

OPINION SHOPPING AND THE ROLE OF AUDIT COMMITTEES WHEN AUDIT FIRMS ARE DISMISSED: THE US EXPERIENCE

Clive Lennox

Hong Kong University of Science & Technology

Published by
The Institute of Chartered Accountants of Scotland

First Published 2003
The Institute of Chartered Accountants of Scotland

© 2003
ISBN 1 871250 93 5

This book is published for the Research Committee of
The Institute of Chartered Accountants of Scotland.
The views expressed in this report are those of the author
and do not necessarily represent the views of
the Council of the Institute or the Research Committee.

No responsibility for loss occasioned to any person acting
or refraining from action as a result of any material
in this publication can be accepted by the author or publisher.

All rights reserved. No part of this publication may be
reproduced, stored in a retrieval system, or transmitted, in
any form or by any means, electronic, mechanical, photocopy,
recording or otherwise, without prior permission of the publisher.

Printed by Bell and Bain Ltd, Glasgow

RESEARCH REPORTS REFEREEING PROCESS

The Research Committee applies a rigorous refereeing process to all stages of its research reports. The refereeing process operates by sending the initial research proposal to two independent referees (one academic and one practitioner). The academic referee will either be a member of the Panel listed below or an *ad hoc* referee. All proposals are also reviewed by the Professorial Research Fellow and the Director of Research who remain in close contact with the project. The two referees are consulted on the academic and technical standard of the draft research report. In particular, they are asked to comment on:

- the academic rigour of the document;
- the validity of the approach taken in the report;
- whether the presentation of the report identifies the key issues and brings these to the attention of the intended reader; and
- whether the document will add to the knowledge and understanding of the interested reader.

Professor J Broadbent	Royal Holloway, University of London
Professor R H Gray	University of Glasgow
Professor J Haslam	Heriot-Watt University
Professor J Holland	University of Glasgow
Professor T Lee	University of Dundee
Professor W M McInnes	University of Stirling
Professor S McLeay	University of Wales
Professor H Mellett	Cardiff University
Professor M J Page	University of Portsmouth
Professor C Roberts	University of Aberdeen
Professor M J Sherer	University of Essex
Professor R Taffler	Cranfield University
Professor P Weetman	University of Strathclyde
Professor R M S Wilson	University of Loughborough

The Research Committee is grateful to all those who participate in the refereeing process.

CONTENTS

<i>Foreword</i>	<i>i</i>
<i>Acknowledgements</i>	<i>iii</i>
<i>Executive Summary</i>	<i>v</i>
1 ACCOUNTING IN CRISIS?	1
The corporate governance role of audit firms	5
Alternative definitions of ‘opinion shopping’	6
The corporate governance role of audit committees	8
Opinion shopping: Incentives and constraints	9
Aims of the research project	11
2 OPINION SHOPPING AND AUDIT COMMITTEES	15
Opinion Shopping	15
Why a US study?	17
Extant research on audit committee effectiveness	18
Extant research on audit quality	22
Key issues	23
3 EMPIRICAL EVIDENCE ON OPINION SHOPPING	25
The sample and descriptive statistics	25
The methodology underlying the analysis of opinion shopping	32
Do companies engage in opinion shopping?	34
Why are there conflicting conclusions in prior academic research?	38
Opinion shopping and the voluntary disclosure of reasons for audit firm dismissals	39
Opinion shopping and the timing of audit firm dismissals	40
Opinion shopping and audit firm size	42
Key issues	43

CONTENTS

4 THE ROLE OF AUDIT COMMITTEES	45
Opinion shopping and audit committee existence	45
The methodology for examining audit committee participation and approval	47
To what extent do audit committees participate in auditor dismissal decisions?	50
Audit committee meeting activity and disclosure bias	55
How does opinion shopping affect audit committee participation in auditor dismissal decisions?	56
Are audit committees more likely to disapprove of audit firm dismissals that are motivated by opinion shopping?	57
What happens to audit committee members when audit committees disapprove of opinion shopping?	59
Key issues	64
5 CONCLUSIONS AND RECOMMENDATIONS FOR PUBLIC POLICY	67
Recommendations for public policy	70
REFERENCES	75

FOREWORD

The wisdom of Sir Thomas Gresham is probably now best remembered, some 400 years after he became famous as adviser to Queen Elizabeth I on reform of the currency, for his opinion that “bad money drives out good” – a dictum that has become known as Gresham’s Law. The same principle may well be true in many other areas of life too, such as auditing.

