Beattie, V. and Fearnley, S. (1998) Audit market competition: auditor changes and the impact of tendering. *The British Accounting Review* 30(3):261-289.

Audit Market Competition: Auditor Changes and the Impact of Tendering

Vivien Beattie and Stella Fearnley***

* Vivien Beattie is a Professor of Accounting in the Department of Accountancy and Finance, University of Stirling.
** Stella Fearnley is a Principal Lecturer in Accounting in the Department of Accounting and Management Science, University of Portsmouth.

Address for correspondence
Department of Accountancy and Finance, University of Stirling, Stirling, UK, FK9 4LA.
Tel. 0144-1786 467306; Fax 0144-1786 567308.

Acknowledgements
The financial support of the Research Board of the Institute of Chartered Accountants in England and Wales is gratefully acknowledged. We also wish to thank the Editor, Stuart Turley, and the anonymous referees, for their extremely helpful comments.

Audit Market Competition: Auditor Changes and the Impact of Tendering

ABSTRACT

Increased competition within the external audit market and the recent phenomenon of audit tendering has renewed interest in the factors influencing auditor changes. In this paper, a questionnaire instrument is used to elicit perceptions of the factors which influence auditor-client realignments in this new environment and to indicate the relative influence of economic and behavioural factors. Positive, statistically significant associations were found between unsolicited approaches and the consideration of either a change in auditor or the conduct of a competitive tender. Fees are both the most frequently cited reason for considering auditor change and the most frequently cited factor influencing the selection of a new auditor. The chemistry of the relationship with senior audit firm personnel was ranked as more important than service issues in new auditor selection. Several significant associations between the reasons for change and both company size and type of change are identified. In particular, smaller companies, and companies changing from a non-Big Six firm, were more likely to change due to the need for a wider range of services and the influence of third parties. Findings indicated that 55% of auditor changes were effected by means of a tender, with the incumbent auditor having only an 18% chance of retaining the client. The various stages of the tender process appear to be dominated by the finance director, with audit committees having a restricted role. Tenders resulted in significant fee reductions in the year of change.

Keywords: auditor change, audit quality, audit tender, auditor independence, low-balling, opinion-shopping, price cutting.

Audit Market Competition: Auditor Changes and the Impact of Tendering

INTRODUCTION

Background

The last decade has seen major changes in economic and regulatory aspects of the auditing environment in many countries. These changes began with the worldwide recession, dating from the late 1980s, which led to a significant increase in the level of competition within the external audit market. Many companies failed, resulting in overcapacity on the supply side of the market, while those companies which survived sought to cut costs, including the audit fee. The fee minimisation strategies employed by companies included aggressive renegotiation with the incumbent auditor and the emergence of audit tendering.[1] It is also alleged that companies felt more able, due to their increased bargaining power, to `opinion shop', i.e., to exert pressure on the incumbent auditor to change their opinion by seeking a second view on an accounting or auditing issue (Waller, 1991).[2] Audit firms also appeared to adapt their behaviour in response to these new competitive pressures: audit fees began to decline in real terms, and there were *prima facie* cases of `low-balling', where incoming auditors were believed to have secured their appointment by offering significant fee reductions. In addition, a number of international audit firms merged in the late 1980s, with further mergers among mid-tier and lower-tier firms occurring at the national level.

These behavioural changes have generated concern among the profession's regulatory bodies, since they undermine the actual or perceived quality of the audit function, principally by threatening auditor independence. For example, in the UK, the chairman of the Financial Reporting Council stated that `the highly competitive nature of the audit market, the right of directors to seek an "alternative" opinion where an auditor's guidance is unwelcome, and their ability to control audit fees, may be seen as a potential source of pressure on auditors...' (Financial Reporting Council, 1991, p.6).[3]In the US, the Texas Public Accountancy Act specifies that audits performed for less than reasonable labour costs violate independence. Those auditors found guilty could lose their practising licence. Similarly, in the UK, the Chartered Accountants' Ethical Guide has been revised to require audit firms who offer fees lower than another to ensure that clients are not misled as to the services covered or the determination of current or future fee levels and, where audit work is obtained, be able (in the event of a complaint) to demonstrate that independence and quality are unimpaired (ICAEW, 1994, p.227). A recent ICAEW working group has, however, found `no evidence of a reduction in quality or effectiveness of audit work arising as a result of competitive pricing' (ICAEW, 1995).

This changing environment of the external audit market has impacted upon the three principal inter-related dimensions of this market: pricing, auditor-client alignments, and audit quality. The present paper focuses on auditor-client realignments and related pricing issues. Increased competition is believed to have resulted in tendering, audit fee discounting, low-balling, opinion-shopping, and audit firm mergers. Tendering has been specifically identified as a means by which independence is threatened (Moizer, 1994, p.20). Direct consequences of this behaviour are real decreases in audit fees and an increase in auditor switching. In the US, Maher, Tiessen, Colson & Broman (1992) found that, after controlling for the effect of changes in company size, complexity, and risk, real audit fees fell between 1977 and 1981, a period of apparent increasing competition, while in the UK real audit fees paid by the top 100 publicly traded companies fell in 1992 and 1994 (Accountancy, November 1992; Accountancy Age, 26th May 1994). Evidence of price cutting associated with auditor changes has been found in both the US (Simon & Francis, 1988), and the UK (Pong & Whittington, 1994; Gregory & Collier, 1996), although not in Australia (Butterworth & Houghton, 1995). In a recent study of changing levels of auditor concentration in the UK listed company market, there was found to be a general increase in concentration from 1987 to 1991, with the six-firm concentration ratio rising from 0.546 to 0.723. This increase was attributable to both voluntary realignments and audit firm mergers. The annualised rate of voluntary realignments was high compared to that found in previous periods and in other countries, indicating greater instability in auditor-client relationships (Beattie & Fearnley, 1994, pp.319-320). The need to understand the effect of increased competition on the factors influencing auditor changes is emphasised by Anderson, Stokes & Zimmer (1993, p.65).

At present, the theory of auditor choice and change is grounded in economic theory. It is recognised, however, that this extant theory is not comprehensive (Knapp & Elikai, 1988, p.78). In particular, we argue that this economic theory is deficient in three areas. First, it does not address the *specific* audit firm selected from a general class. Second, the imperfect explanatory power of statistical models indicates that extant theory is unable to rationalise the cause of a significant number of auditor changes, and third, that there are companies which, though predicted to change auditors, do not do so.

We suggest here that these deficiencies are due partly to a failure to incorporate *behavioural* factors into theoretical explanations of the choice process. For example, the specific choice of audit firm is often attributed to positive personal client-auditor relationships, with negative relationships giving rise to auditor changes in some cases (Eichenseher and Shields, 1983). More generally, the potential for new insights into buyers' behaviour is offered by the `relationships approach' to professional services developed in the service marketing literature, which classifies relationships (in the present case, auditor-client relationships) based on buyer type (Sharma, 1994). This approach can explain, for example, why some buyers remain loyal to one seller, while others are inherently bargainers. Thus an economics-based framework can be expected to provide only a partial explanation of auditor choice. The relative influence of economic and behavioural factors in this choice process awaits detailed empirical research.

Aims and objectives

The general aim of the present study is to extend our understanding of the range of factors influencing auditor changes within the current external auditing environment, which is characterised by increased competition. Existing beliefs are based largely on intuition and casual empiricism and, from a research perspective, it is important to confirm or refute these beliefs on the basis of systematic empirical evidence. This aim is achieved by means of a questionnaire survey of 508 listed UK company finance directors. This method provides richer insights than is possible using secondary data analyses, which focuses on economic factors, since the questionnaire instrument includes both economic and behavioural factors. Questionnaires do, however, (in common with all research methods) have inherent limitations, resulting from non-response bias, uninformed respondent bias, variable interpretation of the meaning to be attributed to key terms, and conscious or unconscious misreporting.

The process of auditor change can be separated into two principal stages (Francis & Wilson, 1988, p.668) - the decision to change and the choice of new auditor. Our general objective is to investigate and compare the relative influence of economic and behavioural factors at each stage of this process. In addition, this study explores audit tendering, which is a pricing mechanism only recently used in the audit market. To achieve this, we have developed nine specific objectives, which fall into three groups, moving from the general to the more specific:

The general incidence and effectiveness of alternative auditor change mechanisms

1. to establish the incidence of various mechanisms (i.e., unsolicited approach from audit firm, approach by company to another audit firm, audit tender) through which auditor-client realignments can occur within the population;
2. to investigate whether there exists an association between an unsolicited approach by an audit firm and the consideration of either a change in auditor or the conduct of a competitive tender within the population;

Factors relating to auditor changes

3. to document the declared reasons why companies considered changing auditor and compare the responses of `changers' with `non-changers';
4. to investigate the association, if any, between the incidence of auditor change and client company industry, size, and the existence of an audit committee;
5. to investigate the association, if any, between declared reasons for change and (a) company size, and (b) type of change (i.e., to/from a Big Six/non Big Six firm);
6. to identify the factors influencing the selection of a new auditor;
7. to identify the effects of auditor change on the client company; and

Factors relating to audit tendering

8. to investigate the association, if any, between the incidence of audit tendering and client company industry, size, and the existence of an audit committee;
9. to collect descriptive data on the tendering process, i.e., the number of firms invited to tender, the basis of their selection, and the parties involved.

