Auditor Size vs. Audit Quality: An Analysis of Auditor Switches

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Abstract

In recent years, there has been a debate over whether public companies should be required to have either a mandatory retention period or a mandatory rotation period for their external auditors. With all of the financial scandals that occurred in the late 1990s and early 2000s, the idea of auditor switching has come to the forefront. There are some opponents to auditor switching when companies switch auditors due to opinion shopping. However, research has identified many other reasons for switching auditors, such as business growth or requirements for new audit procedures. When companies require more complex audits, it may become necessary to choose a different auditor. When faced with the decision to choose a new auditor, more often than not, a company will choose a Big Four firm. I collected research on 17 different companies that experienced corporate fraud and analyzed the company’s decision to switch auditors. I found that in many cases the company decided to switch to one of the Big Four firms, and in a few cases, the company retained its original auditor.

Introduction

When faced with litigation or criticism, it is likely that a company will switch auditors, either out of dissatisfaction with the former auditor or because litigation against the auditor results in a situation where the auditor is no longer independent of the company and can no longer conduct the audit. My paper examines companies’ decisions to retain or switch auditors following corporate fraud. I find that large companies that already use a Big Four firm are most likely going to stick with a Big Four firm rather than switch to a smaller firm.
Evidence.

I researched Press Releases on the Securities and Exchange Commission website for all instances of fraud that experienced litigation and selected seventeen cases to analyze. I then looked at each company’s annual SEC filings (10-K) to see who the external auditor was prior to the fraud and who the external auditor was after the fraud. All the press releases were from 2005 to 2011, but the fraud occurred as early as 1994. Table 1 on page 26 summarizes my sample.

The following cases are those of companies using smaller (non-Big Four) auditors:

1. Koss Corporation

   In 2010, Koss Corporation sued Grant Thornton for failing to find an alleged $31 million fraud committed by the Company’s Vice President of Finance over a period of five years. Companies blame their auditors because they believe auditors should detect the fraud. Indeed the auditor does have the ability to conduct various tests for detecting fraud, however at times it is not the responsibility of the independent external auditor to perform such tests. In fact in the audit opinion, Grant Thornton stated, “The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting,” because Koss was too small to fall under the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002. Koss Corporation could have hired Grant Thornton to review internal controls and perform procedures that are specifically designed to detect fraud, but did not do so. Koss
Corporation ultimately decided to switch independent external auditors to a smaller firm, Baker Tilly Virchow Krause, LLP. Koss is one of only two instances in my sample where the company switched to a smaller tier accounting firm.

2. DHB Industries Inc.

In February 2011, the Securities and Exchange Commission alleged that Florida-based DHB Industries Inc., the maker of body armor used by U.S. combat troops, was involved in fraudulent financial reporting by its senior officers and also, assets were misappropriated to personally benefit the CEO. The fraudulent activity resulted in the filing of materially false and misleading periodic reports to investors. The directors of the company were criticized for their willful blindness to red flags allowing senior management to manipulate key financial figures and public filings between 2003 and 2005. Grant Thornton was the auditor for DHB and resigned the engagement after they found the company failed to disclose a transaction valued at more than $7 million. UNITE, an apparels and textiles union, filed three letters of complaint claiming the company violated federal securities rules requiring disclosure of information to investors. After Grant Thornton quit, DHB had to hire a new auditor to perform their audit. In this case, the company went from the 6th largest firm to a smaller mid-size firm, Weiser LLP. The company claimed they switched because they believed that the smaller firm would perform higher quality audits and would be more committed to follow through with their engagement. It is evident that Grant Thornton was more concerned with their reputation than completing the engagement.
3. China Intelligent Lighting and Electronics Inc. (CIL)

A similar situation where the accounting firm quit prior to completing the engagement was China Intelligent Lighting and Electronics Inc. (CIL). MaloneBailey LLP, CIL’s independent auditor, resigned and withdrew its audit opinions on the financial statements included in the companies’ registration statements. The company hired Friedman LLP, a mid-sized firm, to perform an audit of the 2010 and 2011 financial statements to test for material deficiencies. MaloneBailey LLP is a very small firm and the allegations the firm has made against this company are being carefully considered. According to these allegations, the company is not in compliance with Amex listing standards and is now subject to delisting. The PCAOB is currently conducting an investigation of the accounting firm to ensure audit deliverables were professional and the auditors exercised due care.

