

The Effect of Dismissal Threat on Auditor Independence

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* The authors appreciate helpful suggestions from Dan Simunic as well as seminar participants at Taiwan NSC Outstanding Scholar Series, 2004 Accounting Theory and Practice Conference in Taiwan, and 2005 Chinese Accounting Professors' Association Meeting in Beijing. We also thank Taiwan NSC for research funding.

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Abstract

This study investigates whether dismissal threats imposed by clients jeopardize auditor independence, which is surrogated by auditor's propensity to issue a going-concern opinion to a financially distressed client. We use an auditor switch model to predict the unobserved switches clients would have made had they received opposite audit opinions, and then measure the unobserved switch probability as a proxy for dismissal threats. This study identifies two types of strategic conducts that may result from dismissal threats. One is the clients' coercing the auditors to issue a clean instead of a going-concern opinion. The other type of misconducts may be induced by clients who request a shared opinion (involving other auditors) in lieu of a going concern opinion. We argue that whether auditors surrender their independence to these two dismissal threats depends heavily on the professional responsibility and potential future failure costs. The results show that the probability of a financially distressed company's receiving a going concern opinion increases with the likelihood of dismissal to coerce clean opinions. However, the probability of a financially distressed company's receiving a going concern opinion decreases with the likelihood of dismissal to coerce shared opinions. Overall, our results show that responsibility divisibility is the key factor to auditors' decision of whether or not to surrender their professional independence to dismissal threats.

Keywords: dismissal threats, auditor independence, auditor switch, going-concern opinion, shared opinion.

1. Introduction

This paper empirically examines whether threats to dismiss the incumbent auditor decreases the likelihood of a financially distressed company's receiving a going concern opinion. Independent auditing is essential to efficient capital markets. The auditor, however, bears great pressure from the business operations of audit firms given the increasing audit market competition. Therefore, the investing public, financial statement users, and regulators may all be concerned as to whether auditors are susceptible to dismissal threats and sacrifice their independence to issue favorable audit opinions.

This paper identifies a going-concern opinion as an unfavorable opinion and classifies favorable audit opinions into standard unqualified and unqualified with modified wording (involving other auditors). When an audit opinion involves other auditors, the report is called a shared opinion. The auditing standards give auditors the discretion to decide whether to assume responsibility for the work of other auditors. The decision to assume or not to assume responsibility has significant legal as well as professional consequences. In a report with references, the principal auditor does not intend to assume any legal responsibility for the work of the other auditors (SAS 64 AU 543). It may add to the literature by examining whether principal auditors compromise their independence because of different professional responsibilities involved.

Heavy investments in foreign countries and recognizing fictitious overseas revenues, coupled with shared auditor opinions, characterize current scandals in Taiwan, such as Procomp, Infodisc, etc.¹ In 2004, Procomp was sued to remedy

¹ Since some of Taiwan's listed companies inflate their income from overseas long-term investments, Taiwan Stock Exchange (TSE) and Greta Securities Market (GSM) begin to require the principal auditor to issue a clean opinion on an IPO client, even with the presence of other auditors. If the

injured investors for an amount over NT\$ 5 billion, approximately US\$ 150 million, because of fraudulent financial statements. Besides lawsuits, Financial Supervisory Commission took disciplinary action against the auditors of Procomp by enforcing a 2-year suspension of practice according to the Taiwan Securities and Exchange Law. This was partly based on the charge against auditors of Procomp for not collecting sufficient and competent audit evidence on reported investment income from fully owned subsidiaries (Taiwan Commercial Times 2004.7.16).

A massive financial scandal involving Italy's largest food company, Parmalat, has underscored the fact that corporate fraud is a common issue. In December 2003, it was discovered that Parmalat had been using more than EU\$ 10 billion of nonexisting assets to offset more than a decade's worth of liabilities through a network of offshore and foreign finance companies. Deloitte & Touche replaced Parmalat's auditor Grant Thornton in 1999 because of a provision in Italian law which mandates change of audit firms every nine years. However, Parmalat continued to retain Grant Thornton as its auditor for its Cayman Islands subsidiary, Bonlat, which was not subject to Italian law and was allegedly where the missing assets were located. Although Deloitte & Touche was the first to scrutinize the nonexistent accounts, it gave a shared opinion to Parmalat.²

This study examines two types of undue favorableness in audit opinions that may result from dismissal threats. Specifically, management may threaten to dismiss the incumbent auditor and coerce him or her to issue (1) a clean instead of a going-concern opinion, or (2) a shared in lieu of a going-concern opinion. We test for dismissal threats by predicting the unobserved switches management would have made had they received opposite audit opinions. Can management successfully

principal auditor issues shared opinion, TSE and GSM will reject the application of going listed (Taiwan Economic Daily News 2003.2.17).

² See O'Rourke (2004) for more details regarding Parmalat.

engage in dismissal threats? The effectiveness of the management's dismissal threat, nevertheless, depends on the auditor's trade-offs between the benefits of retaining clients and the costs of sacrificing independence. We do not test if auditors surrender their independence to different types of dismissal threats imposed by *different* clients. In contrast, we test the effects of different types of dismissal threats imposed by the *same* client. Therefore, the benefits of retaining the client are the same for both types of dismissal threats. The difference in these two dismissal threats is the costs of sacrificing independence: one is full responsibility; the other is divided.

Shared opinions, which imply responsibility divided among auditors, pose another question for auditors to ward off legal liability in law. Bonner et al. (1998) provide evidence that judges' and juries' reasoning process about auditors' responsibility for detecting fraud might not be the same as that of auditors'. They find that auditors are more likely to be sued when the financial statement frauds are of a common variety or when the frauds arise from fictitious transactions. Their analysis rules out various accounting and auditing explanations for the results. Namely, given that litigations occur, auditors may still become defendants on lawsuits no matter what opinions they issue. Even so, for fear of legal liability, they may issue modified audit reports. Carcello and Palmrose (1994) find that, while modifying a client's audit report may not be sufficient to protect auditors from legal liability, such disclosures reduce the likelihood of litigation. Hence, though shared opinions might not entirely dismiss the principal auditor's responsibility for other auditors' work in the event of a lawsuit or SEC action; they are likely to affect auditors' behavior based on the perception created by auditing standards.

We apply this test to Taiwan context. The potential impact of cultural and standard-setting differences on auditor behavior is a relevant issue. With respect to

reporting behavior, Taiwan's audit market possesses some peculiarities that differentiate it from the typical audit markets in Anglo-Saxon countries, where most of the existing empirical audit literature originates. First, shared opinions, which are uncommon in the US, are frequently provided in Taiwan.³ Second, the audit obligation of corroborating the audit work of other auditors is ambiguous due to the exception provisions in Taiwan's auditing standards.⁴ Therefore, with its popularity of shared opinions and lenient audit regulation on shared opinions, Taiwan provides an ideal institution setting to test for the impact of dismissal threats, especially when clients are willing to receive shared opinions.

In Taiwan, there are market-based institutional incentives, such as quality control in Big 5, reputation loss, and litigation risk, to promote auditor independence and to outweigh economic dependence. Member firms of Big 5 audit more than 70% of Taiwan listed/OTC companies. In addition, empirical Taiwan evidence shows that auditors who have substandard performance lose their clients (Liu 2004). Finally, auditor litigation risk in Taiwan has significantly changed since Asian economic crisis. A government-supported institution was established to provide litigation services on behalf of investor. Until now, there are several class-action lawsuits filed. All of the above-mentioned market-based institutional incentives promote auditor independence. Hence, we expect that Taiwanese auditors may resist the dismissal threat when clients prefer clean opinions to going-concern opinions, like America.