The remainder of this paper is structured as follows. Section two reviews the extant auditor choice literature and identifies the importance of behavioural factors which may affect auditor-client alignments. Section three outlines the sample and data collection procedures employed. The results, together with discussion, are presented in section four. The final section summarises and concludes.

AUDITOR CHANGE LITERATURE

Auditor choice depends upon the client's characteristics, potential auditors' characteristics, and the auditing environment. For a company to change its auditor, there needs to be a significant change in one (or more) of these three factors, since switching costs (direct and indirect) are material.[4] Auditor change can have a number of consequences, such as a share price reaction, change in audit fee, change in audit opinion and/or a change in the quantity of non-audit services (NAS) purchased from the incumbent.

The auditor choice literature emerged 25 years ago in response to concerns that long periods of auditor tenure, whilst potentially resulting in improved service and lower fees, may impair the auditor's independence. Early empirical studies predated theoretical work, and initially took the form of questionnaire studies, which collected management's declared reasons for actual auditor changes (Burton & Roberts, 1967; Bedingfield & Loeb, 1974). Given the absence of any theoretical framework, these questionnaires were apparently open-ended in nature. Carpenter & Strawser (1971) selected for questioning only companies making an initial public offering, in order to investigate the hypothesis that this event often triggers an auditor change.

These early studies suffered from two major problems. First, the method used typically generates unidimensional responses and, second, the analysis of responses involves a degree of subjective classification. To overcome these problems, Eichenseher & Shields (1983) used an indirect semantic-differential scaling method to rate clients' perceptions about the attributes of their displaced and new auditors. Eleven auditor characteristics were rated, with perceived changes in the relative levels of fees and quality of working relationships emerging as most strongly associated with auditor changes.

Wallace (1985) provided one of the first theoretical analyses of the demand for external audit services. She identified three related sources of demand: agency (or stewardship) demand, information demand and insurance demand. An audit can reduce the agency costs attributable to self-interested behaviour and information asymmetries. Since agency costs vary, there is a heterogeneous demand for audit services, characterised by deAngelo (1981a, b) as different levels of audit quality. Information asymmetries also generate the information demand for audit. The selection of credible auditors not only signals management's honesty and quality, but also reduces agency costs via the monitoring function. This particular form of audit differentiation was explored originally by Dopuch & Simunic (1980 and 1982). The arguments of both deAngelo and Dopuch & Simunic are often referred to as the `product differentiation hypothesis'. The third source of demand is provided by the insurance dimension of an audit, insofar as investors and creditors are indemnified against financial loss via the auditor's professional liability exposure.

Demand-side factors indicate client characteristics (in particular, agency-related factors such as size, level of gearing, and management share ownership) which will determine the *type* of audit firm selected, in terms of its quality and credibility. The *specific* audit firm chosen is also influenced by supply-side factors, i.e., auditor characteristics such as specialisation in audit technologies, industry specialisation, and the quality of working relationships with the audit team. Specialisation can be expected to yield both economies of scale, which permit firms to offer competitive fees, and economies of scope, which enable the provision of sophisticated audit services in addition to a range of NAS.

Several other client or auditor characteristics have been cited as relevant in the auditor choice decision. First, it is argued that the existence of significant foreign operations increases the likelihood that a large audit firm will be selected since these firms can achieve multinational scale economies (Eichenseher, 1985). Second, it is argued that auditor choice can be partly explained by the existence of interlocking directorates between client companies (Davison, Stening & Wai, 1984). Third, client and auditor structure are believed to be associated, with unstructured clients choosing unstructured auditors and vice versa (Kaplan, Menon & Williams, 1990).[5] Finally, the geographical proximity of the auditor has been argued to be relevant since it permits a flexible and timely response to client needs (Stokes, 1992).

In the 1980s, statistical studies using publicly available data employed an indirect approach, examining the association between a specific client or auditor characteristic and observed auditor choice, initially using univariate tests. The specific characteristics examined were those economic factors cited frequently in the early questionnaire studies and/or arising from a priori theory.

Statistical studies have examined the association between either (i) specific client or auditor characteristics and observed auditor choices, or (ii) *changes* in these characteristics and observed auditor *changes*. Firth & Smith (1992) find that the selection of a Big Eight audit firm (a brand name proxy for audit quality) is associated with agency cost variables and the need for signalling. Positive associations have been found between the propensity to change auditors and the early and late stages of the auditor-client relationship (Levinthal & Fichman, 1988), initial public offerings (Menon & Williams, 1991), disagreements (deAngelo, 1982), and financial distress (Schwartz & Menon, 1985; Schwartz & Soo, 1994). Moreover, Dhaliwal, Schatzberg & Trombley (1993) find that clients changing auditor after a disagreement have poorer economic performance than comparable non-changers. The relatively high frequency of auditor change associated with corporate takeovers where companies changed to the acquiror's auditor, is taken as evidence of economies of scale by Anderson, Stokes & Zimmer (1993). Chow & Rice (1982), Craswell (1988), and Citron & Taffler (1992) find a positive relationship between auditor change and the receipt of a qualified audit opinion, although this finding is not supported by Schwartz & Menon (1985). Krishnan (1994) finds evidence that it is the auditor's overall conservatism (reflected in their tendency to issue qualified opinions), rather than the receipt of a qualification per se, which triggers the change. The propensity to change auditors has, however, been found *not* to be related to the level and type of NAS purchased (DeBerg, Kaplan & Pany, 1991).

More recent multivariate studies have shown auditor changes to be associated with the incumbent's industry specialisation and tenure, the receipt of adverse media publicity by the client company (Williams, 1988), client company financial distress, size and mergers, and the market share and size of the auditor (Lindahl, 1992), client financial distress, size, and growth, together with audit firm fee levels and industry dominance (Haskins & Williams, 1990), changes in client characteristics that influence supplier costs (expansion, financing, profitability and audit risk) (Johnson & Lys, 1990), and agency cost variables (Francis & Wilson, 1988; DeFond, 1992). Healy & Lys (1986) find that companies audited by a non-Big Eight firm are more likely to retain a Big Eight acquiror following an audit firm merger if they benefit from the Big Eight firm's specialised services and/or reputation. A useful summary of many of these studies is provided by Yardley, Kauffman, Cairney & Albrecht (1992).

A further type of empirical study to emerge during this period explored the observable consequences of auditor change. Although auditor changes generally result in negative share price reactions,the price fall is, in most cases, not significant (Fried & Schiff, 1981; Nichols & Smith, 1983; Smith, 1988; and Johnson & Lys, 1990). Auditor changes associated with disagreements, qualified audit opinions, and changes away from Big Eight auditors do, however, result in statistically significant negative price movements, especially at high levels of management ownership (Smith, 1988; Eichenseher, Hagigi & Shields, 1989; and Albrecht & Lamy, 1992). Hagigi, Kluger & Shields (1993) use capital market data to show that auditor change announcements reduce the dispersion of investor beliefs by reducing information asymmetries and increasing consensus. A second consequence of auditor change following receipt of a qualified opinion has been the receipt of `improved' opinions in some studies (Craswell, 1988), but not in others (Chow & Rice, 1982 and Smith, 1986). The level of NAS purchased has been found to decline following auditor change (DeBerg, Kaplan & Pany, 1991). A final consequence relates to audit fees. Although early studies did not find evidence of price cutting (Francis, 1984; Palmrose, 1986), Simon & Francis (1988) and Ettredge & Greenberg (1992) find an average discount in the initial year of 24% and 25%, respectively. Evidence of low-balling has also been found in the UK (Pong & Whittington, 1994; Gregory & Collier, 1996), but not in Australia (Butterworth & Houghton, 1995).