4. City of San Diego

In 2002 and 2003, the accounting firm Calderon, Jaham & Osborn, which was the independent auditor for the City of San Diego, issued unqualified audit reports when they contained materially false and misleading information about San Diego’s pension and retiree health care obligations. The city was criticized for hiring a firm with inadequate technical skills, experience and resources to conduct proper audits and hiring the auditor with the lowest bid, rather than the critical factors necessary. The city of San Diego switched from Calderon, Jaham & Osborn, a firm with approximately 30 employees, to Macias Gini &O’Connell LLP, a firm with over 230 professionals. This supports the idea that larger firms, with more resources and people, will provide a better quality audit than
a smaller firm. Cities of this size require a larger firm in order to perform the tests and procedures necessary to provide their constituents with accurate information.

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In 2007, the SEC found sixty-nine different audit firms and partners that issued reports but were not registered with the Public Company Accounting Oversight Board (PCAOB). One of the requirements of the Sarbanes-Oxley Act of 2002 is to be registered with the PCAOB in order to prepare and issue audit reports on the financial statements of public companies. Companies typically hire smaller firms because of the smaller audit fees; however, in this case, these public companies risked not fulfilling the requirement of obtaining an independent accountant’s opinion from a registered public accounting firm. Companies can trust that the larger accounting firms will have certified public accountants on the audit engagement and will be a registered accounting firm.

The following cases are those companies that decided not to switch auditors following litigation:

5. American International Group, Inc. (AIG)

In 2004, The SEC charged the American International Group, Inc. (AIG) with securities fraud. AIG’s reinsurance transactions with General Re Corporation (Gen Re) were designed to falsely inflate AIG’s loss reserves by $500 million. There were additional transactions in which AIG materially misstated its financial results through sham transactions and entities created for the purpose of misleading the investing public.
AIG admitted in its restatement that certain transactions may have “involved documentation that did not accurately reflect the true nature of the arrangements and misrepresentations to members of management, regulators and AIG’s independent auditors.”¹ The fraudulent transactions took place between December 2000 and March 2001. The independent auditor that was responsible for auditing AIG’s financial statements during this time was Coopers and Lybrand, LLP. While the company was required to restate their financial statements, AIG continued to use the same auditing firm in the years to follow because the fraud was committed over a short period of time, and hence might not reflect unfavorably on the quality of the audit.

6. Kmart

A critical portion of the 10-K and 10-Q filings is the section entitled Management’s Discussion and Analysis. In the case of Kmart, the executives failed to acknowledge the reasons for a massive inventory overbuy in 2001. This misled investors about Kmart’s financial condition in the months preceding the company’s bankruptcy. The lies eventually caught up to the executives and they faced charges of financial fraud. This reaffirms the importance of all information contained in documents that include audited financial statements.

PricewaterhouseCoopers was the auditor throughout Kmart’s bankruptcy and Kmart chose to stick with PwC.

7. Enterasys Network Systems, Inc.

From 2000 to 2001, Enterasys Network Systems, Inc. inflated revenue to increase the price of its stock. The company improperly recognized revenue for sales transactions with a right of return. The company also entered into “swapping” arrangements, where they exchanged products or services without having a legitimate business purpose for doing so and recognized revenue on these exchanges. The company overstated its revenue by over $11 million in the quarter ending September 1, 2001. KPMG was the independent auditor of Enterasys during this time and the company decided to not switch auditors.

