QUALIFIED AUDIT OPINIONS AND AUDITOR SWITCHING

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Abstract

External auditors might not provide value by adding to the reliability and credibility of financial reporting if their independence is impaired. This study examines the interactive effects of change in managing director/chief executive officer (MD) and financial distress together with three control variables (type of audit firm; audit fees; and company size) on first, audit opinion and secondly on auditor switching. Based on a sample of 297 UK listed companies between 1986 and 1995 the logistic regression suggests that companies that are financially distressed and change their MD are most likely to receive a qualified audit report, ceteris paribus. Financial distress rather than change in MD is more important in determining audit opinion. Familiarity threat is found to be present specifically when distressed auditees that do not change their MDs receive unqualified audit report. Auditees have a tendency to switch auditor after receiving a qualified audit opinion, and the probability of a switch increases with the severity of qualification. In addition, the study finds that a change in MD influences auditor switching more than financial distress, thus indicating the presence of a dismissal threat.

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1. Introduction

External auditors are thought to provide value by adding to the reliability and credibility of financial reporting through independent audit (Porter, Simon and Hatherly, 1996). This fundamental principle arises from three forms of control which an audit provides: preventive, detective and reporting. However, auditors will not be able to provide these controls and hence, add value to financial reports if they are not independent of the parties being audited, particularly the managing director (MD) who, de facto, determines the auditors' appointment, dismissal and fees (Taylor and Turley, 1986; Mitchell et al., 1991; McInnes, 1993). Here lies the potential problem. Appointment, retention and fees are determined by the client but the auditors must remain independent to report to stakeholders. Independence distinguishes the auditor-client relationship from other professional-client relationships.

Taylor and Glezen (1997) make the point that in the US "no other standard in the Code of Professional Conduct is more important than independence, which is often defined as the ability to act with integrity and objectivity" (p.57). The importance attached to independence in the US is illustrated by the recent formation, by the Securities Exchange Commission (SEC) and the American Certified Public Accountants (AICPA), of an Independence Standards Board.

The Members Handbook (2000) of the Institute of Chartered Accountants in England and Wales (ICAEW) discusses the issue of objectivity and independence in an audit context. Threats to the objectivity and independence of the audit are categorised by the ICAEW (Members Handbook 2000, pp215-6) as: the self-interest threat; the self-review threat; the advocacy threat; the familiarity or trust threat; and the intimidation threat. The familiarity threat suggests that the auditor may be over-influenced by senior executives and become too sympathetic. An over-trusting relationship can impair objectivity by less rigorous testing than...
might be expected from an independent relationship. A similar threat to objectivity may result where the auditor has a financial self-interest conflict, such as the fear of losing a client.

To establish whether the familiarity and self-interest threats are present in the UK auditing environment is extremely difficult because of the problem of observability of the behavioural relationship. One way forward is to use proxies to further our understanding of the context and this is the approach adopted here. Specifically, our work investigates, in a UK context, the associations that: audit report qualifications has with Managing Director (MD) changes and financial distress; auditor switch has with audit report qualification, MD change and financial distress; and auditor switch has with the severity of audit report qualification.

Our proxies are, change in MD, financial distress, qualification and auditor switching with four other variables viz. audit fees, type of audit firm, auditee size and time acting as control variables. The motivation for this research is because of the limited number of studies conducted in the context of the UK environment. Only Citron and Taffler (1992 and 1997) have investigated such issues in the UK and our work extends their contribution by looking at the factors and relationships in greater depth. Specifically, Citron and Taffler (1992 and 1997) focussed mainly on the relationship between distressed companies with only one type of audit qualification, going concern.

Part of the motivation for this study is that work undertaken in the US may or may not be capable of generalisation to other environments. The business and audit environments in the US differs in several ways to that prevailing in the UK so that the interrelationship of factors influencing audit opinions and switching, and therefore audit independence, may differ. The business environment or form of capitalism differs between the two countries. Chandler (1990) classifies the US as competitive managerial capitalism whereas the UK business environment was thought to be personal capitalism. Lazonick and West (1998) classify the US as managerial whereas the UK as proprietary.
With respect to the audit environment, the first difference between the two countries is the extent to which non-audit work may be undertaken by the independent auditor. In the US, the Securities and Exchange Commission (SEC) does not permit an auditor of a listed company to provide services that may be in conflict with that duty, except for Arthur Andersen (Lowe and Pany, 1995). For example, the SEC's regulations state that auditing and accounting services may not be provided for any SEC-registered company since to do so would impair independence. There is no direct equivalent in the UK although members of the ICAEW, for example, are provided with an ethical guide. A possibility is that when a client in the UK is in financial difficulties the auditor may be compromised because to severely qualify the accounts could lead to insolvency and the loss of both audit and non-audit work. For users of accounts in the UK, it is difficult to assess the degree of compromise because, while audit fees are disclosed non-audit work fees were not over the entire period of review. Non-audit work fees have been disclosed with effect from 30 September 1992.