Despite recent theoretical developments (especially deAngelo (1981 a,b), Dye (1991), and Kanodia & Mukherji (1995)), the theory of auditor choice remains under-specified. Extant characterisations of the auditor choice process focus exclusively on the *economic* determinants of the type of audit firm selected and the forces generating change. This framework is, however, deficient, since qualitative behavioural factors are not incorporated. (It may be noted that behavioural extensions to economic models of securities market behaviour are being debated in finance (Kleidon, 1987; Miller, 1987)). The analysis of market structure and competition based on brand choice and switching models has received considerable attention in the marketing literature. Research in this area has adopted one of two approaches, depending on whether product alternatives or consumers are grouped. Recently, models which simultaneously group consumers and brands have been proposed. McCarthy, Kannan, Chandrasekharan & Wright (1992) is a typical example of this line of research. Service marketing research, in particular that relating to professional services, has revealed the importance of the *relationship* between the buyer and the seller, relative to characteristics of either the buyer or seller in isolation (Gronroos, 1990; Sharma, 1991). Sharma (1994) identifies, based on interviews, four buyer types (the bargainer, the loyal, the confused, and the competent) based on two dimensions of buying situations: piecemeal versus project and price versus quality.

In addition, the failure of some companies to change auditors when it is justified in economic terms can be attributed to `inertia'. More formally, the auditor choice decision has a status quo alternative, and it has been shown that people select this alternative disproportionately. The psychological finding is known as `status quo bias' (Samuelson & Zeckhauser, 1988).

The economic theory of auditor choice and the empirical statistical analyses of auditor changes using publicly available data reviewed in this section have enhanced our understanding of the auditor change process. The factors which previous studies have identified as influencing the consideration of auditor change, the selection of a new auditor, and/or the effects of a change have been incorporated into the survey instrument used in the present study. Additional qualitative behavioural factors have been added to the factor set to address objectives 3, 6, and 7. The incidence, nature, and impact of various auditor change mechanisms (in particular, tendering) (objectives 1, 2, 4, 5, 8, and 9) have not been the subject of prior systematic, empirical study. Given the exploratory, and hence largely descriptive, nature of this latter aspect of the study, no formal hypotheses have been developed.

METHODS

Choice of method

Our selected method of investigation is a questionnaire for three reasons. First, since it is acknowledged that current theory is not well specified (Knapp & Elikai, 1988), the general objective of this study is to incorporate qualitative behavioural factors concerning auditor-client relationships into the research design, to assess the relative influence of each factor type. This necessitated the use of a direct method. Second, other specific objectives necessitate the use of direct methods to elicit non-public information. Finally, closed-form questions can be identified from the extant auditor choice literature. This type of question is preferable to the open-form questions used in early questionnaire studies (Converse & Presser, 1986, p.34; Fowler, 1984, p.103).

Sample selection and construction of mailing list

To address the range of research questions posed above, it was necessary to construct two distinct samples. Both samples are drawn from the population of domestic officially listed and Unlisted Securities Market (USM) companies in the UK and Ireland as at 30th April 1992 (n=2079). A listing of these companies was obtained from Extel Financial Ltd. First, to determine the general incidence and nature of certain events, processes and attitudes within the population as a whole it was necessary to use a random sample. A sample size of 300 (sample 1) is used. Second, to permit specific auditor changes and tenders to be investigated using sample sizes which support meaningful analysis, we identified, by reference to relevant Stock Exchange Yearbooks (ISE, various) all those companies which had *voluntarily* changed auditor within the preceding three years. *Involuntary* changes arising from audit firm mergers were not included. Apart from those companies which were already included in our random sample (sample 1), this process yielded a further 208 changers (sample 2). We were then able to partition this combined group, according to their questionnaire responses, into (i) changers/non-changers, and (ii) tenderers/non-tenderers.

However, it must be understood that an externally or legally recognisable auditor change, such as we identified from the Stock Exchange Yearbooks, may not always be viewed in the same way by the auditees themselves. In circumstances where there is a change to or from a joint appointment, or to or from a single appointment, and one firm remains in post, it may be that no real change is perceived by the auditee, especially if the personnel remain the same. As this study focuses on the declared responses of auditees, where discrepancies arose between our respondents' declaration of auditor change and changes identified from the Stock Exchange Yearbooks, we have based our analysis on the questionnaire responses. An alternative explanation of these discrepancies arises where the respondent recently joined the company after a change of auditor, and therefore has no recall of the change.

Design of research materials and questionnaire administration procedures

The research instrument was designed with close reference to the literature on questionnaire design (Hoinville, Jowell & Associates, 1978, ch.3; Moser & Kalton, 1979, ch.13; Sudman & Bradburn, 1982; Fowler, 1984, ch.6; and Converse & Presser, 1986]. The questionnaire contained six sections, of which the third and fourth form the basis of the present paper. The first section contained general questions about the company and its auditors. The third section identifies those companies which have considered making a voluntary change in auditors during the past five years, elicits how seriously this change has been considered and asks the respondent to indicate which of 26 reasons caused a change to be considered. This section also covers cases of *actual* change and status quo decisions. The fourth section deals with a range of mechanisms (including tender) through which change can occur.

The draft questionnaire was pretested with the assistance of several senior business executives and audit partners and the content, ordering and terminology was revised accordingly. The questionnaires (serially numbered to permit non-respondents to be followed up) were accompanied by an explanatory letter which assured the confidentiality of responses and return envelopes were provided. A reminder letter was sent out after ten days, with a second request (accompanied by a duplicate copy of the questionnaire and the original covering letter) being sent after a further ten days (Fowler, 1984, ch.3).

RESULTS

Response rate

From a total of 508 companies surveyed during June 1992 (samples 1 and 2), 328 usable responses were received (a response rate of 65%). The sample design and response rates are summarised in Table 1.

[Table 1 about here]

Tests for bias

Four tests for response bias were performed on the full complement of 508 companies surveyed. First, the Wilcoxon-Mann-Whitney non-parametric test was used to compare responding and non-responding companies on the basis of size (measured as total assets). The hypothesis that the two groups have been drawn from the same population was not rejected (α = 0.05). This comparison was also applied to early (first 100) and late (last 100) responders, on the assumption that late responders are similar to non-responders (Oppenheim, 1966, p. 34). Again, the null hypothesis of no difference was not rejected (α = 0.05). Third, the companies were formed into four broad industrial groupings based on Stock Exchange groups (capital goods, consumer goods, other and financial). A chi-squared test indicated an association between industry and response/non response (α = 0.01). The percentage of responders was highest among the `other' group (80%) and lowest among the consumer group (59%). Finally, using background data on auditor changes drawn from the Stock Exchange Yearbook, responding and non-responding companies were compared on the basis of this key summary variable. A chi-squared test indicated an association between recent auditor change (i.e., change during the last five years) and response/non response (α = 0.05) with 69% of non-changers responding compared to 60% of changers.[6]

Given the limitations of such tests (discussed by Wallace and Mellor, 1988), and the high response rate obtained, we conclude, however, that response bias is not a serious threat to the validity of our results. In addition, nearly all respondents were senior executives who one would expect to be intimately involved in the auditor choice decision. Thus, the risk of uninformed respondent bias is considered to be minimal. Table 2 analyses respondents by size and industry.

[Table 2 about here]

The remainder of this section addresses three issues. First, the general incidence of various change mechanisms within the population as a whole is considered, based on responses from a random sample (objectives 1 and 2). Second, the reasons for considering change, the selection of a new auditor, and the effects of change are considered (objectives 3 to 7), using the augmented sample partitioned into `changers' and `non-changers'. Finally, the sub-sample of audit tenderers is examined (objectives 8 and 9).

Incidence of potential change mechanisms and status quo decisions within the population based on responses from the random sample (sample 1)

Objective 1 concerns the range of mechanisms through which a change of auditor might occur. In the questionnaire we defined a `competitive tender' as the situation where a company seeks a formal tender (i.e., specification of services and fees) from two or more auditors *other than* the incumbent. We defined the situation where only one other auditor is involved as an `approach' made by the company, which was distinguished from `unsolicited approaches' made by an audit firm.

In the random sample comprising 210 respondents (sample 1), 50 companies (24%) had received, during the past five years, at least one unsolicited approach by another audit firm seeking appointment. This has clearly resulted from the removal of the restrictions on solicitation and the existence of competition among audit firms. In 16 (32%) cases, the company had some form of existing relationship with the audit firm making the approach and in 37 (74%) cases at least one member of senior management had personal experience/knowledge of the firm. Clearly the network of personal contacts is a very important factor.

During the same time period, 54 companies (26%) had made an `approach' to another audit firm with a view to appointing them as auditors and in 42 (78%) of these cases the company had an existing relationship with, or prior knowledge of, the audit firm.

139 (66%) companies had considered changing their auditor, and 37 (18%) actually effected a change during the past five years. The proportion of companies considering change can be taken as an indicator of the level of commitment to, and stability of, the auditor-client relationship. An 18% rate of auditor change over five years equates to 3.6% per annum, which is comparable to the rate found by Beattie & Fearnley (1994). Similarly, competitive tenders had been considered by 140 companies (67%) during the

past five years, with 18% having considered the matter very seriously, 10% seriously, 11% fairly seriously and 28% casually. 32 sample respondents (15%) had actually conducted a tender during this period, with a further 89 (42%) companies indicating that there was some likelihood that a tender would be conducted during the subsequent twelve months. These findings are summarised in Table 3.