The following are those cases that switched from Big-Four firms to another Big-Four firm:

8. Delphi Corporation

The SEC filed financial fraud charges against Delphi Corporation, the auto parts supplier, for engaging in fraudulent activities between 2000 and 2004. Delphi engaged in multiple schemes that resulted in Delphi materially misstating its financial condition and operating results in filings with the Securities and Exchange Commission, offering documents, press releases, and other documents and statements. The independent auditor during this time was Deloitte and Touche and after the investigation the company switched to Ernst and Young in 2006.
9. Xerox

From 1997 through 2000, Xerox Corp. was engaged in a fraudulent scheme that misled investors about Xerox’s earnings in order to improve its reputation on Wall Street and to boost the company’s stock price. It was alleged that the fraudulent conduct was responsible for accelerating the recognition of equipment revenues of approximately $3 billion and increasing pre-tax earnings by $1.4 billion in Xerox’s 1997-2000 financial results. KPMG LLP, the former independent auditor of Xerox, was charged for its connection with the audits of Xerox Corp. The SEC found that KPMG permitted Xerox to manipulate its accounting practices to close a $3 billion “gap” between actual operating results and results reported to the investing public. Prior to the SEC’s investigation, KPMG did not raise any concerns to Xerox’s management about the illegal acts that had occurred (even when they had information about these illegal acts). Moreover, when Xerox ignored KPMG’s request to perform more tests on the financial statements, KPMG never put any pressure on Xerox to follow their guidance and instructions. This case clearly indicates poor audit quality and a lack of professionalism by a Big Four Firm. Xerox hired another Big-Four Firm, PricewaterhouseCoopers, as the new independent auditor.

10. Satayam Computer Services

In 2011, PricewaterhouseCoopers (PwC) also experienced a major lawsuit. It was found that five India-based affiliates of PwC, known as PW India Affiliates, conducted deficient audits of Satyam Computer Services Limited financial statements. These deficient audits enabled a massive accounting fraud to go undetected for several years.
The SEC determined that PW India failed to conduct fundamental audit procedures. PW India did not conduct proper audits and failed to exercise professional skepticism and due care. The accounting firm failed to confirm Satyam’s cash and cash equivalent balances or its accounts receivables. This failure to properly execute third-party confirmation procedures is what enabled the fraud at Satyam to go undetected. This is a clear portrayal of an audit quality failure from a Big-Four firm. As a result of this case, PW India replaced all senior management responsible and suspended its Satyam audit engagement partners. PwC was given a $6 million penalty. While the case is still being settled, Satyam Computer Services Limited has switched audit firms to another Big Four firm, Deloitte & Touche.

11. Nortel Network Limited

Nortel Networks Limited (Nortel) engaged in an accounting fraud from 2000 through 2003. The company made changes to its revenue recognition policies that fraudulently accelerated revenue to meet its revenue targets. It also selectively reversed certain revenue entries. Ultimately, the company inflated its 2000 revenues by approximately $1.4 billion. Once these fraudulent acts were placed in motion, the following years maintained these numbers and effectively continued the fraud for four years. Deloitte & Touche LLP had been the independent auditor but eventually Deloitte was phased out and currently Nortel uses KPMG as their independent auditor.
12. Just for Feet

The failure of an auditor to deliver quality services can result in the failure of the auditor’s client. The failure to detect discrepancies can enable a fraud to continue longer. This is the case for the company Just for Feet, Inc. Deloitte & Touche failed to adequately test the financial statements, and the partners involved on the audit were found to have performed their audit with improper professional conduct. They should have reasonably known that Just for Feet’s 1998 financial statements had not been in accordance with GAAP. Deloitte’s National risk management program had identified Just for Feet, Inc. as a high-risk client, but the partners on the engagement did not carry out the proper tests that should have been performed on such a risky client. Eventually, the company went bankrupt and was acquired by Foodstar Inc., which uses KPMG LLP as their independent auditor.