Of considerable importance is the fact that the UK does not have the equivalent of the SEC. Certain functions undertaken by the SEC are dispersed in the UK through the accounting profession, the London Stock Exchange, the Financial Services Agency and the Department of Trade and Industry. However, the resources available to these disparate organisations are very small compared to those available to the SEC. A further aspect is that US regulation stems from the SEC and is mandatory which contrasts with the voluntary arrangement of the professional body, the AICPA. Whilst the AICPA has enforcement powers over its members there is no compulsion for an auditor to be a member of the Institute. In the UK in contrast, an auditor must be a member of a recognised accounting body or approved by the Secretary of State (Section 389, Companies Act 1985). A further difference is that the UK is subject to European Directives and in this context the Eighth Directive on the qualifications and work of auditors (see, for example, Evans and Nobes, 1998a and b) is relevant. The UK has implemented the Directive although the specific requirements to ensure auditor independence have been delegated to member states. Furthermore, there has been a major innovation in the form of corporate governance procedures implemented by the London Stock Exchange which do not apply in the US (Citron and Taffler, 2000).
Differences also exist between the US and UK in the extent of litigation in which the former is far greater with a consequential impact on the perceived business risk of auditors. The extent of the difference may be difficult to quantify since many cases are settled out of court to avoid an adverse impact on reputation and the loss of income resulting from staff attending court for long periods of time. The role of the SEC may be significant since it has a low tolerance threshold and is not a party to settlements out of court. Such powers contrast sharply with those of the Secretary of State in the UK.

In the US, class actions and contingency fees are common but are relatively uncommon in the UK (Woolf, 1986). Over the last five years contingency fees have become more common in the UK but over the period of analysis of this paper, the UK and US differed markedly. Auditors in the UK are implicitly permitted to accept contingent contracts offered by their audit clients while auditors in the US are permitted to accept contingent fees for non auditing work as long as they are not from their audit clients (Dye et al, 1990). In the UK, liability to third parties is limited to special circumstances (Caparo Industries plc v Dickman and Others [1990]) whereas in the US "the auditor's potential liability for ordinary negligence under common law definitely extends to third parties with primary beneficiary relationships, often extends to third parties with foreseen relationships, and sometimes extends to third parties with foreseeable relationships" (Taylor and Glezen, 1997, p: 111).

Differences in environments suggest that results found in the US may not be applicable to the UK. Our analysis involves an examination of 297 UK listed companies between 1986 and 1995, with the logit regression results indicating that the probability of an audit qualification is greatest for a financially distressed firm that changes its MD followed by a financially distressed firm that does not change its MD. This indicates that qualification is driven more by financial condition than MD change. In addition, financially distressed companies that do not change their MDs are found to receive unqualified audit opinions thus indicating the existence of a familiarity threat. Results also show that the probability of an auditor switch is at its highest when a financially distressed firm changes its MD followed by non-distressed firms.
that change its MD. This indicates that MD change is more influential than financial distress in explaining auditor switching. Results also indicate that distressed companies that did not change their MD and received qualified audit opinions were more likely to switch their auditors thus indicating the existence of the dismissal threat. Another important finding is that the propensity to switch increases with the severity of qualification.

The paper is organised as follows. The next section reviews prior research in the area and section 3 provides an understanding of the underlying a priori relations. This is followed by sections on research methodology, the empirical results, and finally section 6 provides a summary and discussion.

2. Prior research
The literature on audit qualifications and auditor switching is interrelated but will be dealt with separately, as much as possible, to enhance our initial understanding. Variables that have been advocated as explanatory factors of audit qualification include audit fees (McKeown et al., 1991), financial distress and company size (Haskins and Williams, 1990; Citron and Taffler, 1992), management changes (Burton and Roberts, 1967; Carpenter and Strawser, 1971), type of audit firm (Warren, 1980; Shank and Murdock, 1978; Chow and Rice, 1982), reporting disputes (Magee and Tseng, 1990), and asymmetric information (Dye, 1991).

McKeown et al. (1991) have argued that larger auditees benefit from their bargaining power because of fee level and as a result are less likely to receive a qualified opinion i.e. the self-interest threat to objectivity and independence. The Guide to Professional Ethics issued by the ICAEW (2000) recognises this threat: "if the recurring fees from a client company or group of companies constitute a substantial proportion of the fee income of an audit firm, a self-interest threat is likely to arise, so as to imperil objectivity" (Section 4.1, Integrity, Objectivity and Independence). The threat is very real even when the fee income does not constitute a substantial proportion of fee income where an audit firm has difficulty in replacing lost clients. Even for large audit firms, mergers and acquisitions of corporate clients in the 1980s and 1990s created displacement problems. Consequently, this variable is incorporated into our analysis
i.e. the larger the fee level the less likely a qualified audit opinion will be issued since a client would not tolerate an audit qualification when higher than average audit fees have been paid. Unlike DeAngelo (1981) who classified high audit fees based on the ratio of paid fees to the audit firm’s total fees, this study uses the ratio of audit fees paid to auditee’s total assets as a proxy for high audit fees. The reason for adopting this ratio rather than the ratio used by DeAngelo (1981) is because it is the auditee who executes dismissal and as such, the focus is on the auditee rather than the audit firm.

Auditee size is another important explanatory variable because of the auditors' self-interest threat. Several studies have found that smaller companies are more likely to receive qualified audit opinions than larger auditees and subsequently change auditor (Gul et al., 1992; Krishnan et al., 1996). Both audit qualification and auditor switching are thought to be functions of the size of the client i.e. the smaller the company the higher the probability of audit qualification and subsequent switching. This variable is incorporated into our analysis i.e. the larger the auditee size, the less likely a qualified audit opinion will be issued and also less likely for the auditor to be replaced.