[Table 3 about here]

Objective 2 concerns whether the consideration of either a change in auditor or the conduct of a competitive tender may be triggered by an unsolicited approach to the company. Using chi-squared tests, highly significant associations between the receipt of an unsolicited approach and the consideration of change was found ($\chi^2 = 13.95$, $p = 0.00$) and between the receipt of an unsolicited approach and the conduct of a tender ($\chi^2 = 10.75$, $p = 0.00$). Of those companies which had received such an approach, 88% had at least considered changing auditor, compared to 59% of those companies which had not received an approach.[7] Similar results were obtained for the consideration of tendering, with the relevant percentages being 86% and 61% respectively. These associations may reflect inertia within the audit market and/or careful targeting by audit firms. Again, using chi-squared tests, we investigated whether these associations were related to company size by splitting the sample into two groups based on the median level of total assets (£50m). The incidence of change consideration following an unsolicited approach was identical across the two groups and, although large companies were more likely to consider tendering following an unsolicited approach, the difference was not significant ($\chi^2 = 1.53$, $p = 0.216$).

Auditor changes

The total 328 respondents were partitioned into three groups on the basis of their declared responses: 109 companies which stated that they had changed auditors during the past five years (`changers'), 126 companies which had considered (to a greater or lesser extent) changing auditors but had not currently made a change (`potential changers'), and 93 companies which had not considered changing auditors at all (`non-changers'). To address objective 3, a comparison of the stated reasons for considering change for the changers and potential changers is given in Table 4. These reasons include both economic and behavioural factors which potentially affect auditor-client realignments. We identify 18 reasons as purely economic factors, five reasons purely behavioural factors, and the remaining three as having both economic and behavioural dimensions. The 109 changers cited a total of 431 reasons, representing an average of 3.9 contributory reasons each, while the 126 potential changers cited a total of 369 reasons, representing an average of 2.9 contributory reasons each.

[Insert Table 4 about here]

It is apparent that there are many significant differences between the two groups. Interestingly, given the concern regarding price-cutting, the level of audit fee is of significantly *less* importance to actual changers compared to potential changers, although it is still the most frequently cited contributory reason for change for both groups. This level of importance is broadly consistent with the growing body of evidence documenting price cutting on initial audit engagements (Simon & Francis, 1988; Ettredge & Greenberg, 1990; Pong & Whittington, 1994; and Gregory & Collier, 1996).

Other reasons cited by 25% or more of the changers and which are of significantly *more* importance to the actual changers are dissatisfaction with audit quality (41%), changes in company's top management (35%), need for group auditor rationalisation (28%), need for Big Six audit firm (26%) and merger/takeover with/by another company (25%). Lower down the table appears a group of reasons which are also of significantly *more* importance to the actual change group and which mostly relate to audit team and the influence of third parties. These reasons are: poor working relationships with audit partner/staff, inaccessibility of audit partner, influence of merchant banker/underwriter, influence of actual or potential equity or loan providers and need for multinational audit firm with foreign offices in same geographical areas as client's operations. Curiously, the use of inexperienced audit engagement staff is of significantly *less* importance to actual changers. It would appear that this problem is not sufficient in itself to precipitate an auditor change. Overall, economic factors appear to dominate behavioural factors in auditor-client relationships.

Disagreements over accounting principles and disagreement with the audit opinion are cited by 6% and 3%, respectively, of actual changers. The `information suppression hypothesis' posits that the relatively high proportion of `audit failures' following auditor changes results from client management successfully concealing sensitive financial information (Knapp & Elikai, 1990). Based on a questionnaire study of 94 US audit partners, Knapp & Elikai (1990) find that their respondents believe that 20% of all auditor changes result from an information suppression motive. However, based on the evidence from declared responses in the present study, information suppression is a less common cause of auditor change in the UK, although the documented level may, nevertheless, be considered cause for concern. In addition, given the sensitive nature of this issue, it is likely that declared responses underreport the incidence of these reasons for change.

A comparison was made between the industry group, size distribution, and existence of an audit committee of changers compared to non-changers plus potential changers (objective 4). A chi-squared test indicated no association between industry group and auditor change ($\chi^2 = 4.69$, $p = 0.20$). Three approximately equal size classes were formed, based on information supplied by Extel Financial Ltd.: large companies (total assets $\geq$ £100m), medium companies (£20m $\leq$ total assets $<$ £100m) and small companies (total assets $<$ £20m). The incidence of auditor change was significantly higher among smaller companies ($\chi^2 = 13.87$, $p = 0.001$): 21% of large companies changed auditors, compared with 36% of medium companies, and 45% of small companies. The incidence of auditor change was also significantly higher among companies which did *not* have an audit committee $\chi^2 = 2.60$, $p = 0.107$): 28% of companies with an audit committee changed auditor compared with 36% of companies with no audit committee. This may be due simply to the fact that smaller companies, which are less likely to have an audit committee, are more likely to need to change auditors as growth causes changing needs. We speculate that this may be attributable to either greater inertia due to the committee structure or the audit committee preventing *ad hoc* changes arising at the instigation of the executive directors (especially the finance director).

Next, we investigated whether the declared reasons for change were associated with company size (objective 5a). Changers were split into two groups based upon the median level of total assets (£22.9 million). Not surprisingly, significantly more small companies cited the influence of actual or potential equity or loan providers ($\chi^2 = 4.35$, $p = 0.037$), the need for an audit firm with a local domestic office (χ^2 = 2.84, p = 0.092), and the need for a national, rather than local, audit firm (χ^2 = 6.39, p = 0.011), whereas significantly more large companies cited merger/takeover with/by another company (χ^2 = 9.05, p = 0.003) and need for group auditor rationalisation (χ^2 = 16.96, p = 0.000). Interestingly, there was no significant difference between the frequency with which level of audit fee (the most frequently cited reason for considering a change across all changers) was cited by small and large companies.

We also investigated whether the declared reasons for change were associated with the *type* of change, i.e. to/from a Big Six/non-Big Six firm (objective 5b). Changers were divided into four groups; Big Six to Big Six, Big Six to non-Big Six, non-Big Six to Big Six, and non-Big Six to non-Big Six. Using chi-squared tests, significant associations were found at the 10% level for 11 of the 26 reasons. Of these, five reasons were cited most frequently by the non-Big Six to Big Six group: influence of merchant bankers/underwriters (χ^2 = 6.87, p = 0.076), influence of actual or potential equity or loan providers (χ^2 = 9.55, p = 0.023), company growth required increased technical capacity from audit firm (χ^2 = 14.78, p = 0.002), need for multinational audit firm with foreign offices in same geographical areas as foreign operations (χ^2 = 14.95, p = 0.002), and need for Big Six firm (χ^2 = 15.03, p = 0.002). Thus it is the influence of third parties and changing needs which tend to cause changes from non-Big Six to Big Six firms. These findings are consistent with the existence of a `size effect', whereby smaller companies tend to have smaller audit firms (Moizer & Turley, 1987, p.120). Since smaller growing companies have changing needs not satisfied by smaller audit firms, this results in `Big Six drift'. It is these changes which are responsible for the rising level of seller concentration in the UK listed audit market (Beattie & Fearnley, 1994). Five reasons were cited most frequently by the (relatively small) Big Six to non-Big Six group: audit firm merger (χ^2 = 7.24, p = 0.065), change in audit partner (χ^2 = 9.35, p = 0.025), need for local (rather than national) audit firm (χ^2 = 16.34, p = 0.001), level of audit fee (χ^2 = 11.60, p = 0.009), and high turnover of audit engagement staff (χ^2 = 12.33, p = 0.006). This suggests a group of companies who became disenchanted with either the nature of Big Six audit staffing or the premium paid for a Big Six firm. Merger/takeover with/by another company (χ^2 = 10.88, p = 0.012) was most frequently cited by the Big Six to Big Six changers.

Objective 6 concerns the factors which influenced the selection of a new auditor (stage two of the auditor change process). Five factors were cited by over 25% of the 109 auditor changers (see Table 5). `Competitive audit fee' is most frequently cited (73%), closely followed by `chemistry of relationship with senior audit firm personnel' (63%). This illustrates the influence of both economic and behavioural factors in this stage of the auditor choice decision.[8] We also investigated whether the factors influencing the selection of a new auditor were associated with company size. The only significant association was in respect of international spread and capabilities of audit firm, the fourth most frequently cited factor (χ^2 = 4.50, p = 0.034). 45% of large companies cited this, compared to only 25% of small companies.