13. Adelphia Communications

Deloitte & Touche was charged with another case in which the engagement team failed to deliver quality audits. Adelphia Communications Corporation perpetrated a massive fraud and Deloitte’s team failed to implement audit procedures designed to detect the illegal acts that surfaced. As with Just for Feet, Inc., Deloitte identified Adelphia as a high-risk client but failed to design an audit appropriately tailored to address those audit risk areas. During the fiscal year 2000, Adelphia improperly excluded $1.6 billion in debt from its balance sheet, failed to disclose significant related party transactions and overstated its stockholders’ equity by $375 million. As a result, Deloitte agreed to substantive undertakings to increase the training of Deloitte’s audit
professionals in fraud detection and increase partner involvement in the audits. Adelphia Communications Corporation ultimately decided to switch auditors to PricewaterhouseCoopers LLP.


Cardinal Health, Inc., a pharmaceutical distribution company, engaged in a fraudulent revenue and earnings management scheme from September 2000 through March 2004. The litigation found that the company materially overstated its operating revenue, earnings and growth trends. The company misclassified more than $5 billion of bulk sales as operating revenue. The company also failed to disclose the impact of the change from applying the last-in-first-out (LIFO) inventory valuation method. On the 2007 10-K, the legal proceedings mentioned that the company’s external auditors Deloitte & Touche, would possibly be charged with the misstatements of the financial statements, but this case was later dismissed. Deloitte failed to find the fraudulent schemes for four years of financial statements and the company decided to switch to Ernst & Young, LLP.

The following are the Arthur Anderson cases (which was considered a “Big-Five” firm). The collapse of Arthur Anderson is an excellent portrayal of how a large professional services firm can fail.
15. United Health Group

As UnitedHealth Group’s auditors, Arthur Anderson LLP failed to find fraud. The CEO was secretly backdating stock options to obtain undeserved compensation. During the years between 1994 and 2005, he picked grant dates for UnitedHealth options that coincided with dates of low quarterly closing prices so that the grants would be priced at in-the-money options. The company ended up having to restate all of its financial statements for each year from 1994 through 2005. They disclosed material errors that totaled $1.526 billion for that period. After this fraud was disclosed, Deloitte & Touche LLP was hired to take over the independent audits.

16. Freddie Mac

One of the largest fraud scandals was that of the Federal Home Loan Mortgage Corporation (Freddie Mac). Freddie Mac improperly reported its earnings for the years between 1998 and 2002. The company improperly used derivatives to shift earnings between periods, which resulted in misreporting its net income in 2000, 2001, and 2002 by 30.5 percent, 23.9 percent and 42.9 percent, respectively. In an investigation by PricewaterhouseCoopers, the independent auditor in 2002, PwC found various warning signs in the Management Assessment Risk and Controls (MARC) self-assessment reports. The information in the reports indicated that Freddie Mac had inadequate accounting personnel and expertise, and the shortages of staff and expertise caused serious deficiencies in crucial control areas. All of the warning signs identified were signs that Arthur Anderson LLP, the former independent auditor, should have discovered. The
company switched to PricewaterhouseCoopers after Arthur Anderson collapsed in the wake of the Enron Scandal.

17. Nicor Inc.

From 1999 to 2002, Nicor, Inc. executives were engaged in a financial fraud that misrepresented inventory balances to reach certain financial targets and increase the company’s revenues. In connection with the company’s adoption of LIFO to account for inventory, the company officers approved improper transactions and allowed material misrepresentations in the financial statements. They also failed to disclose the effects of LIFO in the financial statements. During these years, Arthur Anderson LLP was responsible for the audit. The company switched to Deloitte & Touche LLP.

Limitations.

There are no private companies included in this study. Financial and auditor information about private companies are not publicly disclosed and thus difficult to obtain. Also, any material misstatements that did not result in litigation are not included in this study. Most companies that are publicly traded are large companies and use Big-Four auditors. I attempted to find a mix of small and large companies in this study.

Discussion of Findings.