The evidence that large audit firms are more likely to issue qualified audit reports than their smaller counterparts is somewhat mixed. Whereas Warren (1980) did find a significant association between the two variables, Shank and Murdock (1978) found otherwise. Chow and Rice (1982) put the different findings down to the type of statistical tests and their own work, using a conditional logit model, supported the work of Warren (1980). Additionally, Krishnan et al. (1996) found that smaller firms in the US are less likely to be audited by Big 6 firms and also tend to switch auditors following a qualified audit report more than larger firms audited by Big 6 firms. DeAngelo (1981) has argued that large audit firms have greater incentives to avoid criticism that could harm their reputation and Dye (1993) suggests that because of their 'deeper pockets' they are more likely to disclose problems because of their greater risk exposure. To control for this possible effect the type of audit firm was incorporated into our analysis, although with some uncertainty as to the expected direction.
Research to date suggests that financial distress is very important in the issuance of an audit qualification (Haskins and Williams, 1990; Citron and Taffler, 1992). In testing for the presence of opinion-shopping in the UK, Lennox (2000) found that high leverage companies are more likely to receive modified audit report but in the subsequent period. Financial distress poses two main self-interest problems for the auditor. First, the loss of audit income and associated consultancy work and secondly, the probability of legal action against the auditor. The problem is likely to be most acute in going concern qualifications but other forms of qualification may be the harbinger of financial difficulty. For this reason we classified financial condition into non-distress and distress and incorporated it as an explanatory variable i.e. the greater the financial distress the higher the probability of audit qualification. Another motive for including non-distressed companies is to control for the possible effect of auditee’s financial condition on auditor switching as proposed by Chow and Rice (1982) and Schwartz and Menon (1985). This is operationalised by using company Z-scores which are composite measures based on published accounting information of auditee solvency/insolvency position (Taffler, 1983). Operationalisation of this variable is explained in detail in the next section.

There is evidence that a change in MD leads to switching because new management attempts to disassociate from previous relationships and prefers to deal with familiar parties (Burton and Roberts, 1967; Carpenter and Strawser, 1971; Beattie and Fearnley, 1995). However, Chow and Rice (1982) found that management change is insignificant to explain switching. Similarly, Schwartz and Menon (1985) found that neither change in MD nor qualified audit report in failing companies leads to switching. The extant literature (e.g. Chow and Rice, 1982; Schwartz and Menon, 1985) fails to consider the interactive effects of both distressed and non-distressed firms and MD change on type of audit report and switching. As suggested earlier, companies that receive qualified opinions may switch their auditors regardless of the solvency of the companies. However, qualification and financial distress may both lead to MD removal with the effect that the new manager will wish to dispense with the existing audit firm. Expectations about the direction of association are outlined in the next section.
Most of the factors influencing audit qualification also influence switching and in the same direction. The most common reason cited in the literature for switching is audit qualification although once the qualification has been given the threat of dismissal is substantially reduced. In reality, it is the threat of dismissal that jeopardises independence although the threat is not observable. What is observable are actual switches which are, in effect, being used as a proxy for situations where switching was threatened. Chow and Rice (1982) found a significant positive association between qualified opinions and subsequent auditor switching based on their study of a sample of US listed companies. In similar studies of Australian and Hong Kong companies, Craswell (1988) and Gul et al (1992) respectively, found results consistent with Chow and Rice (1982). Based on 'going concern qualifications' (giving an opinion on the uncertainty of the client remaining in business in the foreseeable future) and distressed firms, the study by Citron and Taffler (1992) on UK quoted companies over the decade 1977-1986, found a positive association between the presence of 'going concern' qualification and auditor switching in distressed companies. Research, such as that by Smith (1986) and Krishnan (1994) tend to disagree, suggesting that auditors are switched, not because of the type of audit opinions issued, but due to the auditors being too strict in their auditing procedures.

The relationship between audit opinion and switching is not uni-directional. The propensity to switch can influence auditors' opinion, an argument at odds with the empirical work mentioned earlier. Among those who believe that the threat of dismissal due to disagreement over a reporting policy that may cause the auditor to qualify (especially if other auditors are likely to share such professional judgement) include DeAngelo (1982), Magee and Tseng (1990), Dye (1991), Teoh (1992) and Krishnan et al. (1996). For instance, Teoh (1992) argued that the threat of switching by clients can influence the auditors' opinion and consequently, independence. In other words, the auditor will have to weigh the situation between being independent and giving a qualified opinion or facing the possibility of dismissal.

Dye (1991) proposes conditions that may cause a company to switch its auditor and the auditors' incentives to attest to a given report and argued that when the client and corporate auditor possess symmetric information about the firm's financial report, the auditor would not
be replaced. On the other hand, if asymmetric information exists and the auditor is likely to issue a qualified opinion, then it is highly likely that the auditor will be replaced.

In addition, DeAngelo (1982), in rejecting the hypothesis of an association between switching and qualification, argued that the causation may run in both directions i.e. qualified opinions can cause auditor switching and vice-versa. Similarly, Krishnan et al. (1996) confirmed the findings of previous studies on the positive effect of a qualified opinion on auditor switching and further suggest that auditors are more likely to issue qualified opinions (in period \( t_0 \)) when there is a potential for the company to switch (in period \( t_1 \)).