[Table 5 about here]

Objective 7 concerns the perceived effects of auditor change on the company are summarised in Table 6. Improved audit quality, value for money and reduced audit fee are each cited by just over half of the auditor changers. Next in importance were effects relating to other services, while 10% cited `disruption and loss of management time' and 5% cited a `change of accounting policy(ies)' as an effect.[9]

[Table 6 about here]

Audit tenders

Seventy-three companies had conducted a competitive tender during the past five years. Addressing objective 8, no significant association was found between client company industry group, size, or the existence of an audit committee and the conduct of a competitive tender (α = 0.05). The lack of an association between the existence of an audit committee and tendering is perhaps surprising, since anecdotal evidence suggests that non-executive directors (who often form the majority of audit committees) generally favour tenders relative to executive directors. This is attributed to non-executive directors focusing on potential fee reductions rather than the costs of tendering and change which fall on the company.

Objective 9 was to collect descriptive data on the tendering process. Of the 73 tendering companies, 57 (78%) sought a tender from the incumbent auditor. Thus 22% of incumbent auditors were not invited to tender, implying that the company had already taken the decision to change auditors. It has been argued that putting the audit out to tender is merely a strategy adopted for renegotiating the audit fee with the incumbent auditor (MacErlean, 1993, p.43). In our sample, 82% of the tendering companies also changed auditors, suggesting that this is a strategy which is neither widely adopted nor successfully employed. Thus, once a company has decided to incur the costs of actually conducting a tender (rather than merely threatening to do so), the incumbent has only an 18% chance of retaining the client.

The number of tenders invited, including the incumbent where relevant, ranged from two to eight, as shown in Table 7, with a mean of 3.6. Each bid must be evaluated, which is a costly exercise for the client, however the larger the number of bidders, the higher the probability that the lowest-cost supplier will be included and the greater the level of competition in the bidding process. The bases on which companies selected those audit firms invited to tender are shown in Table 8. Audit firm reputation was most frequently cited, either exclusively (22% of companies), or in combination with other factors (49% of companies). Previous knowledge and experience of the audit firm was the next most important basis for selection, with the expectation of a reduced audit fee cited by less than 50% of companies.[10]

[Insert Tables 7 and 8 about here]

Eleven companies (15%) were approached by additional audit firms seeking to tender - in 3 cases the approach was from one additional firm, in six cases from two firms and in 2 cases from three firms. These audit firms may have become aware of the tender through media comment or personal contact.

Currently, little is known about the audit tendering process. We therefore identified five stages in this process: (i) initiation of idea, (ii) invitation of bids, (iii) attendance at presentations, (iv) evaluation of bids, and (v) final decision, and sought to identify those individuals or groups within the company who were involved in these stages. The results are summarised in Table 9, which distinguishes *sole* from *joint* involvement in each tender stage. A number of observations can be drawn from the general pattern of responses in this table. First, fewer parties are involved in the early stages of the tendering process (initiation and invitation of bids) compared to the later stages (presentations, evaluation and decision), with the early stages more frequently being the responsibility of a sole party. Second, the sole party most often responsible for these early stages was the finance director, who initiated the idea in 27 companies and invited bids in 39 companies. Thus audit committees generally play a passive role in setting the process of auditor change in motion. Third, responsibility for attending and evaluating audit firm presentations was generally not the sole responsibility of any one individual or group. Those parties most frequently involved were, in descending order and in both stages, the finance director, managing director, chairperson, chief accountant, audit committee and audit committee chairperson. Fourth, the final decision was taken by a single party in 23 companies; most frequently by the chairperson (five cases) and the audit committee (five cases). Finally, the pervasive influence of the finance director throughout the process, and the restricted role of the audit committee, is clearly apparent. In this context, it should be noted that at the time of this study only 32 of the companies which tendered (44%) did in fact have an audit committee.[11] Further research based on a survey of audit committee members would provide triangulation of these findings.

[Insert Table 9 about here]

The extent of price cutting following tender is summarised in Table 10. Two points can be noted from this table. First, there does not appear to be any difference between the pattern of prices quoted by incumbent auditors and others, when compared to the current level of audit fees. Both sets of auditors are prepared to offer significant fee reductions. 59% of incumbent auditors quoted materially (i.e., 5%) below the current fee level, compared with 69% of other quotes. Second, just over one third of all quotes are more than 20% lower than the current audit fee, which suggests widespread undercutting. These results support those of Gregory & Collier (1996), who estimate a discount of 22.4% for the 28 companies in their study who changed auditors in the past three years. It can also be noted that 88% of respondent companies considered the fees quoted to be realistic.

[Table 10 about here]

Discussion

Major findings of this study relate to the role of audit fee level in audit relationships and the influence of behavioural factors in the process of auditor choice. Each is now discussed briefly. The relative importance of audit fee levels to auditees appears to change throughout the auditor selection and change process. When selecting firms to tender, the expectation of a reduced audit fee is not a top priority. This finding is consistent with the findings of a study by Beattie & Fearnley (1995) which reports that low absolute level of audit fee is ranked in importance only 22nd out of 29 audit firm characteristics. In triggering the consideration of change, however, and in either selecting the new auditor or making the status quo decision, fees are the primary decision variable. This may occur because the decision maker can more readily justify their selection decision to third parties on the basis of an observable benefit such as fees. Fees are, however, of significantly less importance to actual changers compared to potential changers, and fees are seldom the only reason for change. The existence of substantial price competition in the tendering process is demonstrated by the willingness of audit firms involved in tenders to quote materially below the current fee level.

The relative influence of economic and behavioural factors varies throughout the change process. Economic factors dominate in the decision to change auditors; behavioural factors seldom being the sole reason for change. In selecting a new auditor, however, the `chemistry of the relationship with senior audit firm personnel', although secondary to price considerations, dominates factors relating to the range and level of service offered. It may be that companies genuinely consider the quality of relationships to be of greater importance to them than service issues. Alternatively, companies may take for granted that all audit firms will deliver an acceptable range and level of service. The influence of behavioural factors in the auditor selection and change process is further revealed in the use of personal contacts made by both auditors and auditees. This is evident both in unsolicited approaches and invitations to tender.

SUMMARY AND CONCLUSIONS

Further understanding of the motivations for auditor change, and the impact of increased competition within the external audit market, is hampered by the fact that these motivations are not generally observable. Casual empirical evidence suggests that the level of audit fee is a major cause of recent auditor changes, with competitive tenders a primary mechanism of change. In this paper the reasons for auditor change are elicited by means of a closed-form questionnaire instrument developed from the extant literature. Since this study is conducted in a more overtly competitive environment than existed at the time of prior surveys, it provides a relevant setting for the examination of the current dynamics of the market.

The incidence of potential change mechanisms within the population as a whole is estimated from a questionnaire survey of 300 randomly selected listed UK companies. Between 1987 and 1992, 24% of companies had received an unsolicited approach, 26% had made an approach, 67% had considered conducting a competitive tender, 15% had conducted a competitive tender and 66% had considered changing auditors. These findings jointly indicate a high degree of potential instability in the market. Moreover, positive, statistically significant associations were found between unsolicited approaches (which were not permitted until 1983) and the consideration of either a change in auditor or the conduct of a competitive tender.

Based on a choice-based sample of 109 companies which had recently changed auditor, auditor change was found not to be associated with industry group, but was significantly higher among smaller companies and companies with no audit committee. Level of audit fee was the most frequently cited reason for changing auditor and the most frequently cited factor influencing the selection of a new auditor. When selecting firms to tender, however, the expectation of a reduced audit fee was not a top priority. Significant differences were found between the reasons for auditor change and the reasons for considering, but not actually making, an auditor change. In particular, fees were of significantly less importance to actual changers. The reasons for change were found to vary with company size. Small companies were more likely to cite as a reason for change the influence of third party capital providers and changing needs. Large companies were more likely to cite merger/takeover and group rationalisation as a reason for change. The reasons for change were also associated with the type of change. The influence of third parties and changing needs were most frequently cited in non-Big Six to Big Six changes, whereas dissatisfaction with aspects of audit staffing and the premium paid for a Big Six firm were most frequently cited in changes from Big Six to non-Big Six.

In general, economic factors were found to dominate behavioural factors in auditor-client relationships. Economic factors were found to dominate the auditor change decision; in selecting a new auditor, however, the `chemistry' of the relationship with senior audit firm personnel (i.e., a behavioural consideration) was more important than the range and level of service offered. Further research into the dimensions of the `chemistry' factor is clearly warranted.