However, the market-based institution incentives may not be effective to fend off dismissal threats when clients request shared in lieu of going-concern opinions. The principal and other auditors are responsible for their own report and work in the event of a lawsuit or SEC action. Therefore, the principal auditor has less expected disutility

³ In Table 3 of Butler et al. (2004), shared opinions account for 5% of all the modified audit opinions.

⁴ Section 3 provides a detailed discussion, page 11.

of issuing a shared opinion than that of issuing a clean opinion when the client deserves a going-concern opinion. Moreover, Taiwan auditing standards are relatively lenient in the area where part of audit is performed by another auditor. Hence, we expect principal auditors in this case to be more likely to compromise their independence and less likely to issue a going-concern opinion to their clients.

Our results reveal that the probability of issuing a going-concern opinion increases in spite of the client's dismissal to coerce clean opinions. In contrast, the auditor decreases the propensity of issuing a going-concern opinion when the client threatens to dismiss the auditor for issuing a going concern opinion in lieu of a shared opinion. Overall, these findings suggest that whether auditors surrender their independence to dismissal threats relates closely to the divisibility of professional responsibility.

The next section reviews related literature and develops hypotheses. Section 3 analyzes the Taiwan context. Section 4 describes the methodology employed to test the dismissal threat argument, while section 5 explains how the data were collected and variables measured. Section 6 presents empirical results and the final section concludes the study.

2. Dismissal threats and Auditor's Going-Concern Opinion

Unfavorable audit opinions adversely affect clients. For example, prior research associates modified audit opinions with stock price declines (Jones 1996; Chow and Rice 1982; Firth 1978), lower earnings response coefficients (Choi and Jeter 1992), having applications of security offerings returned, and difficulty in raising debt capital (Firth 1980). By switching auditors, Teoh (1992) identifies two ways management might avoid unfavorable audit opinions. First, management can threaten the incumbent auditor to switch to a new auditor. The fear of losing the client can compromise the incumbent's independence. Second, management may switch if it

believes a new auditor is more likely than the incumbent to give a clean opinion.

Lennox (2000) calls the first method, the switch threat argument; the second, the opinion-shopping argument, which is previously examined by Lennox (2000). This paper focuses on the switch threat argument.⁵

Dismissal threats to Coerce Clean Opinions Rather Than Going-Concern

Opinions

Previous research has identified two economic incentives facing auditors when evaluating the reporting alternatives concerning a company's ability to continue as a going-concern. First, the cost incurred by auditors in issuing a going-concern opinion is the possibility of losing the client and related future quasi-rents. Second, the cost incurred by auditors in issuing a clean opinion is the potential costs of litigation and reputation loss. Different papers have analyzed the economic trade-offs facing the auditor that arise in the going-concern decision, using different proxies. Krishnan and Krishnan (1996) indicate that auditor litigation risk and the relative importance of the client in the auditor's portfolio are factors in the audit opinion decision. Geiger and Raghunandan (2002) argue that not signaling significant concerns regarding the client's ability to continue as a going concern, prior to the filing of bankruptcy, is likely to be construed as an audit failure by those outside the accounting profession. In this situation, auditors may suffer litigation costs as the target of injured investors claiming losses; therefore, the disutility of issuing an inappropriate opinion would be great. Magee and Tseng (1990) show that no compromise of independence will occur when the auditor regards expected disutility as extremely large. Reynolds and Francis (2001) conclude that reputation protection and litigation avoidance are sufficient to

⁵ Magee and Tseng (1990) show that the following condition is one of the necessary conditions for a reduction in auditor independence: the client must benefit from the preferred reporting strategy even after an auditor switch. Lennox (2000) finds companies do successfully engage in opinion shopping and therefore Lennox's result may be used as our maintained hypothesis.

override the possible impairment of objectivity resulting from economic dependence. DeFond et al. (2002) conclude that market-based incentives, such as loss of reputation and litigation costs, predominate over the expected benefits from compromising auditor independence. All of these literatures focus on the audit opinion trade off between a going-concern opinion and a clean opinion. Accordingly, we develop hypothesis 1 as follows.

H1: The probability of financially distressed companies' receiving going-concern opinions increases with the likelihood of dismissal to coerce clean opinions.

Dismissal threats to Coerce Shared Opinions Rather Than Going-Concern Opinions

As for circumstances when clients accept shared opinions but not going-concern opinions, the incentive of compromise independence might be stronger because auditors do not have to bear full responsibility when they fail to qualify a going-concern assumption. In other words, *ceteris paribus*, the lower the expected disutility of issuing an inappropriate opinion is, the more likely that the auditor surrenders to the dismissal threat. Specifically, in the consideration of the costs of sacrificing independence, principal auditors might think they have referred to other auditors in the audit report and therefore divided responsibility for the audit work. The principal and other auditor are responsible for their own report and work respectively in the event of a lawsuit or SEC action. Furthermore, principal auditors may believe they have completed their audit work with due care and will not be perceived as an audit failure even if clients subsequently experience financial distress that relate to audit work covered by other auditor. Thus, it is perceived that the negligence of other auditors causes less harm to the principal auditor's reputation. In sum, the principal auditor has less expected disutility of issuing a shared opinion than that of issuing a

clean opinion for the clients who deserves a going-concern opinion. Hence, principal auditors are more likely to compromise their independence and to issue shared opinions instead of going-concern opinions to their clients. Hypothesis 2 is developed as follows.

H2: The probability of financially distressed companies' receiving going-concern opinions decreases with the likelihood of dismissal to coerce shared opinions.

3. Taiwan Context

In the Taiwan context, there are market-based institutional incentives, such as quality control in Big 5, reputation loss, and litigation risk, to promote auditor independence and outweigh economic dependence. However, there is more lenient regulation on auditing standards for shared opinions in Taiwan.

It is well known that Big 5 have the incentive to protect reputation. In order to protect reputation and avoid litigation, enlightened self-interest has led Big 5 to emphasize quality control and to discipline professionals who depart significantly from firm and professional standards (POB 2000, 153). We believe that these quality control measures have not only been applied to Big 5 in US, but also been applied to all of their worldwide affiliations or member firms, including Taiwan member firms. Member firms of Big 5 in Taiwan audit over 70% of public companies listed in Taiwan Stock Exchange (TSE) and Greta Securities Market (GSM), an organization with the mission to develop Taiwan's over-the-counter market. Consistent with the notion that Big 5 are the higher quality suppliers, prior empirical studies in Taiwan show that they charge higher audit fee (Su, 2000) and reduce earnings management (Chang, 2001). Namely, quality control in Big 5 is one of the mechanisms in Taiwan to promote auditor independence.

Failure to issue a going-concern opinion to a deserving client may harm the

auditor's reputation, in turn leading to being fired by some other clients (DeAngelo 1981, 190). Another penalty may be lower fees from new clients who subsequently hire the audit firm (Davis and Simon 1992). Empirical Taiwan evidence shows that auditors who have substandard performance lose their clients (Liu 2004).

Finally it is important to note that auditor litigation risk in Taiwan has significantly changed since Asian economic crisis. In 1998, Taiwan Securities and Futures Institution established the Investor Service and Protection Center (hereafter, ISPC).⁶ ISPC provides mediation of disputes arising from the trading of securities and futures and litigation services on behalf of investors. Should a dispute arise involving a sum of over NT\$ 100 million, approximately US \$3 million, ISPC may waive the arbitration fee. For the litigation services, ISPC may file a suit without providing any collateral as a pledge. From 1998 to 2004, 35 class-action lawsuits were filed. In a nutshell, all of the above-mentioned market-based institutional incentives are applicable to Taiwan audit market. They lead auditors to promote professional independence and therefore to resist the dismissal threat.