3. Conceptual framework
The relationships between audit opinion, switching and the various explanatory variables suggested in the literature are complex. Our conceptual framework is shown in Figure 1 and illustrates the interactive elements being considered. Relationship 1 in the figure illustrates the possible influence of the two variables under investigation, MD change and financial distress as well as the control variables (type of audit firm, audit fees, time and company size) on audit opinion while relationship 2 indicates the influence of the variables including audit opinion on auditor switching.

Figure 2 illustrates the interactions of MD change and financial condition on audit opinion. When a client is in financial difficulties, the auditor has greater business risk which increases the probability of a qualified audit opinion. Risk may increase with the size and public visibility of the client. Figure 2 shows that the probability of receiving a qualification is highest when the company is financially distressed and changes its MD. A change in MD may be a signal of a corporate problem and together with financial distress is likely to increase the business risk of the auditor considerably and therefore the higher the probability of qualification. At the other extreme, no MD change and strong financial standing will result in a low probability of a qualified opinion. In between these two possibilities are two others. We
hypothesise that the probability of an audit qualification is greater for no MD change and financial distress than for MD change and financial health because of the implications for perceived business risk of auditors. We further hypothesise that the familiarity threat is present when distressed companies do not receive a qualification especially when there is no change in MD. The argument for such an assumption is that distressed firms are expected to receive a qualified audit opinion but if such firms received an unqualified audit opinion and do not change their MD, this may suggest that there may be a close relationship between the auditor and the client which makes the former reluctant to qualify. On the other hand, distressed companies that experience changes in MDs and subsequently receive an audit qualification, suggests that auditors act in a professional manner.

We also hypothesise that the same variables that influence audit opinion are likely to explain auditor switching together with the type of audit opinion. However, the interrelationship between MD change and financial distress may be different to that illustrated above. In the case of distressed firms, a change in management is seen as desirable to resuscitate an ailing firm with a qualified opinion (Schwartz and Menon, 1985). We expect that the two extremes will be as for audit qualification. The probability of a switch will be highest when the company has a qualified audit report, is distressed and changes its MD. The lowest probability of a switch, even when a company receives an audit qualification, will be when the entity is financially healthy and does not change its MD. We believe that the two intermediate positions will be reversed when compared to the factors influencing audit opinion because the influence of the MD change is likely to be higher than financial distress in explaining auditor switching. Alternative allegiances of the new MD or because the new manager will wish to make a fresh start may increase the probability of a switch. The practice of engaging new auditors by the new MD based on familiarity may affect independence. We hypothesise that the relationship will be as illustrated in Figure 3. We further hypothesise that a dismissal threat is present when a financially distressed company that does not change its MD considers switching its auditor subsequent to an audit qualification.
A further explanation of auditor switching is that probabilities may be affected not only by the above factors but also by the severity of qualification (Craswell, 1988; Gul et al. 1992). We hypothesise that, given the other explanatory variables (audit fees; type of audit firm; auditee size; financial health; MD change), the probability of switching will increase with the severity of audit qualification as illustrated in Figure 4.

4. Research methodology

4.1 Data collection and identification of variables
A cross-sectional review of audit reports of a sample of companies listed on the London Stock Exchange over a decade (1986 to 1995) inclusive was undertaken. The sample size selected for this study was initially 317 companies out of a population of 1,800 companies, based on the table of the general scientific guideline for sample size decisions provided by Sekaran (1992). A stratified sampling approach was then used to derive the size of each stratum (see Column 4 in Table 1). However, in the course of the research, 20 companies were eliminated from the sample because of missing data. The final sample was 297 companies in five sectors excluding the financial sector⁸ and the breakdown is shown in Column 6 in Table 1.

The final sample is considered to be representative of non-financial UK companies. The study is a longitudinal survey of 10 years and after adjusting for the entry/exit of firms the total number of corporate annual reports considered was 2715.

Information on the research variables was mainly extracted from annual reports. Table 2 provides a summary of the operationalisation of the variables.
4.2 Data Analysis
Multivariate analysis was adopted to assess the variable relationships using logistic regression because the dependent variables are dichotomous. Model 1 has the dependent variable as qualified/not qualified audit report (Ot) and Models 2 and 3 switching/non-switching (St). Both models 2 and 3 include the interaction effects of financial distress and MD change with the latter model investigating the impact of the depth of audit qualification and auditor switching. The model parameters are estimated using the maximum-likelihood method whereby the coefficients that make the observed results most 'likely' are selected on the basis of an iterative algorithm. Furthermore, the maximum-likelihood method also has the advantage of asymptotic normality.9

4.3 Model specification10
Model 1
In order to test for the relationships between type of audit opinion, financial distress and MD change as well as familiarity threat, we use the following logistic regression model:

\[ O_t = f (\beta_0 + \beta_1 Z_{chMD_1} + \beta_2 AudFees_t + \beta_3 A_t + \beta_4 C_t + \beta_5 T_t + \varepsilon_t) \]

\( O_t \) is a binary variable indicating whether or not the audit opinion is qualified or unqualified. \( Z_{chMD_1} \) represents the four scenarios involving the interaction of financial solvency and MD change where:

- \( Z_{chMD_1} \) = distressed and MD change (1), otherwise (0)
- \( Z_{chMD_2} \) = distressed and no MD change (1), otherwise (0)
- \( Z_{chMD_3} \) = non-distressed and MD change (1), otherwise (0)
- \( Z_{chMD_4} \) is the excluded dummy variable

\( \varepsilon \) = error term.
The other independent variables are as summarised in Table 2. To further test the presence of the familiarity threat on auditor independence, a contingency table was prepared to show the association between change in MD and audit report for financially distressed firms.