Despite the very limited information available in the public domain explaining what has happened when a company’s auditors change, the author of this study has identified some significant and worrying patterns in the timing and consequences of some of these changes. He argues that these patterns are consistent with the assertion that about one auditor change in six is made for reasons which reflect unfavourably on the accounting practices of the company concerned.

The author suggests that radical action may be needed to address the underlying problem of companies seeking out and appointing more compliant auditors, arguing that the evidence suggests that surprisingly often audit committees appear to have been passive in such changes of auditors, even where they do not support them.

This is a hard-hitting report, and its radical nature reflects the concern that the author has at the way that the accounting profession’s power to help ensure the soundness of financial accounts appears to be circumvented by the executives of a significant minority of companies.

The Research Committee of The Institute of Chartered Accountants of Scotland (“ICAS”) is glad to have sponsored the research that has led to this publication, and whilst the recommendations in it are those of the author alone, his analysis provides powerful evidence that a real problem does exist. Some of his recommendations are radical, reflecting his conviction that new ways of tackling the way in which changes occur must be found, if they are not to lead to erosion of professional standards. ICAS believes that the analysis and recommendations deserve careful study, for if the author’s assessment is right, failure to act will extend the areas in which Gresham’s law is seen to have effect.

Nigel Macdonald
Convener
Research Committee

March 2003

ACKNOWLEDGEMENTS

I am very grateful to The Institute of Chartered Accountants of Scotland for funding this research project. I owe thanks to Angel Chu, Dammi Sze and Licardo Chan for their research assistance. This project also benefited from the comments of Mike Adams, Vivien Beattie, Kevin Chen, Elisabeth Dedman, Lee-Seok Hwang, Jen Ireland, Chul Park, T J Wong, and workshop participants at Bristol University, Hong Kong University of Science and Technology, Chinese University of Hong Kong, Hong Kong Polytechnic University, and City University. The opinions expressed in this research report are those of the author and do not necessarily represent those of ICAS.

EXECUTIVE SUMMARY

Enron and other recent corporate scandals (eg WorldCom, Cendant, Waste Management) have fuelled concerns about the standards of financial reporting, not only in the United States but in countries whose financial markets tumbled as the news about Enron became public. Such scandals inevitably result in a search for culprits, which very often include the company's audit firm and audit committee. Enron's auditors (Arthur Andersen) have been criticised because of a perception they may have lacked independence. For example, several of Enron's executives had previously worked for Arthur Andersen and Enron was paying a lot of money for its audit and non-audit services. The members of Enron's audit committee have also been subject to scrutiny, with some arguing that they were too closely affiliated with senior management.

This report provides timely evidence on the relationships between senior management, audit firms and audit committees using data on listed US companies from 1996-1998. The research focuses on the audit committee's role when companies change auditors, and the effect of this role on senior management's ability to engage in 'opinion shopping'. Opinion shopping occurs when a company dismisses (or retains) its incumbent audit firm with the intention of avoiding an unfavourable (modified or qualified) audit opinion. The first stage of the investigation uses a sample of 19,273 observations to test whether US companies engage in opinion shopping. The second stage provides a detailed analysis of the 828 dismissals, partitioning them according to whether they are motivated by opinion shopping or by other reasons. It is then investigated whether opinion shopping dismissals differ from other dismissals, for example regarding the timing of auditor dismissals and the role played by audit committees.

Research findings

The report examines eight questions relating to audit firms, audit committees and the practice of opinion shopping:

Do companies successfully engage in opinion shopping? – Prior academic research is divided on this question. US studies (eg Krishnan, 1994) conclude that opinion shopping is futile because incoming audit firms do not issue unfavourable audit opinions less often than outgoing audit firms. Using a different methodology, Lennox (2000) collects data on both audit firm changes and retentions and he predicts the opinions that companies would have received had they decided to dismiss or not dismiss. He finds opinion shopping is a powerful predictor of audit firm changes in the UK. This report applies the methodology of Lennox (2000) to US data and shows that opinion shopping is an important motivator of audit firm dismissals in the US. It is estimated that opinion shopping motivates approximately 17% of audit firm dismissals.

How does the timing of opinion shopping dismissals compare to other types of dismissals? – Audit firm dismissals that are motivated by opinion shopping are found to occur nearly two months later than other dismissals. This finding is consistent with three explanations: (i) Opinion shopping companies leave the dismissal decision till later in the year in order to form a more accurate assessment of the opinion that would be issued if the incumbent audit firm was retained; (ii) Opinion shopping companies spend more time searching for an audit firm that is likely to give a favourable opinion; (iii) Opinion shopping companies find it harder to find an audit firm that is willing to accept the audit engagement.

