazri et al. (2012a) and Nazri et al. (2012b) recommended that a study should be conducted on corporate governance characteristics such as board independence and Chief Executive Officer (CEO) duality, so as to shed more light on this particular subject. Other prior Malaysian's studies (e.g. Ismail et al., 2008; Joher et al., 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 switch studies by examining the possible influence of internal corporate governance mechanisms on auditor switch decision. Thus, the purpose of this study is to provide an answer to this research question: What is the association between corporate governance and auditor switching 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 organized 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 HYPOTHESES

Most prior studies on the auditor switch or change decision in Malaysia have examined auditor switch determinants such as change in management, audit opinion, client size (Nazri et al. 2012a; Ismail et al., 2008). However, studies on corporate governance characteristics such as board independence, 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 switch. However, despite the findings providing invaluable evidence on the issue of auditor switch in the country, they still recommended a replication of their study with other determinants of auditor switch such as: Audit tenure, Non-audit services, board independence, auditor-client relationship and CEO duality. Ismail et al. (2008) cover the period from 1997 to 1998. The study examined major determinants of auditor switch; however, corporate governance variables were not examined in the study as determinants of auditor switch. Joher et al. (2000) cover a relatively old dataset (1986-1996). While providing invaluable evidence about the auditor switch issue, the study focuses mainly on how the switch 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 et al., 1998). A major role of a company's board is its control function, which includes monitoring top management actions to ensure that executives fulfill their responsibilities to the company (Fama and 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 behavior (Fama and Jensen, 1983). 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 and Petroni, 2001). Thus, the larger the proportion of independent NEDs on the board, the more effective it will be in monitoring managerial opportunism (Fama and Jensen, 1983).

Empirical studies (e.g., Dechow et al., 1996) have shown that when boards of directors are more independent, they tend to act in the best interests of shareholders. 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 and Petroni, 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 NEDs 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 switch.

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 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 switch auditor.

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

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 2007-2011. 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. 25 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 switch was developed to include potential determinant variables. The estimation is as below.

P (audswch=1)=f (nedbod, dual, nas, nasaudfee, mgtchg, levtdta, sizeasset, growth, lgaud fee, opinion and big4).

Where;

audswch=The estimated conditional probability of auditor switch and the dependable variables are:
nedbod=A proxy for BODs independence. 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 switch or '0' otherwise.
nas=Equal '1' if NAS provided to client is higher the sample median or '0' otherwise.
nasaudfee=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 switch.
mgtchg=Equals '1' if the company had change managing director or CEO during the year of auditor switch or '0' otherwise.
levtdta=Total debt/total assets.
lgsizeasset=Natural log of total assets.
growth=Percentage change in sales.
lgaud fee=Natural log of audit fee paid to auditor fee during the year of auditor change.
opinion=A qualified opinion indicator variable, coded '1' if the company was issued with qualified audit opinion during the year of auditor switch or '0' otherwise.
big4=Equals '1' if the company's auditor was a big4 during the year preceding auditor switch or '0' otherwise.

4. RESULTS

4.1. Descriptive Analysis

Table 1 presents descriptive statistics of variables that influenced auditor switch decision in Malaysia. The result is presented in terms of mean, median, standard deviation, minimum and maximum values of each construct. As can be seen from the Table 1, auditor change switch has a mean value of 0.2683, indicating 26.83% of the sample had switched auditor during the period.

Table 1: Results of descriptive statistics

Variables	Mean	Median	Standard deviation	Min	Max
audswch	0.2683	0.00	0.4434	0	1
nedbod	0.4404	0.43	0.1248	0	1
dual	0.1713	0.00	0.3771	0	1
nas	0.5183	1.00	0.5000	0	1
nasaudfee	0.8572	0.09	15.8386	−0.24	422.68
mgtchg	0.0899	0.00	0.2862	0	1
levtdta	57.0734	31.575	264.3675	−3441.55	5146.49
lgsizeasset	5.5402	5.46	0.7390	3.41	8.53
growth	37.6701	6.87	721.9040	−100	19210.54
lgaud_fee	2.1230	2.05	0.4476	0.60	4.20
opinion	0.0253	0.00	0.1571	0	1
big4	0.5548	1.00	0.4973	0	1

With regards to nedbod, 44.04% of the companies were found to have number of NEDs more than the sample median. For duality, 1 is labeled if the chairman is also the CEO during the preceding year of auditor change, then 0 otherwise. The statistics suggests that 17.13% of the companies were run by the CEOS, who was also the chairman. In respect to nas, the mean, median and standard deviation value is 0.5183, 1 and 0.5000. Minimum value is 0 while the maximum value is 1. In terms of nasaudfee, the mean value indicates 0.8572; median value indicates 0.09, while standard deviation value is 15.8386. It shows a minimum value of −0.24 while the maximum value indicates 422.68.

For management change (mgtchg) variable, it equals 1 if the company had changed managing director or CEO during the year preceding auditor change or 0 if otherwise. The mean value indicates close to 9% of companies had changed their CEO. Leverage (levtdta) has a mean value of 57.0734, median value of 31.575 and a standard deviation value of 264.3675. Meanwhile, the assets mean, median and standard deviation value, after transformation, is 5.5402, 5.46 and 0.7390 respectively. The minimum value reports 3.41 while the maximum value is 8.53. Growth indicates a mean value of 37.67014, median value of 6.87 and standard deviation value of 721.904. For audit fee, the mean, median and standard deviation value are 2.1230, 2.05 and 0.4476 respectively; while the minimum value is 0.6 and maximum value is 4.2.

The Table 1 also reports that 2.5% of the sample companies were issued with qualified audit opinion during the year of auditor switch. The results also suggest that 55% of the companies were audited by Big 4, i.e., PWC, EY, KPMG and deloitte.

4.2. Model Estimation

Table 2 presents the results for the auditor switch model. Based on the results of this study, board independence is significant at the P = 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

Table 2: Results of auditor switch model

Variables	Coefficient	Standard error	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
Number of obs	712			
LR Chi-square (11)	89.57			
P>Chi-square	0.0000			
Pseudo R^2	0.1082			
Log likelihood	−369.25745			

The dependent variable (audswch) is 1 for auditor-changed companies. The P values are based on two-tailed tests. *, **, ***Denotes significance at 10%, 5% and 1% level, respectively

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 H_2 which stated that the presence of dual chairman/CEO is positively associated with auditor change. The result supports the findings of O'Sullivan (2000), 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 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 = 0.077, indicating that management changes could influence auditor switch decision. The result is consistent with the findings of Nazri et al. (2012a). 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. (2012b), Ismail et al. (2008), Hudaib and Cooke (2005) and Huson et al. (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 switch auditor if its current auditor is one of the Big 4.

5. SUMMARY AND CONCLUSION

The research objective of the study is to investigate the impact of corporate governance on auditor switch decision. In particular, the study investigates the association between board independence, duality and the propensity to switch auditor. Based on a sample size of 712 non-financial companies, the results suggest board independence as one of the determinant factors of auditor switch. 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 switch 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.

6. ACKNOWLEDGEMENT

This paper is financially supported by the Universiti Utara Malaysia's PIBT research grant.

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