Conflict of Interests, Alien Factor and Auditor Switches
—Empirical Evidences from Chinese Capital Markets

SHEN Hong-bo, WANG Yue
(Shanghai University of Finance & Economics, Shanghai 200433, China)

Abstract: In the audit market of China, it is of theoretical and empirical importance to research the determinants of auditor switches. Using data selected from the 2003 and 2004 annual reports, we analyze the determinants of auditor switches with the Logistic model. We find that the qualified audit opinions and alien factor affect the switch of auditors. We hold that the qualified opinions embody the interest conflict between listed companies and auditors.

Key words: auditor switches; audit opinions; conflict of interests

1. Introduction

Auditor switches have been concerned by the securities regulatory departments and academic researches. They come from the regulatory consideration, i.e., that the auditor switches may imply the audit opinions purchasing; on the other hand, concern also rests with how to understand the switches in the capital market (Bockus and Gigler, 1998). In the United States, the Securities and Exchange Commission (SEC) regulates that listed companies must submit a report to the commission in an 8-K format when they want to switch a certified public accountant. In China, the emerging accounting data fabrication appears to have some certain links with frequent auditor switches. Through frequent switches of CPA，some listed companies intended to achieve the purpose of purchasing audit opinions and concealing false financial information.

According to the conclusions of the overseas scholars, there have some typical views of auditor switches. First, Chow and Rice (1982) proposed the “unclean audit opinions”. They thought firms received unclean audit opinions were more likely to switch accounting firms in the following year. Secondly, Schwarz and Menon (1985) proposed the “conception of financial distress”. They discovered that the companies in the deteriorating financial position or on the verge of bankruptcy were more likely to replace certified public accountants. Thirdly, Lys and Watts (1994) supposed “risk of litigation”. They believed that the more the scale of earnings management companies, the greater disagreement of choosing the accounting policies between the CPAs and clients, so accounting firm had more possibilities to submit the resignation. Fourthly, Johnson and Thomas (1997) proposed the “concept of transaction costs”. They said that in order to reduce audit fees, companies replaced the accounting firms.

Based on the data of listed companies in 2003 and 2004, our paper finds that the qualified audit opinions and alien factors affect the switch of auditors. The framework of this paper is as follows: the second part is the literature and research hypothesis about the main factors of the auditor switches. The third part is research design;

SHEN Hong-bo(1979-), male, PhD candidate of Shanghai University of Finance & Economics; research fields: theory of financial accounting, auditing, corporate finance.
WANG Yue(1978-), female, PhD candidate of Shanghai University of Finance & Economics; research fields: management accounting, theory of auditing.

the fourth part is empirical research results and illumination. Finally, we get the conclusions and give some recommendations.

2. Literature Review and Research Hypothesis

2.1 Audit opinions and auditor switches

The audit opinions transfer useful information to external users of financial statements and benefit the investment decisions. In general, when the manager believes that the unfavorable audit opinions will affect share price and the financing capacity, qualified opinions are likely to offend management and eventually lead to the end of contract between the company and the auditor. Chow and Rice (1982) supported the contention that firms tended to switch auditors after receiving a qualified opinion. GENG Jian-xin and YANG He (2001) found that the listed companies receiving unclean opinions were more likely to switch auditors than receiving clean opinions. Based on the above analysis, this paper proposes the following assumption:

H_1: The incumbent auditor firms issued a qualified opinion are more likely to be switched subsequently.

2.2 Local protectionism, geographical factors and auditor switches

YU Yu-miao (1999) considered that actions of auditor firms were obviously regional, CPA in the audit business were particularly influenced by the local government and difficult to resist such interference when there were much gains and losses between enterprises and local government. GENG Jian-xin and YANG He (2001) also confirmed the existence of geographical factors potentially impact the auditor switches and empirically supported the results. Based on the above analysis, this paper makes the following assumption:

H_2: The different area features between auditors and listed companies are more easily lead to the replacement of auditors.

2.3 Other factors and auditor switches

2.3.1. Saving audit fee

Johnson and Thomas (1997) proposed “the concept of transaction costs” that the company switched auditor firms to reduce audit fees. In the research of Dianel · T. Simon and Jere · R. Francis (1988), they analyzed the audit fee cut for a sample of 412 firms having changed auditors over the period 1979~1984, and the results indicated on average 24 percentage of audit fee was cut.

2.3.2 Changes of company size

Johnson and Lys (1990) proposed, if the company expanded the scale of their operation, there would be a corresponding increase in the complexity of accounting. Then, clients needed to find a higher quality audit firms to meet the audit needs after expansion. We will look the above two factors as control variables and therefore will no longer propose hypotheses about them.

3. Research Design

3.1 Sample and data

In this paper, the sample consists of A-share companies in Shanghai and Shenzhen Stock Exchanges from 2003 to 2004. Our aim is to research the determinants leading to auditor switches. We delete observations following these principles: (1) companies listing time less than one year from the annual reports; (2) companies in the field of finance and insurance industry; (3) data are incomplete. Finally, we get 2307 effective observations (in 2003 and 2004). Financial data and the data of auditor switches come from the website of the China Securities

Regulatory Commission (CSRC) designating—Http://www.cninfo.com.cn and CSMR database.