As for lenient regulation on related auditing standards, according to item 6 of Taiwan SAS No. 15 (Taiwan Accounting Research and Development Foundation 1999, TARDF), the principal auditor is obligated to corroborate the audit work of the other auditor,⁷ except when there are long-term business associations between the principal auditor and the other auditor, or other specific reasons. Such exceptions increase the ambiguity of audit tasks required under various circumstances. Salterio and Koone (1997, 573) find that auditors facing an ambiguous situation are likely to

⁶ The Investor Service and Protection Center administered the investor protection until Securities Investors and Futures Traders Protection Center was founded in 2003, which is an organization set up under the Securities Investors and Futures Traders Protection Act.

⁷ Normally, the audit procedures required by Taiwan SAS are as follows: (1) discussion with other auditors about their audit procedures and results, (2) reviewing other auditors' audit programs, and (3) reviewing other auditors' working papers.

adopt the client's position. Furthermore, it is difficult for auditors to personally obtain the sufficient and competent evidence regarding overseas investments and related accounts. Hence, the difficulty and ambiguity in corroborating overseas investment audit may render the auditor susceptible to management pressure. A shared opinion instead of a going-concern opinion turns out to be the result of a concession. Overall, dismissal threats are likely to be the most credible where the auditor can divide and lower professional responsibility, coupled with ambiguous audit promulgation regarding necessary verifying procedures when referring to another auditor.

4. Methodology for Dismissal threats Argument

In the present investigation, we have adapted the analogy of Lennox's (2000) opinion-shopping variable to our dismissal threats variable. In the scenario of a dismissal threat imposed by the client, auditors are more likely to be dismissed if they are inclined to issue an unfavorable audit opinion. On the contrary, auditors are not dismissed if they promise their client to issue a favorable opinion. Hence, the difference in auditor switching probability had the auditor issued opposite opinions can be used to as a proxy variable for dismissal threats and expressed in notation as follow:

$$[pr(S = 1|Q = 1) - pr(S = 1|Q = 0)] > 0,$$

where pr is the probability, $Q=1$ (0) stands for the unfavorable (favorable) opinion, and $S=1$ means auditor switch, 0 otherwise.

To estimate the dismissal threat variable, we construct an auditor switch model.

$$\begin{aligned}
 S_{t+1}^* &= \theta X + \theta_1 OA_t + \theta_2 GC_t + u & (1) \\
 S_{t+1} &= 1 \quad \text{if } S_{t+1}^* > 0, \\
 S_{t+1} &= 0 \quad \text{if } S_{t+1}^* \leq 0
 \end{aligned}$$

where $u \sim \Phi(0, \sigma_u^2)$ and Φ is the standard normal cumulative distribution function.

S^* stands for the latent variable of propensity to switch auditor. X controls for other determinants of auditor switch. Two dummy variables (i.e. OA and GC) are used to capture the audit opinion effect. $OA=1$ ($GC=1$) means a shared (going-concern) opinion, 0 otherwise.

The clean opinion is reflected by both OA and GC coded as 0. Hence, auditors are dismissed in period $t+1$ with probability $pr(S_{t+1}|X, OA_t = 0 \text{ and } GC_t = 0)$ if they issue a clean opinion in period t . As to the switching probability conditional on a going-concern opinion, we define $pr(S_{t+1}|X, GC_t = 1)$ to accommodate multiple qualifications, which occur frequently in audit practice. From the probability $pr(S_{t+1}|X, GC_t = 1)$, we can represent both single (i.e. $OA=0, GC=1$) and multiple qualification (i.e. $OA=1, GC=1$) situations. Therefore, when the client prefers a clean to a going-concern opinion, the dismissal threat ($THREAT^{GC-Clean}$) can be defined as

$$[pr(S_{t+1}|X, GC_t = 1) - pr(S_{t+1}|X, OA_t = 0, GC_t = 0)].$$

In the situation involving a client's coercing a shared instead of a going-concern opinion, the dismissal threat ($THREAT^{GC-OA}$) may be defined as

$$[pr(S_{t+1}|X, OA_t = 1, GC_t = 1) - pr(S_{t+1}|X, OA_t = 1, GC_t = 0)].$$

This means, in the multiple qualifications circumstance, the shared opinion is agreed upon by the client and the auditor while the going-concern modification opens to argument between the client and the auditor.

Both $THREAT^{GC-Clean}$ and $THREAT^{GC-OA}$ are estimated by Equation (1) and included in an auditor report model as follow:

$$\begin{aligned}
QUAL^* &= \gamma Y + \gamma_1 THREAT^{GC-Clean} + \gamma_2 THREAT^{GC-OA} + v \quad (2) \\
QUAL &= 2 \quad \text{if } QUAL^* > \mu_1, \\
QUAL &= 1 \quad \text{if } QUAL^* \leq \mu_1, \\
QUAL &= 0 \quad \text{if } QUAL^* \leq 0,
\end{aligned}$$

where $v \sim \Phi(0, \sigma_v^2)$ and $E(u, v) = 0$. The latent variable ($QUAL^*$) in Equation (2) represents the auditor's judgment of the client's financial condition. The remaining explanatory variables (Y) control for other determinants of audit opinions. The auditor applies threshold values, μ_1 , in determining the modified audit opinion. The auditor's choice of opinions are clean ($QUAL=0$), shared ($QUAL=1$), and going concern ($QUAL=3$) when $QUAL^*$ falls in the ranges of (< 0), ($0, \mu_1$) and ($> \mu_1$), respectively.

The variable $THREAT^{GC-Clean}$ is used to test H_1 ; accordingly, we expect the coefficient on $THREAT^{GC-Clean}$ is positive ($\gamma_1 > 0$). As for H_2 , we predict the coefficient on $THREAT^{GC-OA}$ is negative ($\gamma_2 < 0$).

5. The Sample and Variable Measurement

5.1 Sample and Data

5.1.1 Data

We apply this test to listed companies in Taiwan and establish the research period from 1999-2001. Since some variable measurements employ data from year $t-2$ to $t+2$, our data collection period covers 1997-2003. All the variables used to construct our empirical analysis are retrieved from the Taiwan Economic Journal (TEJ) database.

5.1.2 Sample Selection

Our sample is composed of publicly traded corporations listed on TSE and GSM, excluding financial institutions. To avoid the same company being classified into both switch and non-switch samples, companies in the non-switch sample are required to have kept (i.e., not switched) auditors for at least 3 consecutive years, the exact

duration of the research period. In addition, we exclude insolvent companies that are judicially declared a special arrangement by TSE since an auditor's reporting discretion declines when a company has filed for bankruptcy (Carcello and Neal 2000). Furthermore, we do not include litigation qualifications because liability for lawsuits is not recorded in the financial statements (Krishnan and Krishnan 1996). Following this procedure, our sample is reduced to 1,926 companies-year combinations.

Auditors do not generally issue going-concern opinions for non-stressed companies that suddenly fail (McKeown et al. 1991). Therefore, from the preliminary sample we determine those companies that were potentially financially distressed. As in prior research, we define a company as stressed if it exhibits at least one of the following financial stress signals: (1) negative working capital in year t , (2) a bottom line loss in any of the 3 years prior to year t , and (3) negative operating cash flows in the consecutive 3 years prior to year t . After deleting non-stressed companies, we also exclude companies with insufficient data for estimating Equation (1). Therefore, our final sample for Model (1) includes 791 companies-years. Owing to adding the lag variable of audit opinion in Equation (2), the final sample for Equation (2) is further reduced to 607 companies-years. Table 1 presents the details of our sample selection procedure.