**Model 2**

To determine the presence of the dismissal threat on auditor independence, the following logistic regression model was adopted to test the association between auditor switching and the five independent variables (viz. type of audit opinion, financial solvency and MD change; audit fees; type of audit firm; size of auditee; and time):

\[
S_t = f (\beta_0 + \beta_1 QZ\text{-}chMD_{xt} + \beta_2 \text{AudFees}_t + \beta_3 A_t + \beta_4 C_t + \beta_5 T_t + \varepsilon_t)
\]

\(S_t\) is a binary variable indicating whether or not the auditor has been switched. \(QZ\text{-}chMD_{xt}\) represents the four scenarios involving the interactions of financial solvency, MD change and qualification, where:

- \(QZ\text{-}chMD_1\) = unqualified [the excluded dummy variable]
- \(QZ\text{-}chMD_2\) = qualified, distressed and no MD change (1), otherwise (0)
- \(QZ\text{-}chMD_3\) = qualified, distressed and MD change (1), otherwise (0)
- \(QZ\text{-}chMD_4\) = qualified, non-distressed and MD change (1), otherwise (0)
- \(QZ\text{-}chMD_5\) = qualified, non-distressed and no MD change (1), otherwise (0)
- \(\varepsilon\) = error term.

The other independent variables are as summarised in Table 2.

**Model 3**

Prior research suggests that there is a significant association between audit opinion and switching and we extend this by incorporating the severity of auditor opinion in our model to shed more light on the dismissal threat. The measure of financial distress, Z-score, is now treated as a separate continuous variable rather than an interactive dummy variable as previously:

\[
S_t = f (\beta_0 + \beta_1 O_{xt} + \beta_2 \text{chMD}_t + \beta_3 Z_t + \beta_4 \text{AudFees}_t + \beta_5 A_t + \beta_6 C_t + \beta_7 T_t + \varepsilon_t)
\]
$S_t$ is a binary variable indicating whether or not the auditor has been switched or not. $O_{xt}$ is audit opinion where:

- $O_1 =$ unqualified audit opinion [the excluded dummy variable]
- $O_2 =$ received disclaimer (1), other type of audit opinion (0)
- $O_3 =$ received except for: limitation of scope (1), other type of audit opinion (0)
- $O_4 =$ received except for: uncertainty on going concern (1), other type of audit opinion (0)
- $O_5 =$ received except for: disagreement on accounting treatment (1), other type of audit opinion (0)
- $O_6 =$ received except for: disagreement on disclosure matter (1), other type of audit opinion (0)
- $O_7 =$ received unqualified with paragraph on fundamental but not material matter's such as going concern (1), other type of audit opinion (0)
- $O_8 =$ received subject to – Material & Fundamental uncertainty on GC (1), other type of audit opinion (0)
- $O_9 =$ received subject to – Material but not Fundamental uncertainty (1), other type of audit opinion (0)

$\varepsilon =$ error term.

The other independent variables are as summarised in Table 2. The same model is run twice by splitting the time to pre- and post- SAS600. The pre-SAS600 (1987-1991) refers to audit opinions ($O_1, O_2, O_8$ and $O_9$) while opinions $O_1$ to $O_7$ are for post-SAS600 (1992-1994). Any opinions that are reported in accordance with SAS600 before the mandatory introduction, are classified as such i.e. following the new style.

5.0 Empirical results
5.1 Descriptive Statistics

Table 3 presents the statistical summary of the continuous variables viz. auditees' assets, Z-scores and auditors' remuneration.

------------ Table 3 about here --------------

Table 4 provides descriptive statistics relating to auditor switching, MD change and type of audit opinion. Between 1987 and 1991, i.e. pre-SAS600, the popular forms of qualified opinion were ‘except for: disagreement on disclosure matters’ and ‘except for: disagreement on
accounting matters’ respectively. However, from 1992 onwards, i.e. post-SAS600, 'unqualified with paragraph' became the popular form compared to the other types of qualification. This sudden increase in 'unqualified with paragraph' opinion and the reduced 'except for: disagreement on disclosure matters' may be attributed to the introduction of SAS 600: Auditors' Reports on Financial Statements. In terms of severity, the popular form of qualification pre-SAS600 was ‘subject to’ material and fundamental uncertainty on going-concern but the popular form post-SAS600 was 'unqualified with paragraph'. This indicates that SAS600 caused a structural break in the popularity and severity of audit reporting.

5.2 Results of the Logistic Regressions
The correlation matrix for all variables used in the analyses is shown in Table 5. Since the correlation coefficient does not exceed 0.7 for any two of the independent variables, there is no problem of multicollinearity (Anderson et al., 1996).

Model 1 tests which independent variables (viz. type of audit opinion, financial solvency and MD change; audit fees; type of audit firm; size of auditee; and time) are associated with audit opinion. The results of testing Model 1 are shown in Table 6.

Auditee size and the interactive variables are found to be significantly associated with audit opinion whereas audit fees and type of audit firm were found not to be significant. The fact that the coefficient for auditee size is negative indicates that smaller companies receive more qualifications. The coefficients and significance levels for the interactive variables indicate that the probability of a qualified audit opinion increases in the direction hypothesised. The highest coefficient is for distressed companies that change MD, followed by distressed firms
that do not change MD, and then by non-distressed firms that change MD. The coefficients are all higher than the benchmark, non-distressed with no MD change. An additional aspect is that the time variable is not significant for any of the years. Qualification appears invariant to time indicating consistency in the work of auditors. Note that one dummy variable must be excluded (here 1988) to avoid perfect collinearity and act as the benchmark for comparison.