How do opinion shopping dismissals compare to other dismissals in terms of the size of outgoing and incoming audit firms? – Previous academic

research argues large audit firms (the Big 4/5/6) supply more credible audits compared to small firms. It is therefore expected that opinion shopping companies are more likely to dismiss large audit firms and are more likely to appoint small audit firms. The evidence provides some support for this hypothesis. Although opinion shopping dismissals and other dismissals do not differ in terms of the size of outgoing audit firms, opinion shopping dismissals are significantly associated with the appointment of small audit firms.

Is there a need for audit firms and audit committees to provide more informative and timely disclosures? – Audit firms rarely communicate problems in their audit opinions, and companies strategically dismiss auditors that issue unfavourable opinions. US companies are required to disclose more detailed information about audit committees and audit firms than UK companies (eg audit firm dismissals, whether audit committees approve audit firm dismissals). These disclosures are found to be useful for assessing why companies dismiss audit firms and the role of audit committees. However, there are a number of deficiencies in the disclosure system. Companies are not required to disclose why audit firms are dismissed, and it appears that some voluntary disclosures lack credibility. Despite the requirement that companies disclose the number of audit committee meetings, a large number of companies fail to disclose this information, and there exists a disclosure bias such that disclosure is less likely when audit committees meet infrequently. Although audit committees are required to disclose whether they approve audit firm dismissals, they are not required to explain why they disapprove of dismissals. The evidence suggests that disagreements between management and audit committee members about audit firm dismissals are associated with the departure of audit committee members. However, companies are not required to disclose why audit committee member departures occur (eg are they due to dismissal or

resignation) and there is no requirement that departures be disclosed on a timely basis.

Are companies that have audit committees less likely to engage in opinion shopping compared to companies that do not? – Since audit committees should help to prevent opinion shopping, it is expected that a company is less likely to engage in opinion shopping if it has an audit committee. The evidence supports this argument, but the degree of statistical significance is sensitive to the inclusion of company size as a control variable.

To what extent do audit committees participate in audit firm dismissal decisions? – The hiring and firing of audit firms is a primary function of the audit committee, and this should help prevent senior management from engaging in opinion shopping. Unfortunately, many audit committees do not play an active role in corporate governance. It is estimated that 15% of audit committees do not participate in audit firm dismissal decisions and in a typical (non-dismissal) year, nearly half of audit committees hold fewer than the recommended number of meetings (two), and at least 10% have no meetings at all.

Are audit committees more likely to disapprove of dismissals that are motivated by opinion shopping? – Consistent with the view that audit committees help maintain the integrity of the audit reporting process, it is found that audit committees are more likely to disapprove of audit firm dismissals that are motivated by opinion shopping. However, audit firms are dismissed even when audit committees disapprove, implying that senior management exert considerable influence over the auditor dismissal decision.

What happens to audit committee members when audit committees disapprove of opinion shopping? – When audit committees disapprove of opinion

shopping, there is significantly higher turnover of audit committee members. The association between disapproval and turnover is particularly strong for audit committee members that are independent of senior management. This finding is consistent with two explanations. First, senior management remove disapproving audit committee members in order to exert more influence over the audit committee and over the auditor dismissal decision. Second, audit committee members resign in protest when the audit committee disapproves of audit firm dismissal but the company still dismisses its audit firm. The association between disapproval and audit committee turnover indicates that opinion shopping results in a weaker audit committee.

Recommendations for public policy

There is one specific recommendation arising from this research that would help reduce the frequency of opinion shopping. Since opinion shopping dismissals occur significantly later than other dismissals, regulators should reduce the window of opportunity for opinion shopping. For example, audit firm changes might only be permitted within the first nine months following the previous year-end. This would have three potential benefits. First, it would give companies less time to search out compliant incoming audit firms. Second, it would give incoming audit firms more time to assess audit risk and to discover any underlying problems. Third, it would give companies less time to assess the opinion that would likely be issued if the incumbent audit firm was retained.

Other findings indicate that senior managers have considerable control over auditor decisions. First, the evidence shows companies do successfully engage in opinion shopping. Second, there is a worryingly low level of audit committee meeting activity and it is estimated that only 85% of audit committees participate in auditor dismissal decisions. Third, companies often dismiss their auditors even when

audit committees disapprove of auditor dismissal decisions. Fourth, there is higher turnover of audit committee members when audit committees disapprove of opinion shopping. These findings imply that audit committee effectiveness is strongly affected by the willingness of management to permit good corporate governance. This suggests there may be little that regulators can do to mandate more effective audit committees.