Insert Table 1

5.2 Variable Measurement

5.2.1 Auditor Switch (S)

A dummy switch (S) has been set to one if a company changes its auditor in the

year following the issuance of the opinion, zero otherwise. By comparing both the audit firm and the individual auditors in the current year with that in the following year, we identify the auditor switch.⁸ Therefore, any one of following conditions shall not be coded as switches: (1) same audit firm but different individual auditors, (2) audit firm merges, (3) same individual auditors who have joined a new audit firm, and (4) audit firm name changes.

5.2.2 Auditor Report (*QUAL*, *OA*, *GC*)

The auditor report (*QUAL*) is the dependent variable in Equation (2). We estimate the three-level ordered logistic auditor report model. *QUAL* is coded as zero for clean opinions, one for shared opinions, and two for going-concern opinions.^{9,10} Multiple qualifications arising in conjunction with the going-concern opinion are included in the going-concern opinions category. Two opinion dummies (i.e. *OA* and *GC*) are designated as independent variables in Equation (1) due to the three-level *QUAL*. *OA*, shared opinion, is 1 when *QUAL*=1, zero otherwise. *GC*, a going-concern opinion, is 1 when *QUAL*=2, zero otherwise.

5.2.3 Control Variables (*X*) Included in the Auditor Switch Model

In addition to auditor reports of interest, we control for the effects of other factors likely to affect a client's decision to dismiss its auditor: (1) changes in client characteristics, (2) characteristics of the incumbent auditor, (3) financial distress, and (4) miscellaneous, which are designated as year dummies (*YEAR_j*).

(1) Client Changes

⁸ The switching status of each company is verified by examining other sources such as the website information on Market Observation Post System in Taiwan.

⁹ Prior auditor report research classifies a modified audit opinion for material uncertainties and going-concern problems depending on the severity of qualifications. In Taiwan, as most material uncertainties have involved litigation which cannot be predicted by financial variables, we eliminate the litigation category as has been done by prior research (e.g. Krishnan and Krishnan 1996).

¹⁰ In line with previous research (e.g., Krishnan 1994; Jeter and Shaw 1995), consistency exceptions for voluntary and mandatory accounting changes are one cause for a modified auditor report, but they are included in the clean opinion category because the auditor has little discretion in such matters.

We expect a positive relation between auditor switch and each of the following variables that reflect changing auditee characteristics. Johnson and Lys (1990) argue that audit firms achieve competitive advantages through specialization, and that clients purchase audit services from the least cost supplier. Client-auditor realignments thus represent efficient responses to changes in client operations and activities over time. Following the model used by Johnson and Lys, four variables are used as proxies for expansion, profitability, financing and audit risk: changes in asset growth ($|GROWCH|$), changes in cash flow ($|CFOCH|$), changes in financing ($|FINCH|$), and changes in times-interest-earned ($|TIECH|$), respectively. $|GROWCH|$ is constructed by the absolute value of the difference obtained from subtracting the pre-switch two-year average assets growth rate from the post-switch average growth rate. The absolute value is used since the primary focus is on whether the client changes its auditor, not the direction of auditor changes. Similarly, the variable, $|CFOCH|$, is the absolute value of change in two-year average operating cash flows (deflated by total assets) before and after an auditor switch. $|FINCH|$ is measured by the absolute difference of two-year mean proceeds from external financing before and after the switch, where external financing is measured by the proceeds from newly-issued equity and debt (public or private), divided by total assets. We construct $|TIECH|$ from the absolute difference between the two year mean times-interests-earned (TIE) before and after the switch. TIE is defined as earnings before interests and taxes divided by interest expenditure. We winsorize both the upper and lower 5% of TIE because TIE is inflated by minor interest expenditures.

A change in top management is often associated with a change in auditors.¹¹ A new manager may change auditors in order to obtain a fresh perspective on the

¹¹ See Chow and Rice (1982), Williams (1988), and Carcello and Neal (2003).

company's financial results, or because he or she had positive experience with another audit firm (Carcello and Neal 2003). In Taiwan, both chairman of the board and chief executive office (CEO) are charged with the execution of the company's decisions. Therefore, we set dummy variable *MGTCH* to 1 if both chairman and CEO changed in the year the auditor was dismissed or in the previous year and 0 otherwise.

(2) Incumbent Auditor Characteristics

Following Krishnan et al. (1996), we use *IMS* and *BIG5* to represent auditor-related factors and predict a negative relation between these auditor-related factors and auditor switch. The auditor's industry market share (*IMS*) is measured as the percentage of the log of total assets that the auditor audits for all companies in the client's industry¹². The auditor's industry market share can reflect audit expertise and can also proxy for reputation effect. The greater the auditor's market-share in the client's industry, the less likely the client is to dismiss its auditor (Krishnan et al. 1996). Previous studies have used the Big 5 auditing firms to proxy for both auditor quality and reputation effects. A client is less likely to switch from a Big 5 (Krishnan et al. 1996). Therefore, variable *BIG5* takes the value of one for the member firms of Big 5 in Taiwan, zero otherwise.

(3) Financial Distress

Previous studies (e.g., Schwartz and Menon 1985; Krishnan and Stephens 1995) have suggested that financially distressed companies may be more likely than healthy companies to change auditors. The motivation for such a change could be a need for different services, an inability to pay audit fees or disagreements with the incumbent auditor over accounting policies or disclosures. We use a 2-year consecutive net loss (*LOSS2*) to represent financial distress and predict a positive sign for this variable.

¹² Each company's industry comes from TEJ's classification of companies into industries, which is based on the TSE version SIC and adjusted by primary products.

5.2.4 Control Variables (*Y*) Included in the Auditor Report Model

Beside the threat variables of interest, the choice of independent variables in the auditor report model is classified into four categories: (1) contrary factor, (2) mitigating factors, (3) auditor characteristics (quality and tenure), and (4) miscellaneous.

(1) Contrary factors

Prior studies find that the greater the client's financial distress, the greater the probability of receiving modified auditor reports (Carcello and Neal 2000; Geiger and Raghunandan 2002). We use dummy variable *DISTRESS* to identify whether the entity is declared insolvency in the subsequent year.¹³ We expect a positive relationship between *DISTRESS* and the receipt of a going concern opinion.

Mutchler et al. (1997) find that debt covenant violations are positively associated with the probability of receiving a going-concern opinion. We include leverage variable *LEV* to capture proximity to covenant violations because firms close to violation are likely to have high leverage (Beneish and Press 1993), and predict a positive sign. *LEV* is measured by total liabilities over total assets at the end of the year.

Following Dopuch et al. (1987), we also include the ratio of receivables and inventories to assets (*RIA*) to capture high risk accounts which call for greater caution and exercise of independent auditor judgment. *RIA* is expected to have a positive association with a going concern opinion.

(2) Mitigating factors

¹³ Dopuch et al. (1987) employ whether a loss was reported (*LOSS*) to measure a client's financial health. In contrast, we use *LOSS* as one of several financial stress signals mentioned earlier in section 5.1.2. To avoid multicollinearity, we use the *DISTRESS* variable, which reflects the ex post event of being classified into insolvent, to be a proxy for the auditor's ex ante perception that the client's financial condition deteriorates. The variable's validity depends on whether one can reasonably assume that the auditor is aware of the client's financial condition at the time of issuing the report.

We include several factors that are likely to mitigate the probability of receiving a going concern opinion and expect the sign on the coefficients for each mitigating factor to be negative. Client size is generally positively associated with its financial health, which in turn decreases with the likelihood of its receiving qualified opinion (Dopuch et al. 1987; Francis and Krishnan 1999). Furthermore, large companies have more negotiating power in the event of financial difficulties and hence are more likely to avoid bankruptcy (Reynolds and Francis 2001, DeFond et al. 2002). Client size (*SIZE*) is measured as a log of total assets.