With regards to the presence of a familiarity threat, a 2x2 contingency table was constructed to show the strength of association between audit opinion and change in MDs for financially distressed companies. Results of the chi-square test are presented in Table 7. The table shows that out of a total of 228 companies that are distressed and do not change MD, 88.6% or 202 received unqualified opinions and the chi-square result shows a significant ($p < 10\%$) positive association. This suggests that the familiarity threat may be present in the UK auditing environment which is also confirmed by the logistic regression in Table 6 where there is a positive sign between unqualified opinion and distressed but no MD change variable ($Z$-chMD$_2$).

Models 2 and 3 focus on auditor switching and the dismissal threat. The results of testing Model 2 are shown in Table 8. The type of audit firm and auditee size were found to be significant with negative coefficients but the level of audit fees was not. This suggests that the propensity to switch is greater for smaller companies and for those that do not have a large firm auditor. In addition, the time variable for 1990 was found to be significant using 1988 as the dummy variable benchmark. With respect to the interactive effects, the probability of a switch is most severe when a company is financially distressed, changes MD, and with a qualified audit opinion. Given an audit qualification, the probability of a switch is the lowest for non-distressed and no MD change companies. The intermediate positions are in the direction hypothesised. Given an audit qualification, change in MD is more important than financial distress in explaining switching i.e. the coefficient for non-distressed and change in MD is higher than for distressed companies with no MD change.
The results in Table 8 also show that distressed companies that do not change their MDs dismissed their auditors following qualification, thus suggesting that the dismissal threat was actually put into practice.

The results of testing Model 3, when auditor switching was regressed on all types of audit qualification with six other independent variables (viz. MD change; Z-score; audit fees; type of audit firm; auditee size; and Time) are shown in Table 9.

The results indicate that in both periods of pre- and post- SAS600, the severity of audit opinion is associated with auditor switching\(^ {15} \). The more severe the qualification the higher the probability of a switch. However, the most severe audit opinion, 'disclaimer', was found not to be significant despite the very high beta coefficient, and this may be attributed to the low frequency of such cases in the sample (4 out of 2224) leading to the variable not being reliably determined.

Unlike the pre-SAS600 results where the ‘subject to going concern qualification’ was found to be significantly associated with auditor switching, the equivalence of this opinion in the post-SAS600 period i.e. ‘except for fundamental uncertainty on going concern’ was found not to be significant. This suggests that the two extra splits in audit opinions i.e. ‘except for on disclosure matters’ and ‘unqualified with paragraph’ brought about by SAS600 provide auditors with more flexibility in rendering their opinion. In other words, auditors may choose to render the less severe opinion as can be seen in the increase in the number of unqualified with paragraph in Table 4 in the post-SAS600 period. This also suggests that the dismissal threat will be higher for auditors issuing severe qualifications.
6. Summary and discussion
This paper investigates associations between audit report qualification with changes in MD and financial distress. Secondly, we consider the association between auditor switching with audit report qualification, MD change and financial distress. Finally, the association between auditor switching and the severity of audit report qualification is also considered.

The focus recognises a complex interrelationship between MD change, financial condition, type of audit opinions and auditor switching in the presence of familiarity and dismissal threats in the context of a UK auditing environment. The examination is based on a sample of 297 UK listed companies between 1986 and 1995.

Consistent with the work by McKeown et al. (1991), we find that smaller companies have a greater likelihood of receiving a qualified audit report, ceteris paribus. Results of the interactive variables indicate that companies that are financially distressed and change their MDs are most likely to receive a qualified audit report, ceteris paribus, compared to non-distressed companies regardless of a change in MD. This suggests that financial distress rather than change in MD is the driver for qualification. However, our findings further indicate that in financially distressed companies, the probability of receiving an unqualified audit opinion is higher when there is no change in MD, thus suggesting the presence of a familiarity threat.

In terms of the dismissal threat, our findings indicate that auditees have a tendency to switch auditor after receiving a qualified audit opinion, and the probability of a switch increases with the severity of qualification, consistent with work by Chow and Rice (1982), Craswell (1988) and Gul et al. (1992). In addition, auditees with a qualified report that are financially distressed and who change their MDs are most likely to switch their auditors, a result contradicting work by Schwartz and Menon (1985). This is followed by auditees with a qualified report that are not financially distressed but do change their MD compared to companies that are financially distressed but do not change their MD, ceteris paribus. The results also show that the propensity to qualify is independent of the type of audit firms but smaller auditees, qualified by a Big 6 auditor, have a higher tendency to switch auditors, ceteris paribus. This is consistent
with the work of Chow and Rice (1982), Schwartz and Menon (1985), Gul et al. (1992) and Krishnan et al. (1996).

Our results show that both the familiarity and dismissal threats seem to be present in the UK auditing environment. In such circumstances, the auditors may be reluctant to express their professional opinions freely due to the existence of a close relationship as well as the penalty of being dismissed. Auditors may weigh the type of qualification (severity) based on their relationship with the management thereby compromising their independence. In effect, the closer the relationship, the less likely an auditor is to give a severe audit opinion (familiarity threat) and in turn are less likely to be dismissed. However, auditors are more likely to be strict (i.e. maintain professional attitude) in rendering their audit opinion in the absence of a close relationship with newly appointed MDs, especially when firms are distressed. This in turn increases the probability of dismissal.