Based on the above-mentioned cases, I find that when faced with fraud, if a company is not already using a Big Four firm, the company is more likely to hire a larger accounting firm to conduct future audits of their financial statements.
There were two such cases in which that did not occur. The first was Koss. Grant Thornton failed to find a $31 million fraud and the company sued Grant Thornton and switched to a smaller firm. With the size and time-span of this fraud, it is easy to accuse the independent auditors. Because companies are apt to blame someone other than their own management, it can be difficult to measure audit quality by the number of lawsuits a firm may be associated with. This case supports the “Deep Pockets Theory” (Dye, 1993), which implies that litigation is a poor signal of audit quality. I will discuss the deep pockets theory in greater detail later. In this case, Koss is attempting to blame Grant Thornton because they know that Grant Thornton has the ability to pay legal damages.

The second case was DHB Industries Inc., which switched to a smaller auditor after their former auditor, Grant Thornton, resigned and retracted their audit opinion. The company criticized Grant Thornton for not exhibiting professionalism and following through with their engagement. In the two instances where the company switched auditors to a smaller firm, Grant Thornton was a common factor. This could suggest that Grant Thornton does not consistently deliver high-quality audits.

The other smaller companies typically went from a small accounting firm to a larger, more reliable firm to conduct future audits. In the third case (CIL), the smaller audit firm retracted its opinion and resigned, expressing that there was fraudulent behavior within the company. The investigation of that company is ongoing so the company hired a larger firm to audit the financial statements. In the meantime, the
PCAOB investigated the smaller firm to ensure they are actually delivering quality audit services.

There were a few companies in the sample that chose to not switch auditors. The reason for this can be explained by the high switching costs associated with changing auditors. This theory will be explained more thoroughly in the next section of the thesis. Another reason for these companies choosing not to switch auditors is the span of time of the fraud. These three cases happened to have the shortest time-span of fraud so the company may have been satisfied with the audit quality of the firm.

The results of my sample suggest a commonality of switching to larger firms in the case of litigation and criticism. Larger firms have better reputations and are more credible than smaller firms. Smaller public companies that go with the lowest audit fees could end up with more trouble in their company by not catching fraud. Fraudulent actions might be more readily detected if the company were to invest more in the audit fees and hire the auditor to issue special opinions on internal control; however, it is not safe to assume that all controls will be tested just because the company uses a larger firm. As in the case of Koss, the company assumed that Grant Thornton tested all internal controls when in the financial statements the engagement auditors specifically stated they did not test internal controls. The responsibility of the auditor is to uphold a sense of professionalism and due care when performing an audit. When aspects of the audit become skeptical to the client, the client’s choice to keep or change auditors is a sign of the audit firm’s quality.
Literature Review and Theory

In this section, I will discuss the theoretical research related to auditor reputation, auditor wealth, audit fees, and the impact of auditor switching.

During the late 1970’s, regulators and small audit firms believed that the size of the audit firm did not affect audit quality. There is some criticism that the large accounting firms should not be arbitrarily distinguished from all the other CPA firms. Some described this as a “discriminatory impact” on smaller firms (DeAngelo, 1981). In 1978, there was a lawsuit filed by 18 small and medium-sized audit firms arguing to break the division of the AICPA into two practice sections. One practice section included those audit firms whose clients include companies that are required to file reports with the SEC, and the other practice section consisted of audit firms with only nonpublic company audit clients. Although the case was dismissed, the reaction to the suit was to establish a committee, the Derieux Committee, to evaluate this correlation between audit size and audit quality. The committee expressed concern that smaller accounting firms were losing audit clients because they were less well known, even though the smaller firms provided high or higher quality services (DeAngelo, 1981). There were several studies that contradicted this argument of “discriminatory impact” on the smaller firms and that provided evidence that larger firms do in fact provide higher quality.

DeAngelo (1981) argues that consumers can use size as a measure of audit quality. DeAngelo defines quality of audit services as “the market-assessed joint
probability that the given auditor will both discover a breach in the client’s accounting system and report the breach.” The ability to discover a breach depends primarily on the auditor’s technological capabilities, the audit procedures and the extent of sampling. If it is found that any one of those factors is inadequate, an audit failure could occur. Auditor independence is the factor pertaining to the auditor’s willingness to report the breach after discovery. For instance, if the auditor has incentives to not disclose certain aspects of the clients financials that should be reported, the auditor fails to be independent of the client. In 1977, Peat, Marwick & Mitchell stated, “the single largest audit fee comprises only ½% of their total revenues” (DeAngelo, 1981). For smaller firms, fees from a single large client may hinder the quality of the audit.