Two other mitigating factors in our model include *FASTSALE* and *FFINANCE* because SAS No.59 specifies managerial actions that mitigate the effect of contrary factors including plans to sell assets, issue new financing or refinance existing debt, and increase ownership equity. Using methodology similar to that of Reynolds and Francis (2001), we examine the subsequent fiscal year financial statements to identify sales of assets or the issuance of new debt or equity. *FASTSALE* is the sum of the proceeds from selling investment and fixed asset in year t+1, scaled by total assets in year t. *FFINANCE* is measured by the issuance of new debt or equity (public or private) in year t+1, divided by total assets in year t.

(3) Auditor characteristics

We include an industry specialist dummy variable (*SPEC*) to control for the impact auditor quality could have on the exercise of independent judgment. High-quality auditors have a greater investment in technology to detect errors and irregularities and are therefore more likely to issue a qualified opinion (Krishnan and Krishnan 1996; Craswell et al. 2002). We expect the sign on the coefficient for *SPEC* to be positive. According to Craswell et al. (1995), we identify the industry specialist if the auditor's market share is greater than 20% in the client's industry with at least

30 companies.¹⁴

We measure auditor tenure (*TENURE*) as the number of consecutive years that the client has retained the auditor.¹⁵ The longer the auditor tenure, the more complacent the auditor becomes and the less independent the auditor's judgment is (Jeter and Shaw 1995; Geiger and Raghunandan 2002; Craswell et al. 2002). It is also the case, however, that over the years an auditor develops in-depth knowledge of the client's business, which is crucial in performing an effective audit, and thus is more likely to be vigilant in exercising independent auditor judgment (Geiger and Raghunandan 2002; Craswell et al. 2002). Therefore, the sign on the coefficient for *TENURE* could be either positive or negative.

(4) Miscellaneous

The remaining control variables are prior year audit opinion (*PRIOROP*), time listed (*AGE*), and indicator variables for year *j* (*YEARj*). *PRIOROP* captures the effect of persistence in audit reporting and is expected to have a positive sign. *AGE* controls firm maturity and is measured as log of the number of years the company has been publicly traded. Finally, *YEARj* control for any year-specific effects. As with Francis and Krishnan (1999), no directional signs are predicted for *AGE* and *YEARj*.

6. Results

6.1 The Empirical Results for the Auditor Switch Model

6.1.1 Descriptive Statistics

Table 2 presents descriptive statistics on the full sample, switch subsample, and non-switch subsample for the variables used in our auditor switch model (i.e.

¹⁴ Craswell et al. (1995) used the threshold of 10% and 20%, respectively, to identify an industry specialist. We chose 20% because both mean and median of *IMS* are greater than 10% (see Table 2).

¹⁵ We truncate auditor tenure at 12 years because of data limitation. Moreover, truncation can reduce the effect of extreme values for clients that have retained their auditors for many years (Carcello and Neal 2003).

Equation (1)).¹⁶ The mean and median values of $|GROWCH|$ in the full sample are 0.168 and 0.104, respectively, indicating the asymmetry of the sample distribution given the absolute value function used in the calculation of this variable. With respect to the differences tests between switch and non-switch samples, clients are more likely to switch auditors when clients have larger changes in profitability ($|CFOCH|$), have incidence of changes in top management ($MGTCH$), and incur financial distress ($LOSS2$). There was no significant relation between auditor dismissals and change in external financing ($|FINCH|$), auditor industry-market share (IMS), and association with Big 5 ($BIG5$). As for $|TIECH|$, the t-test for the difference in mean values was statistically significant, however, this was not the case for the Wilcoxon rank sum test, suggesting the possibility of extreme values. Additional analyses are presented in section 6.3 that control for the effect of outliers.

Insert Table 2

As for audit opinions, OA accounts for 37.0% of the full sample. In z tests for differences in means for OA between switch and non-switch samples, the results show that there is no support for OA increasing the propensity of clients to switch auditors. GC accounts for only 3.8% of the full sample, suggesting uncommon audit opinions. There are marginally statistically significant differences in GC between companies that switch auditors and the comparison group, a result which is consistent with auditors losing clients if they issue unfavorable audit opinions.

6.1.2 Logit Analysis

Table 3 reports the results from a binary logit analysis of the auditor switch model used to estimate the dismissal threat variables. The overall model is highly

¹⁶ The median analysis for dummy variables is not tabulated but is available upon request.

significant ($p < 0.000$), and pseudo- R^2 is 17.5 percent.¹⁷ Hosmer and Lemeshow's (1989) test of goodness-of-fit cannot reject the null hypothesis of a well-fitted model ($p\text{-value} = 0.453$).¹⁸

Insert Table 3

Among the control variables, *|GROWCH|*, *MGTCH*, and *LOSS2* have significant coefficients in the expected direction. Namely, companies are more likely to switch auditors when they have greater changes in firm growth, have incidence of changes in top management, or incur financial distress.

With respect to the audit opinion variables, we find that both *OA* and *GC* have positive signs, as expected, but are insignificant. Possibly as DeAngelo (1982) notes, qualification avoidance is not an important motivation to change auditors. On the other hand, it is also likely that the threat of a switch is followed by the issuance of a clean opinion, whereupon the client decides not to switch, causing no statistically significant relationship to exist between switching and modified auditor reports. The latter explanation is highly related to our hypotheses. Hypotheses testing allow us to empirically analyze which explanation is the most plausible.

6.2 The Empirical Results of the Auditor Report Model

6.2.1 Descriptive Statistics

Table 4 reports descriptive statistics on the full sample, clean opinion subsample, and modified audit opinion (hereafter, MAO) subsample for the variables used in our

¹⁷ The explanatory power of Johnson and Lys (1990) and Carcello and Neal (2003) models are 20.1% (p.293) and 11% (p.109), respectively. Our model's explanatory power is comparable with prior studies.

¹⁸ In order to diagnose the problem of multicollinearity, the auditor switch model was also estimated using OLS regression to derive variance inflation factors (VIF). All VIF are less than 1.70, indicating that multicollinearity is not a problem in the model estimation.

auditor report model (i.e. Equation (2)). As for control variables in Equation (2), the MAO subsample is significantly different from the clean opinion subsample on the following dimensions: they are more likely to have incidence of subsequent insolvency (*DISTRESS*), have a higher leverage (*LEV*), are larger in size (*SIZE*), have longer auditor tenure (*TENURE*), are more likely to have received a prior year MAO, and have listed for a longer time (*AGE*).

With respect to the experiment variables, the mean value of $THREAT^{GC_Clean}$ in the full sample is 0.029, indicating that the dismissal probability conditional on a going concern opinion is 2.9% higher than the probability conditional on a clean opinion.¹⁹ The test statistics for $THREAT^{GC_Clean}$ show there are significant differences in dismissal threats between those receiving clean and modified opinions. Companies with modified opinions have a higher dismissal threats compared to those with clean opinions, suggesting that clients do not appear to succeed on $THREAT^{GC_Clean}$.