The findings have important implications for policy makers in the UK since auditor independence may be impaired. One of the possibilities is to make it mandatory for auditees to disclose the reasons for changing their auditors in their annual reports.

Our study suffers from a number of limitations. We realise that the relationship between qualification and switching is complex as other factors may intervene in the process. The approach adopted here was only to assess the impact of a number of factors on, first, audit qualification and secondly on auditor switching. Further research may look at the subsequent audit opinion in relation to changes in the level of audit fees, change in MDs and switching. In addition, this study did not consider the possible implication of audit committees on auditor switching. In order to fully explain the social relationships that exist between a client's management and members of an audit committee, as well as between auditors and members of an audit committee and its implications on auditor switching in the UK, an alternative research methodology such as symbolic interactionism or ethnomethodology could be employed. This provides a new avenue for research.
Endnotes:

1 The auditors' appointment, dismissal and remuneration are subject to approval by shareholders at an annual general meeting (de jure) but an auditor is unlikely to wish to retain an audit where there has been a fundamental disagreement.

2 Other services provided by auditors include accountancy and bookkeeping assistance, company secretarial help, consultancy services, investigation work, receivership work and taxation work (Moizer, 1985; p:38).

3 If a firm has high level of assets, it may be anticipated that the audit required will be substantial and paid fees will be higher. A high ratio of paid fees to firm’s total assets indicates that the firm is paying higher than average fees for the size of assets it owns.

4 This could be attributed to larger auditees receiving more public attention than their smaller counterparts and as such, are more likely to comply to rules and regulations and maintain proper accounting system.

5 This may be attributed to smaller firms not needing to pay the premium price levied by the Big 6 audit firms.

6 For example, Schwartz and Menon realised that their findings of no significant association between audit qualifications and switching and between management changes and switching in failing firms may be due to failure in incorporating non-financial distressed companies in their sample. This issue is addressed in this research.

7 We follow the approach adopted by Schwartz and Menon (1985) in using the managing director as a proxy for management because such individuals are likely to be full-time executives. In contrast, a chairman might be a non-executive member of the Board.

8 Companies in the financial sector were excluded because differences in regulatory environment may impact on audit fees and differences in the content/format of financial statements will affect accounting ratios.

9 Although the data is strictly a panel structure, the error variance structure over time varies only trivially allowing all companies in the sample at all time periods to be treated as stochastically independent observations. Results of tests for autocorrelation and survivorship bias indicate no potential problem exists.

10 The data constitute a panel so there could be firm-specific effects. However, firms were allocated to one of five industry groupings viz. general industrials; services; consumer goods; mineral extraction; and utilities. In all three logit regressions no industry effect was found and so we concluded that the effects at the individual company level will not be significant.

11 The period considered for both switching and MD change was only eight years due to a one-year period lag for both variables thereby excluding 1986 and 1995.

12 This new long form format of audit opinion was introduced in May 1993 which recommended the removal from the opinion section references to individual financial statements such as Statement of Source and Application of Funds or Cash Flows Statement where auditors applied SAS 600 to periods prior to 1993.

13 The excluded dummy variable to avoid perfect collinearity.

14 The excluded dummy variable is the unqualified category.

15 We observed that auditors who issued a qualified audit opinion based on the failure of their clients to comply with SSAP 10: Statement of Source and Application of Funds, were not switched as most parties may not have attached a great deal of importance to this issue. In fact, SSAP 10 was later withdrawn and replaced by FRS1.
References


Figure 1:
The relationships between audit opinion, explanatory factors and switching

Relationship 1: The possible influence of MD change, financial distress and the control variables on audit opinion.
Relationship 2: The possible influence of MD change, financial distress, qualification and the control variables on auditor switching.

Figure 2: The interaction of MD change and financial distress on audit opinion

No MD change  MD change  No MD change*  MD change
Financial  Financial  Financial  Financial
Health  Health  Distress  Distress

Increasing probability of a qualified audit opinion

* A familiarity threat exists when a distressed firm that does not change its MD receives an unqualified opinion.
Figure 3: The interaction of qualification, MD change and financial distress on auditor switching

<table>
<thead>
<tr>
<th>Qualified opinion</th>
<th>No MD change</th>
<th>No MD change*</th>
<th>MD change</th>
<th>MD change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Health</td>
<td>Financial Distress</td>
<td>Financial Health</td>
<td>Financial Distress</td>
<td></td>
</tr>
</tbody>
</table>

Increasing probability of auditor switching

* A dismissal threat exists when a distressed firm that does not change its MD considers changing its auditor subsequent to qualification.