DeAngelo’s research focused on the idea that large auditors issue more accurate reports because they have “more to lose” from damage to their reputations. An alternative to this reputation theory is the “Deep Pockets Theory.” This theory asserts that auditors with more wealth at risk from litigation have more incentive to issue accurate reports. Dye makes the claim that litigation is a poor signal of audit accuracy (Dye, 1993). Large auditors have more wealth at risk from litigation and thus have more incentives to issue accurate reports. The amount of wealth can factor into the result of the lawsuit and the size of the litigation penalty. Large auditors receive more criticism and are more prone to litigation but still maintain strong demand for their services. DeAngelo’s argument suggests that larger auditors should receive less criticism than smaller auditors but later research supports Dye’s deep pockets theory.
Further evaluation into these two theories was made by Lennox (1999). This study measured audit quality in terms of Type I and Type II errors, assuming that auditors are sued for Type I errors, issuing a negative report when it should have issued a “clean” report. The author explains that litigation is a weak sign of audit quality because large auditors are more likely to be sued for Type I errors because of their “deep pockets.” The author made the assertion that a company would hire a large auditor if they expected a “clean” report because larger firms are more credible. Lennox models the owner’s expected payoff as the company’s expected selling price minus the audit fee. A more credible firm will have greater influence on the company’s selling price. The findings showed that the two firms with the greatest number of lawsuits (the most criticized firms) were Ernst & Young and a mid-sized firm. In comparison to the other large and mid-sized firms, the two firms suffered more losses in clients and in growth than the others categorized by size.

Audit Quality and Audit Fees

Companies can experience high start-up costs when hiring a new auditor. By working on the same clients for a period of years, auditors can earn client-specific quasi-rents that can serve as collateral against opportunistic behavior. Larger auditors have “more to lose” from supplying a lower-than promised level of audit quality and thus have a higher perceived audit quality. DeAngelo also argues that the difference in agency costs indicate a differing “level” of audit quality. A complex audit may be required for a larger client or a client with more complicated accounting procedures, and thus demand a certain type of auditor to deliver the services required.
There are several challenges to the correlation of audit fees and audit quality. First, the total fees will clearly be larger for a larger firm because bigger clients will purchase more services than smaller clients. Auditors may also be contracted to provide special reports and/or opinions in addition to general external audits of financial statements. Audit fees can vary with these additional reports (Palmrose, 1986). Audit fees can also be affected by location and the coordination and complexity of an engagement. For instance, if the client has multiple locations that require on-site visits, the audit fees will be higher. In many cases, an auditor will rely on the client’s inputs or utilize client personnel for some audit tasks. The audit fees are reduced by any of these client inputs. The client’s industry can also affect audit fees by measuring differences in risk. Audit fees are also generally higher among companies with public ownership. Companies with public ownership are at a greater exposure to risk and require more audit evidence. If there are any report modifications, the auditor is required to accumulate a greater amount of evidence to achieve the same quality, which results in more billable hours and higher audit fees (Arens & Loebbecke, 1997). All of these variables can attribute to the difference in fees between a small and large firm; thus it is difficult to determine if audit firms with higher fees provide higher audit quality. This is the reason for my focus on auditor switching rather than audit fees.

**Audit Quality and Auditor Switching**

In the case of switching auditors, the transaction costs of changing auditors often make it unprofitable to do so. This relationship creates a “bilateral monopoly” because
the resignation of the auditor would impose costs for both the auditor and the client. The auditor would lose the benefits of the client-specific quasi-rents and the client would bear transaction costs and start-up expenses for the new auditor. Incumbent auditors have the ability to keep raising fees without making it profitable for clients to actually switch (DeAngelo, 1981). Agency theory suggests that a switch may also signal unfavorable news to investors and companies have more incentive to avoid signaling unfavorable news when agency costs are high (Fried and Schiff, 1981). This may help explain why some companies in my sample chose to keep their auditors even after they had to restate their financial statements. Since the issue was not over a particularly long time frame, the client was satisfied enough to retain its auditors.