3.2 Variable selection and definition

According to the prior theory and literature, we have chosen audit opinion and geographical factor as the explanatory variables, while taking into account the changes of listed companies' assets, audit fees and switch years. We take them as control variables. Audit fee means the natural logarithm of the change after switch (Roberts, 1990). Assets scale changes before and after switches use the natural logarithm of the ratio.

3.3 Model

As the independent variable (SWITCH) is a binary variable, and there are both dummy variables and continuous variables in the explanatory variables, the logistic regression model is adopted in this paper.

$$\Pr ob(SWITCH) = \frac{1}{1+e^{-z}}$$

Z is a linear combination of the explanatory variables and the control variables.

$$Ln\frac{P(SWITCH)}{1-P(SWITCH)} = \beta_0 + \beta_1 OPINION + \beta_2 ALIEN + \beta_3 RANK + \beta_4 LnFEE + \beta_5 LnASSET + \beta_6 YEAR + \varepsilon$$

4. Research Result and Illumination

4.1 Univariate test

We conduct the χ^2 (chi-square) tests to identify these factors who have possibly significant correlation with the auditor switches. Through the test, we can know that qualified opinions and geographical features have significant effects on the auditor switches. Chi-square statistics are 35.362 (significant standard of 1%) and 6.578 (significant standard of 5%) respectively.

Table 1 Chi-square test

	X^2	df
SWITCH*OPINION	35.362^{***}	1
SWITCH * ALIEN	6.578^{**}	1
SWITCH * YEAR	0.613	1

Notes: ***, ** means significant standard of 1%, 5% respectively.

4.2 Binary logistic regression result

Table 2 represents the logistic regression analysis. After controlling the effects of LnFEE, LnASSET and YEAR, we can see variables of OPINION and SWITCH having a significant positive correlation at standard of 1%. This is kept in line with results of Chow and Rice (1982), LI Dong-ping, etc. (2001).i.e., that the auditor switches have a positive correlation with the qualified opinions in the fiscal year prior to switch.

In addition, SWITCH and ALIEN have a significant positive correlation at the level of 5%, which supports the assumption that the listed companies and their auditors belong to different areas are more likely to occur switch. The results reflects the vulnerable characteristics in China's securities and auditing markets (LI Shuang and WU Xi, 2002), because there exist many social relationships between local audit firms and local government. On the other hand, there exist some problems as inconvenient contact and communication.

LnFEE (audit fees changing over the year and the previous year) did not pass the test. One possible reason is that the disclosure of the fees in the statement is incomplete. LnASSET (assets changing over the current year and the previous year) did not pass the test, noting the assets changes are not the main reason for switches. Control variables YEAR not passing the test shows that different years have no significant impact on switches.

Table 2 Logistic regression results (dependent variable: switch)

Variable	Model 1	Model 2	Model 3
Intercept	-2.495	-2.658	-2.743
	(791.686)***	(507.359)***	(346.736)***
Lnasset	-0.489	-0.461	-0.426
	(3.434)*	(3.035)*	(2.557)
Lnfee	-0.014	-0.016	-0.017
	(0.004)	(0.006)	(0.007)
Opinion	0.977	0.962	0.990
	(23.264)***	(22.408)***	(23.242)***
Alien		0.344	0.343
		(5.092)**	(5.060)**
Year			0.153
			(0.987)
Nagelkerke R^2 N	3.1% 2307	3.6% 2307	3.7% 2307

Notes: ***, **, * means significant standard of 1%, 5% and 10% respectively.

5. Research Conclusion and Suggestion

This paper collects data from the 2003 and 2004 annual reports and analyzes the determinants of auditor switches with the Logistic model. The empirical results indicate: (1) when we control the change of audit fee, listed companies' size and fiscal years, auditor switches have significant correlation with the "unclean" audit opinions in last year; (2) when the auditors are alien to listed companies, they are more prone to be replaced.

Therefore, regulatory departments should strengthen the information disclosure and supervision toward the listed companies who switched auditors in the future. In addition, audit firms should establish a combination system of fixed employment with the rotation. The geographical restrictions of competition and local protectionism should also be broken to make the auditor more independent, so as to play its due role in the prosperity of the capital market.

References:

[1] Bedingfield, J. P., Loeb, S. E..(1974). Auditor Changes—An Examination[J]. *Journal of Accountancy*, (3): 66-69.

[2] Chow, C. W., S. J. Rice.(1982). Qualified Audit Opinions and Auditor Switching[J]. *The Accounting Review*, 57(4): 326-335.

[3] De Angelo. L. E..(1982). Mandated Successful Efforts and Auditor Choice[J]. *Journal of Accounting and Economics*, 4(12): 171-203.

[4] Arieh Goldman, Benzion Barlev.(1974). The Auditor-Firm Conflict of Interests: Its Implications for Independence[J]. *The Accounting Review*, 49(4): 707-718.

[5] Keith Bockus, Frank Gigler.(1998). A Theory of Auditor Resignation[J]. *Journal of Accounting Research*, 36(2): 191-208.

[6] Nichols, D..(1976). The Auditor-Firm Conflicts: An Analysis Using Concepts of Exchange Theory[J]. *The Accounting Review*, (4): 335-346.

(Edited by CHEN Xiao-li, Shirley, DAI Xiang)