Figure 4: Severity of audit qualification and probability of auditor switching

<table>
<thead>
<tr>
<th>Severity of qualification</th>
<th>Probability of auditor switching</th>
</tr>
</thead>
<tbody>
<tr>
<td>(most severe)</td>
<td>Post SAS600</td>
</tr>
<tr>
<td>Disclaimer</td>
<td></td>
</tr>
<tr>
<td>Except for: limitation of scope</td>
<td></td>
</tr>
<tr>
<td>Except for: fundamental uncertainty on going concern</td>
<td></td>
</tr>
<tr>
<td>Except for: disagreement on accounting treatment</td>
<td></td>
</tr>
<tr>
<td>Except for: disagreement on disclosure matters</td>
<td></td>
</tr>
<tr>
<td>Unqualified with paragraph</td>
<td></td>
</tr>
<tr>
<td>(least severe)</td>
<td>Pre SAS600</td>
</tr>
<tr>
<td>Disclaimer</td>
<td>Subject to GC: Material &amp; Fundamental</td>
</tr>
<tr>
<td>Except for: Accounting matters</td>
<td></td>
</tr>
<tr>
<td>Subject to GC: Material but Not Fundamental</td>
<td></td>
</tr>
</tbody>
</table>

Table 1: Population and sample size classified by industrial sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>No. of companies</th>
<th>%</th>
<th>No. of companies required</th>
<th>%</th>
<th>No. of companies included</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Industrials</td>
<td>812</td>
<td>45.6</td>
<td>145</td>
<td>45.1</td>
<td>134</td>
</tr>
<tr>
<td>Services</td>
<td>637</td>
<td>35.6</td>
<td>113</td>
<td>35.4</td>
<td>105</td>
</tr>
<tr>
<td>Consumer Goods</td>
<td>236</td>
<td>12.4</td>
<td>39</td>
<td>13.1</td>
<td>39</td>
</tr>
<tr>
<td>Mineral Extraction</td>
<td>43</td>
<td>2.4</td>
<td>8</td>
<td>2.4</td>
<td>7</td>
</tr>
<tr>
<td>Utilities</td>
<td>72</td>
<td>4.0</td>
<td>12</td>
<td>4.0</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1800</strong></td>
<td><strong>100.0</strong></td>
<td><strong>317</strong></td>
<td><strong>100.0</strong></td>
<td><strong>297</strong></td>
</tr>
</tbody>
</table>

Table 3 Continuous variables for sample companies

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>1st Quartile</th>
<th>Median</th>
<th>3rd Quartile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditees’ assets (£000)</td>
<td>269,653</td>
<td>1,465,632</td>
<td>5,974</td>
<td>20,196</td>
<td>96,089</td>
</tr>
<tr>
<td>Z-score (solvency measure)</td>
<td>4.31</td>
<td>6.19</td>
<td>0.98</td>
<td>4.12</td>
<td>7.20</td>
</tr>
<tr>
<td>Auditors’ remuneration (£000)</td>
<td>332</td>
<td>601</td>
<td>36</td>
<td>83</td>
<td>295</td>
</tr>
</tbody>
</table>
### Table 2 variables in the Logistic Regression Models

<table>
<thead>
<tr>
<th>Variables</th>
<th>Coding</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$O_t$ = Type of audit opinion at time $t$</td>
<td>$1=$ qualified; $0=$ unqualified.</td>
<td>Auditor switching is identified from the following year's annual report and after controlling for auditors' mergers. Switching cases were identified after eliminating auditor resignation cases which were determined through letter submitted by the outgoing auditor or letter submitted by the company’s secretary to Companies House. For further discussion regarding auditor resignations, see Dunn et al. (1999).</td>
</tr>
<tr>
<td>$S_t$ = Auditor switching at time $t$</td>
<td>$1=$ switched auditor; $0=$ did not switch</td>
<td></td>
</tr>
<tr>
<td>$A$ = Type of audit firm</td>
<td>$1=$ Big 6; $0=$ Non-Big 6</td>
<td>In 1986, the starting year of the data analysed in this study, audit firms were classified as Big 8 instead of Big 6. However, the Big 8 became the Big 6 as a result of mergers and this fact was taken into account in the coding process. The classification as Big 6 vs. non-Big 6 in this study is based on the classification by Porter et al. (1996).</td>
</tr>
<tr>
<td>chMD = change in MD</td>
<td>$1=$ change in MD; $0=$ no-change in MD</td>
<td>Adopting the approach by Schwartz and Menon (1985), a company is treated as having a management change if the MD was replaced for reasons other than normal retirement or death. This information is identified in the Chairman's Report and also based on the name signed at the bottom of the balance sheet.</td>
</tr>
<tr>
<td>$Z$ = financial condition</td>
<td>Continuous variable</td>
<td>Z-score model based on Taffler (1983; 1991) which captures the bankruptcy risk of a company as a single measurement of a number of weighted and added financial ratios for estimating the financial solvency of each company in the sample was used as proxy. Z-score was used as a continuous variable in model 3.</td>
</tr>
<tr>
<td>$C$ = natural logarithm of size of auditee</td>
<td>Continuous variable</td>
<td>Total assets was used as it may be considered to be the most robust measure of company size due to the fact that it is least affected by external conditions compared to sales and market capitalisation which may fluctuate as a result of changing sectoral and macroeconomic conditions. The effect of mergers and/or companies that were dormant in the sample was also taken into account in the coding process.</td>
</tr>
<tr>
<td>AudFees$_t$ = audit fees paid by an auditee in year $t$ divided by total assets</td>
<td>Continuous variable</td>
<td>Auditors' remuneration (Section 385, Companies Act 1985) extracted from Datastream. Audit fee is high when $(\text{AudFees}_t/\text{TA}_t) &gt; (\text{median} \sum (\text{AudFees}_t/\text{TA}_t))$</td>
</tr>
</tbody>
</table>