There are other reasons for switching auditors. It was found that failing companies were more likely to switch auditors than non-failing companies. Companies that receive a qualified report are also more likely to switch (Lennox, 1999). Previous studies have also shown the effect of accounting disputes on a firm’s choice of auditors. Burton and Roberts (1967) sampled 83 auditor switches made by Fortune 500 firms between 1952 and 1965 and found that companies switched auditors due to accounting disputes, the demand for additional services, changes in management and more specifications due to new financing. Chow and Rice (1982) tested whether the firms switched auditors after receiving qualified opinions by dividing public companies into four categories: receiving a qualified opinion and switching auditors, receiving a clean opinion and switching auditors, receiving a qualified opinion and keeping the same auditor, and receiving a clean opinion and keeping the same auditor. Findings showed
that firms tend to switch auditors after receiving a qualified opinion. In addition, companies that switch firms do not typically switch to smaller firms. However, switching auditors after receiving a qualified opinion does not increase the probability of receiving a clean opinion in the following year.

Becker et. al. measures audit quality by the amount of discretionary accruals. The idea behind this study was that non Big-Six auditors allow more income-increasing earnings management than Big Six auditors. Managers have incentives to adjust earnings to maximize firm and manager wealth. Incentives can be created by contracts that are explicitly based on reported earnings (i.e., management compensation plans and debt agreements), and contracts implicitly based on reported earnings (i.e., implicit contracts between firms and its customer or suppliers). These opportunities are constrained by discretionary accruals, the “accounting flexibility” or the level of variation the auditor allows. Companies using non-Big Six auditors have significantly larger variation than companies with big six auditors. Defond and Subramanyam (1998) describes three implications of auditor switching and discretionary accruals. First, the predecessor auditor prefers conservative accounting choices, therefore, the last year of discretionary accruals are expected to be income decreasing. Also, litigation risk will determine the auditor’s choice of discretionary accruals. Lastly, the incumbent auditor is more conservative than the average auditor; thus, discretionary accruals in the first year with the successor auditor will be less income decreasing than in the last year of the predecessor.
Johnson, Khurana and Reynolds (2002) focused on the debate of audit tenure and audit quality. In the case of short audit tenure, it is evident that auditors have less client-specific knowledge in the early years of the engagement. Therefore, the auditors are less likely to detect a material misstatement. However, the lack of client-specific knowledge on an engagement can be overcome by committing more effort on new engagements. This requires more technology and resources that cannot be implemented immediately. The authors also suggest that long-term tenures also provide less quality audits since the auditor has other incentives to maintain and profit from the client, becoming less concerned with client litigation. The findings showed that most audit failures occur within the first three years of a new auditor-client relationship. It also showed that a five-year tenure is more effective in detecting material misstatements than a twenty-year tenure. This theory encourages auditor switching as a necessary action during the lifetime of a company to ensure higher audit quality.

A more recent study evaluated the association between the audit-firm tenure and audit fees paid to the successor auditors. Kealey, Lee and Stein (2007) asserted that after the sudden collapse of Arthur Anderson, a large number of companies made an involuntary auditor switch that affected the average tenure of auditor-client relationships. The results of the study found that firms with a longer tenure receive higher fees than new auditors.

In recent years, there is more of a tendency for companies to switch auditors. In 2004, more than 1,600 companies changed auditors, 61 of which changed auditors at least twice over a relatively short time frame (Lu, 2008). “Opinion shopping” is the “search for an auditor willing to support a particular accounting treatment designed to help a
company achieve its reporting objects” even though that treatment may not coincide with regular financial reporting. One concern for auditor switches is the resulting decline in reliability of reported financial statements due to a drop in audit quality. Another expressed concern is the expansion of management manipulation of financial statements due to this loss of audit quality.