The financial press and regulators very often blame audit firms and audit committees when accounting scandals occur. Regulators have introduced a number of corporate governance initiatives over the last 15 years aimed at improving the effectiveness of audit committees and audit firms. These initiatives include: the mandatory formation of audit committees, the requirement that audit committee members fulfil certain independence conditions, and the separation of audit from non-audit services. The results from this report and from extant academic research suggest these initiatives may do little to improve the integrity and credibility of financial reporting. Previous studies find mixed results regarding the association between financial reporting quality and audit committee characteristics (*eg* existence, independence). Even if an association exists, it might simply reflect the underlying incentives of managers to produce accurate or misleading financial statements rather than the direct benefits of having independent audit committees. In other words, mandated corporate governance initiatives may not reduce the incidence of accounting scandals since they do not address the underlying incentives of senior management. Similarly, extant research finds no evidence that non-audit fees compromise auditor independence, and yet there have been recent moves to separate the provision of audit and non-audit services.

The results of this report indicate that regulators should focus less on mandated quick fixes such as the independence of audit committees and audit firms. Rather, regulators should provide audit firms and audit committees with more incentives to disclose managerial wrongdoing,

regulatory bodies should use these disclosures to increase the threat of investigation, and the legal infrastructure should increase the threat of imprisonment for dishonest managers.

The results of this report also suggest that the disclosures required of US companies are informative about why companies dismiss audit firms and the role of audit committees. UK companies are not required to disclose this information, so there may be a role for regulators to require better disclosures about auditor changes and whether auditor changes are approved by audit committees. Nevertheless, even in the US, the disclosure system is not wholly effective as companies do not always comply with the requirements.

CHAPTER ONE

ACCOUNTING IN CRISIS?

Recent revelations following the collapse of Enron and WorldCom cast doubt upon the value and integrity of financial reporting and auditing. Enron is the largest accounting scandal to affect corporate America, following closely on the heels of Waste Management (2001), Sunbeam (2001), and Cendant (1999). Other high profile audit failures of the last 15 years include BCCI, Maxwell Communications, the Savings & Loans institutions, and Barings Bank. Such scandals result in a perception that financial statements are unreliable for decision-making purposes and therefore that financial reporting is of poor quality.

Inevitably financial reporting scandals are followed by public concern about lack of protection for investors and for other stakeholders such as employees. In his introduction to Business Week's front page leading headline "Accounting in Crisis", Bruce Nussbaum writes (28 January 2002, p.39):

There are business scandals that are so vast and penetrating that they profoundly shock our most deeply held beliefs about the honesty and integrity of our corporate culture. Enron Corp. is one of them. This financial disaster goes beyond the failure of one big company. This is corruption on a massive scale. Tremendous harm has befallen innocent employees who have seen their retirement savings disappear as a few at the top cashed out. Terrible things have happened to the way business is conducted under the cloak of deregulation. Serious damage has been done to ethical codes of conduct held by once-trusted business professionals.

Why do such scandals occur? Undoubtedly, the most important factor is the integrity and candour of senior management. It appears that Enron's senior managers were aware of the mounting financial problems as indicated by their selling of Enron stock. However, they refused to disclose publicly the mounting financial problems in the company. Sherron Watkins, Enron's Vice-President for corporate development, had written a letter to Enron CEO Kenneth Lay warning that the company might implode in a wave of accounting scandals. Rather than confront the issue head-on, Lay appointed the company's long-term law firm, Vinson & Elkins (V&E), even though V&E had worked on the Special Purpose Entities employed to keep Enron's debt off its balance-sheet. Enron and V&E agreed there would be no second-guessing of Andersen's accounting and no detailed analysis of individual transactions. Rather V&E's enquiry was limited to considering only if new information had arisen requiring further investigation – V&E concluded that there had not.

In an economy such as the United States where investors hold highly diversified share portfolios, individual investors have little incentive to monitor senior management. Instead, the free market economy has instituted corporate governance mechanisms to curb the excesses of senior management. Two corporate governance mechanisms – namely, audit firms and audit committees – are the subject of this report.