Aspects of the audit tender process were explored based on a sample of 73 companies which had conducted a competitive tender. Audit tendering was not associated with industry group, company size or the existence of an audit committee. Findings indicated that 55% of auditor changes were effected by means of a tender, with the incumbent auditor having only an 18% chance of retaining the client. This is despite the fact that significant fee reductions were, in general, quoted by the incumbent, in common with other bidders. Thus tenders are an effective fee cutting mechanism in the year of change. An investigation of the parties involved in five identified stages in the tender process revealed that the finance director dominates the process, and that the role of audit committees is restricted, again particularly in the early stages.

Whilst we have attempted to minimise and identify the threats to validity inherent in the questionnaire approach (i.e., through rigorous piloting, thorough administration procedures, and tests for bias), they cannot be eliminated completely. In particular, the findings are based on declared responses rather than latent facts. Although there has been found to be `a general congruence' between the findings of direct and indirect methods of eliciting reasons for auditor change (Eichenseher and Shields, 1983, p.31), further research using a variety of methods is desirable. In particular, in-depth interviews with changers would provide additional insights into the behavioural aspects of auditor change and the nature of the tender process. Additionally, further research could explore the extent to which auditor changes are averted by fee reductions from the incumbent.

In due course it may be possible to synthesise economic and behavioural/cognitive elements into a theory which is capable of explaining both individual auditor choice decisions and decisions in the aggregate. In the meantime, this study provides further insights into the dynamics of the external audit market.

NOTES

1. For example, in the UK, significant audit fee reductions attributed to keen negotiation include those of Burtons, Budgens and the TSB (Accountancy Age: 11th June 1992, 3rd September 1992, and 25th February 1993). Audit fees were reported to be a significant factor in the change of auditor following tenders by Prudential Assurance, Gresham Telecomputing, Tomkins, John Foster, and RAC (Accountancy, August 1991; Accountancy Age: 10th October 1991 and 30th April 1992; AA Magazine, May 1992; Accountancy Age, 27th April 1995).

2. For example, in the UK, accounting problems and disputes were alleged to have been the cause of auditor changes by Menzies, Holmes Protection, Alexanders Holdings and Adams & Co. (Accountancy Age: 5th September 1991, 28th November 1991, and 3rd December 1992).

3. The Financial Reporting Council and its associated bodies was set up to control the process of standard setting following the Dearing Report (1988).

4. Direct costs to the audit firm include search costs and start up costs (Krishnan, 1992), with start up costs varying due to cross-sectional variation in the level of non-audit services (NAS) and knowledge spillovers (DeBerg, Kaplan & Pany, 1991). Direct costs to the client concern loss of management time. Indirect costs arise from increased information risk, i.e., suspicion of opinion shopping (Williams, 1988), which Smith & Nichols (1982) have shown to result in negative share price reactions.

5. Client structure is measured in terms of industry stability while auditor structure relates to the flexibility permitted in audit planning and testing.

6. This test does not distinguish potential changers from other non-changers, since the required information is not available for non-respondents.

7. This is consistent with recent evidence from the U.S. audit market, which finds that, during the period 1980 to 1988, clients are more likely to change auditors when direct solicitation is allowed (Chaney, Jeter & Shaw, 1997).

8. The `other' reasons cited by respondents included: group auditors (5 cases), auditors of company recently merged with (2 cases), auditors of main shareholder (1 case), suitable location of offices nationally (2 cases), recommendation (2 cases), knowledge of firm (3 cases), to preserve a good partner relationship following partner change of firm (1 case), move away from Big Six (2 cases), need for national/international firm (2 cases) and to avoid a big firm which competes with the company in an area of business (1 case).

9. The `other' effects cited by respondents were: improved relationships (5 cases), close proximity of overseas/local offices to operations (2 cases); better tax advice (1 case), *decrease* in audit quality (1 case), independent approach (1 case) and too early to say (2 cases).

10. The `other' bases for selection related to existing relationships within the group (3 cases), location of offices (2 cases), perception of compatibility of the two firms' styles, technical presentation of audit procedures and practices, personal chemistry, and partner's attitude (1 case each).

11. This study was conducted before the Cadbury committee's proposals were adopted by the Stock Exchange.

REFERENCES

Accountancy, (1991). `Cost isn't everything to clients', Vol.108, p. 10.

______, (1992). `No growth from top 100 companies', Vol.110, November, pp. 14-15.

Accountancy Age, (1991). `Peats ousted as Coopers Deloitte win Menzies audit', 5th September.

________, (1991). `Auditors stay put in fee dispute', 10th October.

________, (1991). `Andersens replace Peats on Holmes audit', 28th November.

________, (1992). `Competitive fees reveal price war', 30th April.

________, (1992). `Burton forces PW to slash audit fee by 29%', 11th June.

________, (1992). `Pressure for lower audit fees increases', 3rd September.

________, (1992). `Audit firm quits major Ford dealer', 3rd December.

________, (1993). `TSB forces Peats audit down by £1m', 25th February.

________, (1994). `FT-SE 100: the £350m fees bonanza', 26th May.

________, (1995). `Institute drawn into RAC "lowballing" row', 27th April.

AA Magazine, (1992). `True and fair blame?', May, pp. 23-36.

Albrecht, W.D. & Lamy, R.E. (1992). `The determinants of the market reaction to an announcement of a change in auditor', AAA conference paper.

Anderson, D., Stokes, D. & Zimmer, I. (1993). `Corporate takeovers and auditor switching', *Auditing: A Journal of Practice and Theory*, Vol.12, No.1, Spring, pp. 65-73.

Beattie, V.A. & Fearnley, S. (1994). `The changing structure of the market for audit services in the UK: a descriptive study', *British Accounting Review*, Vol.26, December, pp. 301-322.

_______________ (1995). `The importance of audit firm characteristics and the drivers of auditor change in UK listed companies', *Accounting and Business Research*, Vol. 25, Autumn, pp. 227-239.

Bedingfield, J.P. & Loeb, S.E. (1974). `Auditor changes - an examination', *Journal of Accounting*, March, pp. 66-69.

Burton, J.C. & Roberts, W. (1967). `A study of auditor changes', *Journal of Accountancy*, April, pp. 31-36.

Carpenter, C.G. & Strawser, R.H. (1971). `Displacement of auditors when clients go public', *Journal of Accountancy*, June, pp. 55-58.

Chaney, P.K., Jeter, D.C. & Shaw, P.E. (1997). `Client-auditor realignment and restrictions on auditor solicitation', *The Accounting Review*, Vol.72, No.3, July, pp.433-453.

Chow, C.W. & Rice, S.J. (1982). `Qualified audit opinions and auditor switching', *The Accounting Review*, Vol.57, No.2, pp. 326-335.

Citron, D.B. & Taffler, R.J. (1992). `The audit report under going concern uncertainties: an empirical analysis', *Accounting and Business Research*, Vol.22, No.88, pp. 337-345.

Converse, J.M. & Presser, S. (1986). *Survey Questions: Handcrafting the Standardized Questionnaire*, Beverly Hills, Sage Publications.

Craswell, A.T. (1988). `The association between qualified opinions and auditor switches', *Accounting and Business Research*, Vol.19, No.73, pp. 23-31.

Davison, A.G., Stening, B.W. & Wai, W.T. (1984). `Auditor concentration and the impact of interlocking directorates', *Journal of Accounting Research*, Spring, pp. 313-317.

DeAngelo, L.E. (1981a). `Auditor independence, "low balling", and disclosure regulation', *Journal of Accounting and Economics*, Vol.3, pp. 113-127.

DeAngelo, L.E. (1981b). `Auditor size and audit quality', *Journal of Accounting and Economics*, December, pp. 183-199.

DeAngelo, L.E. (1882). `Mandated successful efforts and auditor choice', *Journal of Accounting and Economics*, Vol.4, pp. 171-203.

Dearing, R. (1988) *The Making of Accounting Standards*, Report of the Review Committee, London, ICAEW.

DeBerg, C.L., Kaplan, S.E. & Pany, K. (1991). `An examination of some relationships between non-audit services and auditor change', *Accounting Horizons*, March, pp. 17-28.

DeFond, M.L. (1992). `The association between changes in client firm agency costs and auditor switching', *Auditing: A Journal of Practice and Theory*, Vol.11, No.1, pp. 16-31.

Dhaliwal, D.S., Schatzberg, J.W. & Trombley, M.A. (1993). `An analysis of the economic factors related to auditor-client disagreements preceding auditor changes', *Auditing: A Journal Of Practice & Theory*, Vol.12, No.2, Fall, pp. 22-38.

Dopuch, N. & Simunic, D. (1980). `The nature of competition in the auditing profession: a descriptive and normative view'. In J.W. Buckley & J.F. Weston (eds), *Regulation and the Accounting Profession*, Lifetime Learning Publications.