**Conclusion:**

Research has shown that there are adherents and critics of each theory for measuring audit quality. I have discussed the theories based on auditor reputation, auditor wealth, audit fees and auditor switching. The sample used in my research explores the ideas behind auditor switching but also supports the deep pockets theory in that auditor wealth increases the amount of criticism and litigation involving the auditor firm. This rivals the idea that the auditor’s reputation prevents an auditor from issuing poor quality reports in saying that there is more at risk than just reputation. A few studies have shown that audit fees can be an indicator of audit quality because the more an auditor is paid, the more work and quality the auditor will provide.

The focus of this paper has been on auditor switching after corporate fraud and the auditor’s failure to detect the fraud. Previous studies have found that companies that have received qualified opinions are more likely to switch auditors than those that receive clean opinions. While research has shown that litigation is not a good measure for audit quality, the companies that were included in my sample experienced corporate fraud that may indicate major audit failures and the required restatement of years of activity. When faced with decisions to switch auditors, most of the companies in my sample chose a
larger “name brand” auditor. The reputation of a Big-Four auditor signals credibility and creates more value for a company, in the eyes of shareholders, and auditor credibility might take on added importance immediately following the discovery of corporate fraud.
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<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Previous Auditor</th>
<th>New Auditor</th>
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<td>Grant Thornton</td>
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<td>Friedman LLP</td>
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<td>2000-2004</td>
<td>Delphi Corporation engaged in multiple schemes resulting materially misstating its financial condition</td>
<td>Deloitte and Touche</td>
<td>Ernst and Young</td>
</tr>
<tr>
<td>1997-2000</td>
<td>Xerox Corporation engaged in fraudulent schemes that misled investors about its earnings, accelerating the recognition of revenues of approximately $3 billion</td>
<td>KPMG LLP</td>
<td>PwC LLP</td>
</tr>
<tr>
<td>2005-2009</td>
<td>Satayam Computer Services experienced massive accounting fraud that went undetected for several years</td>
<td>PwC (PW India Affiliates)</td>
<td>Deloitte Haskins &amp; Sells</td>
</tr>
<tr>
<td>2000-2003</td>
<td>Nortel Networks Limited (Nortel) made changes to its revenue recognition policies that fraudulently accelerated revenue to meet its revenue target</td>
<td>Deloitte &amp; Touche LLP</td>
<td>KPMG LLP</td>
</tr>
<tr>
<td>1998</td>
<td>Just For Feet, Inc. went bankrupt and the partners involved in the audit failed to perform the proper tests</td>
<td>Deloitte</td>
<td>KPMG LLP</td>
</tr>
<tr>
<td>2000</td>
<td>Adelphia Communications Corporation perpetrated a massive fraud and the audit team failed to implement the proper tests to detect it</td>
<td>Deloitte</td>
<td>PwC</td>
</tr>
<tr>
<td>2000-2004</td>
<td>Cardinal Health, Inc. engaged in a fraudulent revenue and earnings management scheme</td>
<td>Deloitte</td>
<td>Ernst &amp; Young</td>
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<tr>
<td>1994-2005</td>
<td>UnitedHealth Group CEO backdated stock options to seek the return of undeserved compensation</td>
<td>Arthur Anderson</td>
<td>Deloitte &amp; Touche LLP</td>
</tr>
<tr>
<td>1998-2002</td>
<td>Federal Home Loan Mortgage Corporation (Freddie Mac) improperly reported its earnings by using derivatives to shift earnings</td>
<td>Arthur Anderson</td>
<td>PwC</td>
</tr>
<tr>
<td>1999-2002</td>
<td>Nicor, Inc. executives engaged in a financial fraud that misrepresented the inventory to reach certain financial targets</td>
<td>Arthur Anderson</td>
<td>Deloitte &amp; Touche LLP</td>
</tr>
</tbody>
</table>
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