The events at Enron led to considerable criticism of Arthur Andersen, not least because of the document shredding and the perception of a too close relationship with Enron's management. Some of Enron's top executives, including its chief accounting officer, had previously been employed by Arthur Andersen. Arthur Andersen's independence has also been questioned due to its provision of non-audit services. Nussbaum continues (pp39-40),

An astonishing 723 companies have been forced to restate and lower their earnings since 1997. With enormous pressures to produce

earnings growth, auditors are being turned into enablers. They forsake their traditional role of outside sceptic for that of inside business partner and they reject their age-old function of disclosure of information for that of master magician who hides the financial rabbit ... Conflicts of interest abound as accounting firms sell services to the companies they audit and accountants jump to the corporations whose books they examine. The accounting profession has successfully fought all attempts at reform, rebuffing efforts to end conflicts of interest, impose stricter oversight, or increase liability for their actions. In short, most certified public accountants feel little duty to the public at large.

The former Arthur Andersen chief, Joseph Berardino, has responded to criticism that Arthur Andersen's issuance of clean audit opinions to Enron meant that investors were left in the dark. He argues that the problem lies with the institutional framework of communication between auditors and investors. In a speech made in June 2002, he argues that audit firms are unable to disclose when financial statements are misleading if the financial statements comply with generally accepted accounting principles (GAAP). He argues that audit opinions should move towards a grading system with auditors rating the quality of companies' financial statements. He also suggests that auditors should be allowed to convene special meetings with shareholders in order to disclose problems uncovered during audits. In fact, Berardino's comments are a little misleading since auditors in the US *can* disclose problems in their audit opinions even when financial statements comply with GAAP. In particular, US auditors are allowed to disclose "emphases of matter" if they have concerns that should be brought to the attention of shareholders. As shown in chapter three, however, auditors very rarely use this mechanism to disclose problems to shareholders.

Auditors' incentives to disclose problems should be stronger when an audit committee acts as intermediary between the external auditor and senior management. Although audit firms are often blamed for

corporate scandals, the role of the audit committee also comes under scrutiny. Do audit committees have too cosy a relationship with senior management? Do they have sufficient incentives to monitor management effectively? Louis Lavelle (Business Week, 21 January 2002, pp.38-39) writes,

One of the mysteries of Enron Corp.'s fall from grace is how an audit committee chock full of talent could have been blind to the company's financial sleight of hand. So far, speculation has centered around the apparent failure of Enron's auditors, Arthur Andersen LLP, to alert the audit committee to the problem until very late in the game. But the truth is, the audit committee deserves much of the blame for Enron's collapse . . . If [their stock holdings] didn't blind the Enron audit committee members their financial ties to the company may have. It's a problem that governance critics anticipated. But what's troublesome is that SEC disclosure rules required Enron to make known only one of those ties: director John Wakeham's \$6,000-a-month consulting contract. One would need to venture far afield to learn from the University of Texas that Enron, Chairman Kenneth Lay, and their foundations had given \$332,150 to the school's M.D. Anderson Cancer Center since 1999. That's when center President John Mendelsohn became an Enron director. Also undisclosed by Enron: \$50,000 that the company and the Lay family foundation gave to George Mason University's Mercatus Center, where Wendy Lee Gramm has been head of regulatory studies since she joined the center in 1997. Enron and its employees also made political contributions of more than \$80,000 to her husband, Senator Phil Gramm (R-Tex.), since she became an Enron director in 1993 . . . If nothing else, the Enron debacle should occasion some soul-searching on the part of federal regulators and stock exchanges that make the governance rules. It would help if audit committees were required to convene meetings more frequently, conduct an annual review of the internal audit, and educate members in more than just

the balance-sheet basics ... For governance to work directors need to understand that their job is to keep tabs on management – not simply to show up.

The corporate governance role of audit firms

Historically, auditing began as early as the thirteenth century and it gradually evolved into the type of audit required under the first Companies Act of 1844 (Watts and Zimmerman, 1983). Prior to the Industrial Revolution audits were generally undertaken by directors or outside shareholders. During the latter half of the nineteenth century companies increasingly sought external equity and debt financing, causing a separation of ownership from control and a demand for outside professional auditors who could provide assurance to investors that managers were not misusing the company's resources. External auditing subsequently became common in other countries as their economies became industrialised, and a need for external monitoring arose.

The separation of ownership from control (the 'principal-agent problem') is the economic explanation for auditing. Nowadays, external audits are mandatory for all public US companies and for all UK companies (except those small enough to qualify for an exemption). Within a mandatory auditing environment, it is unclear whether audit firms have sufficient incentives to act on behalf of investors. It is virtually unheard of for audit firms to blow the whistle publicly on errant senior management. Audit firms may constrain overly aggressive managerial reporting, but the problem for investors is that this is essentially unobservable. Investors do not generally know whether managers had tried to pull a fast one and were stopped by the auditors or whether managers are inherently honest. Auditors occasionally provide limited information about problems in their audit

opinions, but very often they choose to resign quietly and investors are none the wiser.