Insert Table 4

In order to further explore the two *THREAT* variables, we present the descriptive statistics from various sample partitions. Chung and Kallapur (2003) argue that P_{fire} , the probability of a firm's firing its auditor for reporting the breach, is higher for clients with stronger incentives to manage earnings, or those with weaker corporate governance structures. In addition, P_{fire} could be lower if the client depends on the auditor for expertise. We use leverage (*LEV*) and changes in asset growth ($|GROWCH|$) to control for client incentives to manage earnings. The strength of corporate

¹⁹ The t-statistics for this mean value is 20.92 with p value < 0.0001; while the p value from the Wilcoxon test is also <0.0001 (untabulated).

governance is proxied by whether the chairman and CEO positions are separate (*CEOCHAIR*), and whether the client has 5% blockholders (*BLOCK*). Auditor expertise is proxied by whether he or she is the industry specialist (*SPEC*). For each continuous variable, we divide the sample into two groups by the median of the variable concerned. For indicator variables such as *CEOCHAIR*, we divide the sample into two groups. Table 5 presents descriptive statistics on the two *THREAT* variables for various sample partitions.

As expected, the difference in means between the two groups is statistically significant in sample partition by measures of incentive to manage earnings and client dependence on auditor. For corporate governance factors, the medians of $THREAT^{GC_Clean}$ and $THREAT^{GC_OA}$ for firms with 5% blockholders appear to be significantly greater than those firms without 5% blockholders. As for *CEOCHAIR*, we have the expected sign but not significant. Overall, our *THREAT* variables are greater in subsamples of clients that have higher incentives to manage earnings, weaker corporate governance structures, and are less dependent on auditors, consistent with Chung and Kallapur's (2003) argument.

6.2.2 Logit analysis for auditor reporting

Table 6 reports the results for ordered logit analysis of the auditor switch model. The overall model is significant (LR statistics have p-value less than 0.000). Pseudo R^2 is 60.1%.²⁰ The highly significant positive coefficient on $THREAT^{GC_Clean}$ is as predicted in H1. For the sample of potentially distressed companies, the auditor is more likely to issue a going-concern opinion to the client who threatens to dismiss to get a clean opinion, after controlling for contrary factors, mitigating factors, auditor

²⁰ We also estimate the equation (2) using OLS regression to derive VIF to assess potential collinearity. None of the VIFs are greater than 3.14, indicating that multicollinearity is not a concern in the auditor report model estimation.

characteristics and miscellaneous. The result is consistent with the argument that the expected disutility of issuing an inappropriate opinion is sufficiently large to protect auditor independence.

Insert Table 6

The coefficient f for $THREAT^{GC-OA}$ in Equation (2) is negative and significant ($p < 0.000$), lending a support to H2. In situations with shared legal and professional responsibility and thus lower auditors' expected disutility of sacrificing independence, auditors may easily surrender to dismissal threats and lower the propensity of issuing a going-concern opinion.

In sum, the tests of H1 and H2 indicate that responsibility divisibility is the key factor when an auditor decides whether or not to surrender professional independence to dismissal threats. When the auditor has to assume full responsibility caused by a wrongly issued clean opinion, he or she is more likely to issue a going-concern opinion to a potentially distressed client. On the contrary, when the auditor can divide the professional responsibility with other auditors, he or she is less likely to issue a going-concern opinion to a potentially distressed client.

The control variables, *DISTRESS*, *LEV*, *FFINANCE*, and *PRIOROP* have significant coefficients in the expected direction. Companies are more likely to receive a going concern report if they are financially distressed or with debt default. Future issuance of debt or equity reduces the likelihood of receiving a going concern report. Finally, companies are likely to receive a going concern report because of the persistence in audit opinions.

6.3 Sensitivity Analysis

Additional analyses are reported in this section to assure that our results are not caused by measurement errors and model misspecification.

Alternative measurement of $|TIECH|$. As mentioned in Section 6.1.1, earlier descriptive analyses suggest that $|TIECH|$ might contain extreme values. In order to avoid outlier effects, we dichotomize this variable and set $|TIECH|$ as 1 if $|TIECH| \geq$ median and zero otherwise. When we rerun Equation (1) with the new $|TIECH|$, the coefficient on the new $|TIECH|$ variable remains insignificant. Using the new results from Equation (1) to re-estimate both the $THREAT^{GC_Clean}$ and $THREAT^{GC_OA}$ in Equation (2), the coefficients on the two $THREAT$ variables are still significant in expected direction. Therefore, we conclude the results in Table 6 are robust with respect to the extreme values of $|TIECH|$.

Adding market variables as control variables. The audit opinion prediction model of Dopuch et al. (1987) includes financial and market variables. Equation (2) does not include market variable due to sample size consideration. Nevertheless, when we add $RET-MRET$ (companies return minus market return) and $BETA$ to the model, the coefficients for $RET-MRET$ and $BETA$ are insignificant, and the two $THREAT$ variables are significant in expected direction as shown in Table 6.

Adopting the control variables of Bell and Tabor (1991). Bell and Tabor (1991) develop a model to predict modified audit opinion by using financial statement variables. We replace the control variables originating from the Dopuch et al. (1987) model such as $DISTRESS$, LEV , RIA , and AGE with four control variables from Bell and Tabor (1991): rate of change in ROE, rate of change in the ratio of inventory to net sales, rate of change in the ratio of receivables to inventory, and rate of change in the ratio of current assets to current liabilities. When we rerun Equation (2) with new control variables, none of the new control variables are significant, and the results of

the hypotheses tests are still significant in expected direction. Additional analyses from the complete Dopuch et al. (1987) model and the Bell and Tabor (1991) model further assure that our results are not caused by model misspecification.

First-time qualification. We eliminate prior qualifications to capture first-time qualifiers and rerun the ordered logistic regression of auditor report. As predicted, there exist significant associations between the two *THREAT* variables and propensity to qualify.

7. Conclusion

The Public Oversight Board's Panel on Audit Effectiveness (POB 2000, 109) notes that independence is fundamental to the reliability of auditor's report. This study investigates whether dismissal threats imposed by clients jeopardize auditor independence and result in auditors' decreased propensity to issue going-concern opinions to financially distressed clients. We identify two types of dismissal threats imposed by the same client. One is the client threatens to dismiss the incumbent auditor unless the auditor issues a clean opinion in place of a going-concern opinion. The other is the client steps down from a clean opinion to a shared opinion but still rejects a going-concern opinion. These two types of dismissal threats come from the same client and therefore have the same benefits to the auditor if he or she chooses to please the client. However, the two types of corresponding misconducts have different cost impact to the auditor if he or she chooses to please the client. Possibly due to professional responsibility divisibility, the auditor has less expected costs of issuing a shared opinion than that of issuing a clean opinion when he or she fails to qualify the going-concern assumption. Therefore, we expect these two dismissal threats have different impact on the auditor's reporting behavior.

Our result shows that the probability of stressed clients receiving going-concern

opinions increases when the auditor faces the client preferring a clean opinion. On the other hand, the result shows that the auditor decreases the propensity of issuing a going-concern opinion when he or she faces the client willing to receive a shared opinion. Overall, the results suggest that auditors are susceptible to dismissal threats if they have lower expected costs of issuing an inappropriate audit opinion.

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Table1
Sample Selection Criteria

<i>Sample selection for Equation (1)</i>	
Initial sample: industrial firms for 1999-2001	2,147
Less: Companies not retaining auditors at least 3 years in the non-switch sample	(145)
Insolvent	(67)
Litigation qualification	(9)
Preliminary sample	1,926
Less: Non-stressed firms	(1,062)
Insufficient data for Equation (1)	(73)
Final sample for Equation (1)	791
Breaking down as:	
Non-switcher ^a	760
Switcher ^b	31
<i>Sample selection for Equation (2)</i>	
Original sample from Equation (1)	791
Less: Insufficient data for Equation (2)	(184)
Final sample for Equation (2)	607
Breaking down as:	
Clean opinions	344
Shared opinions	239
Going concern opinions	24

^a Companies in the non-switch sample are required to have kept auditors for at least 3 consecutive years (financial institutions and service companies excluded).