Dopuch, N. & Simunic, D. (1982). `Competition in auditing: an assessment', Fourth

Symposium on Auditing Research, University of Illinois)

Dye, R.A. (1991). `Informationally motivated auditor replacement', *Journal of Accounting and Economics*, Vol.14, pp. 347-374.

Eichenseher, J.W. (1985). `The effects of foreign operations on domestic auditor selection', *Journal of Accounting, Auditing and Finance*, Vol.8, No.3, pp. 195-209.

Eichenseher, J.W. & Shields, D. (1983). `The correlates of CPA - firm change of publicly-held corporations', *Auditing: A Journal of Practice and Theory*, Vol.2, No.2, pp. 23-37.

Eichenseher, J.W., Hagigi, M. & Shields, D. (1989). `Market reaction to auditor changes by OTC companies', *Auditing: A Journal of Practice and Theory*, Fall, pp. 29-40.

Ettredge, M. & Greenberg, R. (1990). `Determinants of fee cutting on initial audit engagements', *Journal of Accounting Research*, Vol.28, No.1, pp. 198-210.

Financial Reporting Council, (1991). *The State of Financial Reporting - A Review*, London, Financial Reporting Council.

Firth, M. & Smith, A. (1992). `Selection of auditor firms by companies in the new issue market', *Applied Economics*, Vol.24, pp. 247-255.

Fowler, F.J. (1984). *Survey Research Methods*, Beverly Hills, Sage Publications.

Francis, J. (1984). `The effect of audit firm size on audit prices: a study of the Australian market, *Journal of Accounting and Economics*, Vol.6, pp. 133-151.

Francis, J.R. & Wilson, E.R. (1988). `Auditor changes: a joint test of theories relating to agency costs and auditor differentiation', *The Accounting Review*, Vol.63, No.4, pp. 663-682.

Fried, D. & Schiff, A. (1981). `CPA switches and associated market reactions', *The Accounting Review*, April, pp. 324-341.

Gregory, A. & Collier, P. (1996). `Audit fees and auditor change: an investigation of the persistence of fee reduction by type of change', *Journal of Business Finance and Accounting*, March (forthcoming).

Gronroos,C. (1990). `Relationships approach to marketing' *Journal of Business Research*, Vol.20, pp.3-11.

Hagigi, M., Kluger, B.D. & Shields, D. (1993). `Auditor change announcements and dispersion of investor expectations', *Journal of Business Finance and Accounting*, Vol.20, November, pp. 787-802.

Haskins, M.E. & Williams, D.D. (1990). `A contingent model of intra-big eight auditor changes', *Auditing: A Journal of Practice and Theory*, Vol.9, No.3, pp. 55-74.

Healy, P. & Lys, T. (1986). `Auditor changes following big eight mergers with non-big eight audit firms', *Journal of Accounting and Public Policy*, Vol.5, pp. 251-265.

Hoinville, G., Jowell, R. & Associates. (1978). *Survey Research Practice*, Heinemann.

ICAEW (1994). *Members Handbook Volume 1: Constitutional, Legal, Ethical*, London, Institute of Chartered Accountants in England and Wales.

___ (1995). *Report to the council of the ICAEW of the working group on competitive pricing*, London, Institute of Chartered Accountants in England and Wales.

ISE. (various years). *The International Stock Exchange Official Yearbook*, Macmillan Publishers Ltd.

Johnson, W.B. & Lys, T. (1990). `The market for audit services: evidence from voluntary auditor changes', *Journal of Accounting and Economics*, Vol.12, pp. 281-308.

Kaplan, S.E., Menon, K. & Williams, D.D. (1990). `The effect of audit structure on the audit market', *Journal of Accounting and Public Policy*, Vol.9, pp. 197-215.

Kanodia, C. & Mukherji, A. (1995). `Audit pricing, lowballing and auditor turnover: a dynamic analysis', *The Accounting Review*, Vol.69, No.4, October, pp. 593-615.

Kleidon, A.W. (1987). `Anomalies in financial economics: blueprint for change' In R.M. Hogarth & M.W. Reder (eds), *Rational Choice: the Contrast Between Economics and Psychology*, pp. 285-315, Chicago, University of Chicago Press.

Knapp, M.C. & Elikai, F.M. (1990). `Auditor changes and information suppression', *Research in Accounting Regulation*, Vol.4, pp. 3-20.

Krishnan, J. (1992). `An empirical model of opinion shopping behaviour', Paper presented at the AAA Annual Conference.

______ (1994). `Auditor switching and conservatism', *The Accounting Review*, Vol.69, No.1, January, pp. 200-215.

Levinthal, D.A. & Fichman, M. (1988). `Dynamics of interorganizational attachments: auditor-client relationships', *Administrative Science Quarterly*, Vol.33, pp. 345-369.

Lindahl, F.W. (1992). `How much do we know about auditor changes? The effect of observed and unobserved heterogeneity', Paper presented at the AAA Annual Conference.

MacErlean, N. (1993). `Entrants line up for a beauty contest', *Accountancy*, May, pp. 42-43.

Maher, M.W., Tiessen, P., Colson, R. & Broman, A.J. (1992). `Competition and audit fees', *The Accounting Review*, Vol.67, No.1, pp. 199-211.

McCarthy, P.S., Kannan, P.K., Chandrasekharan, R. & Wright, G.P. (1992). `Estimating loyalty and switching with an application to the automobile industry', *Management Science*, Vol.38, No.10, pp. 1371-1393.

McConnell, D.K. (1984). `Auditor changes and related disagreements', *Auditing: A Journal of Practice and Theory*, Vol.3, No.2, pp. 44-56.

Menon, K. & Williams, D.D. (1991). `Auditor credibility and initial public offerings', *The Accounting Review*, Vol.66, No.2, pp. 313-332.

Miller, M. (1987). `Behavioral rationality in finance: the case of dividends' In R.M. Hogarth & M.W. Reder (eds), *Rational Choice: the Contrast Between Economics and Psychology*, pp. 285-315, Chicago, University of Chicago Press.

Moizer, P. (1994). `Review of recognised supervisory bodies: a report to the Department of Trade and Industry on the audit monitoring process', London, Department of Trade and Industry.

_____ & Turley, S. (1987). `Surrogates for audit fees in concentration studies', *Auditing: A Journal of Practice and Theory*, Vol.7, No.1, pp. 118-123.

Moser, C.A. & Kalton, G. (1979). *Survey Methods in Social Investigation*, 2d ed., Gower.

Nichols, D.R. & Smith, D.B. (1983). `Auditor credibility and auditor changes', *Journal of Accounting Research*, Autumn, pp. 534-544.

Oppenheim, A.N. (1966). *Questionnaire Design and Attitude Measurement*, Heinemann.

Palmrose, Z. (1986). `Audit fees and auditor size: further evidence', *Journal of Accounting Research*, Vol.24, No.1, pp. 87-110.

Pong, C.K.M. & Whittington, G. (1994). `The determinants of audit fees: some empirical models', *Journal of Business Finance and Accounting*, Vol.21, No.8, pp. 1071-1095.

Samuelson, W. & Zeckhauser, R.(1988). `Status quo bias in decision making', *Journal of Risk and Uncertainty*, Vol.1, No.1, pp. 7-59.

Schwartz, K.B. & Menon, K. (1985). `Auditor switches by failing firms', *The Accounting Review*, Vol.60, No.2, pp. 248-261.

Schwartz, K.B. & Soo, B.S. (1994). `An analysis of form 8-K disclosures of auditor changes by firms approaching bankruptcy', Working Paper.

Sharma, D.D. (1991). *International Operations of Professional Firms*, Studentlitteratur, Lund, Sweden.

______ (1994). `Classifying buyers to gain marketing insight: a relationships approach to professional services', *International Business Review*, Vol.3, No.1, pp. 15-30.

Simon, D.T. & Francis, J.R. (1988). `The effects of auditor change on audit fees: tests of price cutting and price recovery', *The Accounting Review*, Vol.63, No.2, pp. 255-269.

Smith, D.B. (1986). `Auditor "subject to" opinions, disclaimers, and auditor changes', *Auditing: A Journal of Practice and Theory*, Fall, pp. 95-108.

______ (1988). `An investigation of Securities and Exchange Commission regulation of auditor change disclosures: the case of accounting series release No.165', *Journal of Accounting Research*, Spring, pp. 134-145.

Smith, D.B. & Nichols, D.R. (1982). `A market test of investor reaction to disagreements', *Journal of Accounting and Economics*, October, pp. 109-120.

Stokes, D. (1992). `The market for audit services: evidence from audit firm mergers', AAA conference paper.

Sudman, S. & Bradburn, N.M. (1982). *Asking Questions: A Practical Guide to Questionnaire Design*, Jossey-Bass.

Wallace, R.S.O. & Mellor, C.J. (1988). `Nonresponse bias in mail accounting surveys: a pedagogical note', *British Accounting Review*, Vol.20, pp. 131-139.