^b Companies in the switch sample are required to dismiss their auditors in year t+1 (financial institutions and service companies excluded).

Table 2
Descriptive Statistics for the Variables in Auditor Switch Model

	Full Sample N=791		Non-switcher N=760		Switcher N=30		Test for difference	
	Mean (Median)	Std. Dev.	Mean (Median)	Std. Dev.	Mean (Median)	Std. Dev.	t Value (Z Value)	Pr> t (Pr> Z)
<i>/GROWCH/</i>	0.168 (0.104)	21.471	0.162 (0.104)	18.608	0.298 (0.139)	56.543	1.330 (1.685)	0.192 (0.092 [*])
<i>/CFOCH/</i>	0.062 (0.041)	0.078	0.060 (0.041)	0.072	0.115 (0.062)	0.171	1.760 (1.664)	0.088 [*] (0.096 [*])
<i>/FINCH/</i>	0.051 (0.020)	0.080	0.051 (0.020)	0.079	0.055 (0.018)	0.103	0.180 (-0.317)	0.855 (0.751)
<i>/TIECH/</i>	35.374 (3.645)	119.623	36.406 (3.698)	121.760	10.082 (2.505)	32.430	-3.600 (-1.139)	0.001 ^{***} (0.255)
<i>MGTCH</i>	0.076	0.265	0.067	0.250	0.290	0.461	4.597	<.000 ^{***}
<i>IMS_t</i>	0.162 (0.162)	0.081	0.163 (0.167)	0.081	0.141 (0.128)	0.081	-1.470 (-1.515)	0.143 (0.130)
<i>BIG5_t</i>	0.779	0.415	0.780	0.414	0.742	0.445	-0.500	0.615
<i>LOSS2_t</i>	0.277	0.448	0.264	0.441	0.581	0.502	3.853	0.000 ^{***}
<i>OA_t</i>	0.370	0.483	0.366	0.482	0.484	0.508	1.330	0.183
<i>GC_t</i>	0.038	0.191	0.036	0.185	0.097	0.301	1.748	0.081 [*]

*, **, and *** indicate significance at $p < 0.10$, 0.05 , and 0.01 , respectively.

N stands for number of observation.

Tests for differences in the means between non-switcher and switcher are based on t-statistics (z-statistics) for continuous (dummy) variables. Nonparametric tests for differences in location are based on the Wilcoxon rank sum test.

Year $t+1$ is the year of auditor switch.

/GROWCH/= absolute difference between two-year average asset growth before and after switch

/CFOCH/= absolute difference between two-year average cash flows before and after switch

/FINCH/= absolute difference between two-year average financing proceeds before and after switch

/TIECH/= absolute difference between two-year average times-interests-earned before and after switch

MGTCH= 1 if both chairman and CEO changed in the year of auditor switch or in the previous year, 0 otherwise.

IMS= incumbent auditor's market share within the client's industry

BIG5= 1 if member firms of BIG 5 in Taiwan, zero otherwise.

LOSS2= 1 if consecutive 2 years bottom line loss, zero otherwise.

OA= 1 if shared opinion, zero otherwise.

GC= 1 if going-concern opinions, zero otherwise.

Table 3
Results for Logistic Regression of Auditor Switch on Auditor Reports

$$S_{t+1}^* = \theta X + \theta_1 OA_t + \theta_2 GC_t + u \quad (1)$$

$$S_{t+1} = 1 \text{ if } S_{t+1}^* > 0,$$

$$S_{t+1} = 0 \text{ if } S_{t+1}^* \leq 0$$

	Predicted Relation	Estimated Coefficients	χ^2	Pr> χ^2
Intercept		-4.190	41.118	<.000***
Clients Changes				
<i>/GROWCH/</i>	+	0.017	3.328	0.068*
<i>/CFOCH/</i>	+	1.531	0.644	0.422
<i>/FINCH/</i>	+	-0.384	0.030	0.862
<i>/TIECH/</i>	+	-0.005	0.585	0.444
<i>MGTCH</i>	+	1.232	6.517	0.011**
Auditor characteristics				
<i>IMS_t</i>	—	-3.656	1.164	0.281
<i>BIG5_t</i>	—	0.316	0.265	0.607
Financial Distress: <i>LOSS2_t</i>	+	1.414	11.233	0.001***
Year Dummies: <i>YEARj</i>	?	included		
Auditor Rport				
<i>OA_t</i>	+	0.654	2.529	0.112
<i>GC_t</i>	+	0.467	0.391	0.532
LR statistic			39.894	<.000***
Hosmer and Lemeshow's (1989) test of goodness-of-fit			7.808	0.453
Pseudo R ²		17.5%		

*, **, and *** indicate significance at p < 10%, 5%, and 1%, respectively.

Year t+1 is the year of auditor switch.

Number of observations: 791.

/GROWCH/= absolute difference between two-year average asset growth before and after switch

/CFOCH/= absolute difference between two-year average cash flows before and after switch

/FINCH/= absolute difference between two-year average financing proceeds before and after switch

/TIECH/= absolute difference between two-year average times-interests-earned before and after switch

MGTCH= 1 if both chairman and CEO changed in the year of auditor switch or in the previous year, 0 otherwise.

IMS= incumbent auditor's market share within the client's industry

BIG5= 1 if member firms of BIG 5 in Taiwan, zero otherwise.

LOSS2= 1 if consecutive 2 years bottom line loss, zero otherwise.

OA= 1 if shared opinion, zero otherwise.

GC= 1 if going-concern opinions, zero otherwise.

YEARj= year dummies, j=0,1. For example, *YEAR1*=1 if sample year=2001, 0 otherwise.

Table 4
Descriptive Statistics for the Variables in Auditor Report Model

	Full Sample N=607		<i>QUAL</i> =0 N=344		<i>QUAL</i> =1,2 N=239+24		Test for difference	
	Mean (Median)	Std. Dev.	Mean (Median)	Std. Dev.	Mean (Median)	Std. Dev.	t Value (Z Value)	Pr> t (Pr> Z)
<i>DISTRESS</i>	0.127	0.333	0.102	0.303	0.160	0.367	2.124	0.034 **
<i>LEV</i>	0.479 (0.483)	0.176	0.455 (0.462)	0.170	0.510 (0.505)	0.179	3.840 (3.500)	0.000 *** (0.001 ***)
<i>RIV</i>	0.268 (0.212)	0.200	0.274 (0.224)	0.194	0.260 (0.193)	0.207	-0.850 (-1.717)	0.397 (0.086 *)
<i>SIZE</i>	15.424 (15.346)	1.191	15.237 (15.094)	1.185	15.668 (15.593)	1.155	4.490 (5.200)	<.000 *** (<.000 ***)
<i>FASTSALE</i>	0.018 (0.005)	0.039	0.017 (0.004)	0.045	0.019 (0.007)	0.031	0.460 (2.168)	0.643 (0.030 **)
<i>FFINANCE</i>	0.066 (0.026)	0.118	0.074 (0.027)	0.134	0.056 (0.025)	0.091	-1.980 (-0.736)	0.048 ** (0.462)
<i>SPEC</i>	0.224	0.417	0.233	0.423	0.213	0.410	-0.574	0.566
<i>TENURE</i>	7.591 (9)	3.124	7.343 (8)	3.071	7.916 (10)	3.167	2.250 (2.471)	0.025 ** (0.014 **)
<i>PRIOROP</i>	0.356	0.519	0.076	0.265	0.722	0.541	15.542	<.000 ***
<i>AGE</i>	1.579 (1.641)	1.194	1.362 (1.362)	1.199	1.862 (2.041)	1.127	5.230 (5.932)	<.000 *** (<.000 ***)
<i>THREAT^{GC_Clean}</i>	0.029 (0.020)	0.035	0.015 (0.009)	0.016	0.048 (0.031)	0.043	11.980 (14.740)	<.000 *** (<.000 ***)
<i>THREAT^{GC_OA}</i>	0.027 (0.017)	0.022	0.025 (0.016)	0.022	0.028 (0.018)	0.023	1.670 (1.984)	0.096 * (0.047 **)

*, **, and *** indicate significance at $p < 10\%$, 5% , and 1% , respectively. Tests for differences in the means between $QUAL=0$ and $QUAL>0$ are based on t-statistics (z-statistics) for continuous (dummy) variables. Nonparametric tests for differences in location are based on the Wilcoxon rank sum test. N stands for number of observations. Where $N = \# + \#$, # before (after) “+” represent the sample size of $QUAL=1(2)$

QUAL = 0 if a clean opinion, 1 if a shared opinion, 2 if a going concern opinion.

DISTRESS = 1 if clients are insolvent in the subsequent year, 0 otherwise.

LEV = total liability over total asset at the end of period

RIA = ratio of receivables and inventories to assets

SIZE = client size, measured by the log value of total assets.

FASTSALE = future asset sale, measured by the proceeds from asset sales, deflated by total assets.

FFINANCE = future finance, measured by the issuance of new debt or equity, deflated by total assets.

SPEC = 1 if auditor is an industry specialist, 0 otherwise.

TENURE = auditor tenure

PRIOROP = audit opinion in the prior year.

AGE = log of the number of years listed

THREAT^{GC_Clean} = dismissal threats when clients prefer clean opinions to going-concern opinions

THREAT^{GC_OA} = dismissal threats when clients prefer shared opinions to going-concern opinions

Table 5
Descriptive Statistics for *THREAT* Variables for Sample Partitions

Panel A: <i>THREAT</i>^{GC_Clean}										
Partition Variables	Small group			Large group			Test for Difference			
	N	Mean	Median	N	Mean	Median	t Value	Pr> t	Z Value	Pr> Z
Proxies for Client Incentives										
<i>LEV</i>	303	2.46%	1.44%	304	3.44%	2.47%	-3.52	0.00***	-5.34	<.00***
<i>GROWCH</i>	303	2.82%	1.99%	304	3.07%	2.14%	-0.90	0.37	-3.03	0.00***
Proxies for Corporate Governance										
<i>CEOCHAIR</i>	438	2.90%	1.85%	169	3.06%	2.19%	-0.54	0.59	-1.07	0.28
<i>BLOCK</i>	455	3.11%	2.24%	118	2.50%	1.47%	1.73	0.08*	2.83	0.00***
Proxies for Client Dependence on Auditor										
<i>SPEC</i>	471	3.11%	2.16%	136	2.39%	1.70%	2.56	0.01***	2.77	0.01***
Panel B: <i>THREAT</i>^{GC_OA}										
Partition Variables	Small group			Large group			Test for Difference			
	N	Mean	Median	N	Mean	Median	t Value	Pr> t	Z Value	Pr> Z
Proxies for Client Incentives										
<i>LEV</i>	303	2.21%	1.48%	304	3.13%	1.89%	-5.21	<.00***	-5.74	<.00***
<i>GROWCH</i>	303	2.43%	1.43%	304	2.91%	1.81%	-2.70	0.01***	-4.93	<.00***
Proxies for Corporate Governance										
<i>CEOCHAIR</i>	438	2.66%	1.67%	169	2.71%	1.79%	-0.26	0.79	-0.69	0.49
<i>BLOCK</i>	455	2.77%	1.75%	118	2.40%	1.59%	1.59	0.11	1.82	0.07*
Proxies for Client Dependence on Auditor										
<i>SPEC</i>	471	2.76%	1.73%	136	2.35%	1.47%	2.07	0.04**	2.47	0.01***

*, **, and *** indicate significance at $p < 0.10$, 0.05 , and 0.01 , respectively.

N stands for number of observations.

Tests for differences in the means between small and large group are based on t-statistics (z-statistics) for continuous (dummy) variables. Nonparametric tests for differences in location are based on the Wilcoxon rank sum test.

Small group means continuous (dummy) partition variables is below median (equal to zero). On the contrary, large group means continuous (dummy) partition variables is above median (equal to 1).

THREAT^{GC_Clean} = dismissal threats when clients prefer clean opinions to going-concern opinions

THREAT^{GC_OA} = dismissal threats when clients prefer shared opinions to going-concern opinions

SIZE = client size, measured by the log value of total assets.

LEV = total liability over total asset at the end of period

|*GROWCH*| = changes in asset growth

CEOCHAIR = 1 if CEO is also the chairman of the board, 0 otherwise.

BLOCK = 1 if client has 5% block-holders, 0 otherwise.

SPEC = 1 if auditor is an industry specialist, 0 otherwise.

TENURE = auditor tenure

Table 6

Results for Ordered Logistic Regression of Auditor Report on Dismissal Threats

$$QUAL^* = \gamma Y + \gamma_1 THREAT^{GC_Clean} + \gamma_2 THREAT^{GC_OA} + v \quad (2)$$

$$QUAL = 2 \text{ if } QUAL^* > \mu_1,$$

$$QUAL = 1 \text{ if } QUAL^* \leq \mu_1,$$

$$QUAL = 0 \text{ if } QUAL^* \leq 0,$$

	Predicted Relation	Estimated Coefficients	χ^2	$Pr > \chi^2$
Intercept 2		-8.766	27.219	<.000***
Intercept 1		-3.729	5.330	0.021**
Experimental Variables				
<i>THREAT^{GC_Clean}</i>	+	52.807	83.421	<.000***
<i>THREAT^{GC_OA}</i>	-	-69.686	43.615	<.000***
Control Variables (Y)				
<i>DISTRESS</i>	+	1.190	10.315	0.001***
<i>LEV</i>	+	1.969	7.066	0.008***
<i>RIA</i>	+	0.850	2.223	0.136
<i>SIZE</i>	-	0.065	0.365	0.546
<i>FASTSALE</i>	-	-1.184	0.121	0.729
<i>FFINANCE</i>	-	-2.386	3.813	0.051*
<i>SPEC</i>	-	0.326	1.630	0.202
<i>TENURE</i>	?	0.060	2.243	0.134
<i>PRIOROP</i>	+	2.412	102.725	<.000***
<i>AGE</i>	?	0.059	0.225	0.635
<i>YEARj</i>	?	included		
LR statistic			400.947	<.000***
Pseudo R ²		60.1%		

*, **, and *** indicate significance at $p < 10\%$, 5% , and 1% , respectively.

Number of observations: 607.

QUAL = 0 if a clean opinion, 1 if a shared opinion, 2 if a going concern opinion.

THREAT^{GC_Clean} = dismissal threats when clients prefer clean opinions to going-concern opinions

THREAT^{GC_OA} = dismissal threats when clients prefer shared opinions to going-concern opinions

DISTRESS = 1 if clients are insolvent in the subsequent year, 0 otherwise.

LEV = total liability over total asset at the end of period

RIA = ratio of receivables and inventories to assets

SIZE = client size, measured by the log value of total assets.

FASTSALE = future asset sale, measured by the proceeds from asset sales, deflated by total assets.

FFINANCE = future finance, measured by the issuance of new debt or equity, deflated by total assets.

SPEC = 1 if auditor is an industry specialist, 0 otherwise.

TENURE = auditor tenure

AGE = log of the number of years listed.

PRIOROP = audit opinion in the prior year.

YEARj = year dummies, $j=0,1$. For example, *YEAR1*=1 if sample year=2001, 0 otherwise.