Wallace, W.A. (1980). `The economic role of the audit in free and regulated markets', The Touche Ross and Co. Aid to Education Program, (reprinted in *Auditing Monographs*, (1985) Macmillan Publishing Co.

Waller, D. (1991). `A matter of opinion shopping', *CA Magazine*, May, p. 53.

Williams, D.D. (1988). `The potential determinants of auditor change', *Journal of Business Finance and Accounting*, Vol.15, No.2, pp. 243-261.

Yardley, J.A., Kauffman, N.L., Cairney, T.D. & Albrecht, W.D. (1992). `Supplier behaviour in the US audit market', *Journal of Accounting Literature*, Vol.11, pp. 151-184.

Table 1 Sample Design and Response Rates

	Sample type: Random (sample 1)	Choice-based (sample 2)	Total
Sample size	300	208	508
Usable responses	210	118	328
Response rate	70%	58%	65%

Table 2 Analysis of Respondents by Company Size and Industry Group

Size group	Total assets (£million)	Random sample No.	Random sample %	Choice-based sample No.	Choice-based sample %
Small	< 20	74	35.9	49	43.4
Medium	20 - 100	80	38.8	37	32.7
Large	≥ 100	52	25.3	27	23.9
		206[1]	100.0	113[1]	100.0

Industry group	Random sample No.	Random sample %	Choice-based sample No.	Choice-based sample %
Capital goods	70	33.3	29	24.8
Consumer goods	48	22.9	37	31.6
Other (inc. oil and gas)	50	23.8	26	22.2
Financial	42	20.0	25	21.4
	210	100.0	117[1]	100.0

Note 1: Data on several companies was not available.

Table 3 Incidence of Potential Change Mechanisms and the Stability of Auditor-Client Relationships within the Random Sample over a Five Year Period

Unsolicited approach *from* audit firm	24%
Approach *to* audit firm with a view to appointment	26%
Change of auditor considered	66%
Actual change of auditor	18%
Audit tender considered	67%
Audit tender conducted	15%

Table 4 Stated Reasons for Consideration of a Change in Auditor

Rank[1]	Reason[2]	Auditor changers: No. of companies	Auditor changers: % *(n=109)*	Auditor non-changers: No. of companies	Auditor non-changers: % *(n=126)*	χ^2 note 3
1.	Level of audit fee[a]	53	*49*	93	*74*	**
2.	Dissatisfaction with audit quality (i.e. auditor's ability to detect problems)[a]	45	*41*	32	*25*	**
3.	Changes in company's top management[c]	38	*35*	30	*24*	*
4.	Need for group auditor rationalisation[a]	31	*28*	14	*11*	**
5.	Need for Big Six audit firm[a]	28	*26*	6	*5*	**
6.	Merger/takeover with/by another company[a]	27	*25*	10	*8*	**
7.	Company growth required increased technical capacity from audit firm[a]	24	*22*	17	*13*	NS
8.	Poor working relationships with audit partner/staff[b]	19	*17*	11	*9*	*
9.	Need for multinational audit firm with foreign offices in same geographical areas as client's operations[a]	18	*16*	8	*6*	*
10.	Inaccessibility of audit partner[b]	17	*16*	5	*4*	**
11=.	Need for additional services[a]	15	*14*	11	*9*	NS
11=.	Personality clashes with audit partner/staff[b]	15	*14*	17	*13*	NS
13.	Influence of merchant bankers/underwriter[a]	14	*13*	6	*5*	*
14.	Influence of actual or potential equity or loan providers[a]	13	*12*	5	*4*	*
15.	Audit firm merger[b]	11	*10*	19	*15*	NS
16.	Change in audit partner[b]	10	*9*	16	*13*	NS
17.	High turnover of audit engagement staff[c]	8	*7*	19	*15*	NS
18=.	Use of inexperienced audit engagement staff[c]	7	*6*	22	*17*	**
18=.	Disagreements over accounting principles[a]	7	*6*	11	*9*	NS
20=.	Need for national, rather than local, audit firm[a]	6	*5*	4	*3*	NS
20=.	Need for audit firm with local domestic office[a]	6	*5*	3	*2*	NS
22.	Need for audit firm specialising in client's industry[a]	5	*5*	3	*2*	NS
23=.	Influence of regulators[a]	4	*4*	2	*2*	NS
23=.	Influence of company's day-to-day bankers[a]	4	*4*	3	*2*	NS
25=.	Disagreement with audit opinion[a]	3	*3*	2	*2*	NS
25=.	Need for local, rather than national, audit firm[a]	3	*3*	-	-	NS

Notes:

1. Ranks are based on frequency of citation by the auditor change group.
2. Reasons are classified as follows: a = economic; b = behavioural; and c = mix of economic and behavioural dimensions.
3. NS = not significant; * = significant at the 5% level; ** = significant at the 1% level (two-tailed).

Table 5 Stated Factors Influencing Selection of New Auditor

	Factor[1]	Number of companies	% *(n=109)*
1.	Competitive audit fee	80	*73*
2.	\`Chemistry' of relationship with senior audit firm personnel	69	*63*
3.	Business understanding	50	*46*
4.	International spread and capabilities of audit firm	42	*39*
5.	Relevant tax expertise	28	*26*
6.	\`Other'	27	*25*

Note 1: Factors are as shown in decreasing frequency of citation.

Table 6 Stated Effects of Auditor Change on Company

	Effect[1]	Number of companies	*% (n=109)*
1.	Improved audit quality	61	*56*
2=.	Reduction in audit fee	60	*55*
2=.	Improved value for money of audit service	60	*55*
4.	Improved quality of management advice, including management letters	46	*42*
5.	Provision of additional services	26	*24*
6.	Disruption and loss of management time	11	*10*
7.	Change of accounting policy(ies)	5	*5*
8.	\`Other'	12	*11*

Note 1: Effects are shown in decreasing frequency of citation.

Table 7 Number of Tenders Invited (Including Incumbent)

Number	Frequency
2	6
3	31
4	25
5	5
6	2
7	1
8	1
Item non-response	2
Total	73
Mean	3.6

Table 8 Bases for Selection of Audit Firms Invited to Tender

	Basis	Number of companies	% *(n=73)*
1.	Reputation of audit firm	52	*71*
2.	Previous knowledge and experience of audit firm	37	*51*
3.	Expectation of reduced audit fee	30	*41*
4.	\`Other'	9	*12*

Table 9 Parties Involved in the Stages of the Tendering Process

	Stage in tendering process														
	Initiation of idea			Invitation of bids			Attendance of presentations			Evaluation of bids			Final decision		
	Level of involvement			Level of involvement			Level of involvement			Level of involvement			Level of involvement		
Party	Sole	Joint	Combined	Sole	Joint	Combined	Sole	Joint	Combined	Sole	Joint	Combined	Sole	Joint	Combined
Finance director	27	19	46	39	15	54	8	49	57	7	50	57	2	44	46
Managing director	9	11	20	3	8	11	1	35	36	2	30	32	3	30	33
Chairperson	4	7	11	-	6	6	1	23	24	-	23	23	5	32	37
Chief executive	3	-	3	2	-	2	1	2	3	-	3	3	2	2	4
Company secretary	1	1	2	2	1	3	1	2	3	1	1	2	-	3	3
Audit committee	1	1	2	2	3	5	2	14	16	2	15	17	5	16	21
Group financial controller	1	-	1	1	-	1	-	-	-	-	1	1	-	-	-
Holding company	1	-	1	-	-	-	-	-	-	-	-	-	-	-	-
Shareholder	1	-	1	1	-	1	-	-	-	1	-	1	1	-	1
Chief accountant	-	5	5	-	7	7	1	23	24	-	22	22	-	9	9
Non-executive director(s)	-	-	-	-	1	1	-	3	3	1	3	4	2	2	4
Board of directors	-	-	-	-	-	-	-	-	-	-	-	-	3	2	5
Audit committee chairperson	-	-	-	-	3	3	-	13	13	1	12	13	-	9	9
Group internal audit manager	-	-	-	-	1	1	-	-	-	-	1	1	-	-	-
TOTAL	48	44	92	50	45	95	15	164	179	15	161	176	23	149	172
Not applicable/item non-response			7			5			5			4			2

Table 10 Relationship of Audit Fees Quoted in Tender Documents to Current Audit Fee

Audit fee differential	Incumbent auditor's quote		Other audit firms' quotes	
	No.	*%*	No.	*%*
More than 5% higher	3	*5*	8	*5*
Within 5%	23	*36*	40	*26*
Between 5% and 20% lower	15	*24*	53	*34*
More than 20% lower	22	*35*	55	*35*
Total	63	*100%*	156	*100%*