Nevertheless modified (or qualified) audit opinions can signal to investors that all is not well with the company. It might therefore be expected that senior managers try to avoid receiving such opinions. One way managers might do this is by exerting leverage over the audit firm, for example by threatening to dismiss the auditor. Another way is for managers to hire a different auditor if they are able to find an audit firm that is more likely to give the desired audit opinion – this phenomenon is labeled ‘opinion shopping’.

Alternative definitions of ‘opinion shopping’

Since there is no single definition of opinion shopping, it is necessary to discuss what different people mean by it and to define precisely the concept of opinion shopping employed in this project. According to the Securities and Exchange Commission (SEC, 1988):

The term ‘opinion shopping’ is generally understood to involve the search for an auditor willing to support a proposed accounting treatment designed to help a company achieve its reporting objectives even though that treatment might frustrate reliable reporting.

It is important to note the SEC’s definition involves an active search by the company for an auditor who will give the desired report. It does not necessarily involve a lack of auditor independence.

An auditor can be defined as lacking independence if he/she adopts a viewpoint that is biased in favour of management. A lack of auditor independence might be manifest in the design of the audit programme, the volume and quality of audit evidence collected, and the audit opinion issued. The threat of audit firm dismissal and the consequent loss of audit income relates closely to the issue of auditor

independence. An independent audit firm would not change its opinion in response to a client's dismissal threat, whereas a firm that lacks independence might bend to its client's wishes. Dismissal threats need not be explicitly stated in order for them to be effective. If an audit firm is concerned that an unfavourable opinion would lead to the loss of a client, it may be deterred from issuing an unfavourable opinion without explicit threats from client management. Instead, there might be an implicit recognition by the client's management and the audit firm that their economic interests are mutually dependent. The SEC's definition of opinion shopping puts the emphasis on the company's active search for an advantageous reporting treatment rather than the danger of auditor dependence from dismissal threats.

This project defines opinion shopping as a situation in which the company dismisses (or retains) its incumbent audit firm with the intention of obtaining a more favourable audit opinion. This definition is similar to the SEC's in that it does not involve a lack of auditor independence, it emphasises companies' actual auditor dismissal decisions rather than dismissal threats. However, this project's definition of opinion shopping is narrower than the SEC's, since the SEC refers to 'proposed accounting treatments' whereas this project focuses on audit opinions.

Published financial statements are the joint product of the client's proposed accounting treatments and the audit firm's required adjustments. Since the client's proposed treatments and the audit firm's required adjustments are not publicly observable, it is difficult to test empirically whether companies engage in the kind of opinion shopping envisaged by the SEC. In contrast, the audit report is a publicly observable variable, so it is easier to examine than unobservable client-auditor discussions. This project tests for opinion shopping by investigating whether companies dismiss (or retain) their audit firms in order to avoid unfavourable audit opinions ('unfavourable' is defined

later). Although this definition is quite narrow, it at least has the virtue of being readily testable.

The corporate governance role of audit committees

An audit committee is a sub-committee of the main board of directors and it is usually composed of outside (non-executive) directors. The audit committee generally has responsibility for reviewing the financial statements, liaising with external and internal auditors, reviewing internal controls, and hiring and firing external auditors. It is the latter function (audit firm changes) that is the main focus of this project.

The audit committee is a relatively recent development in corporate governance as very few companies had voluntarily formed audit committees by the late 1970s (Collier, 1997). The recent audit committee movement is largely the result of regulatory pressures for better corporate governance in an attempt to reduce the frequency of corporate fraud and audit failures. Independent audit committees were first recommended by the US National Commission on Fraudulent Financial Reporting (Treadway Commission, 1987), and subsequently by the Canadian Macdonald Commission (1988), and the Cadbury Committee (1992). More recently the US Blue Ribbon Committee (1999) has issued recommendations aimed at strengthening audit committee independence. Auditor hiring and firing is an important responsibility of the audit committee (*eg* Cadbury Committee, 1992; Auditing Practices Board, 1994; Braiotta *et al.* 1999). Since opinion shopping impairs the integrity of the financial reporting process it is expected that an effective audit committee should deter opinion shopping.

Opinion shopping: Incentives and constraints

The existence of opinion shopping depends on three assumptions. First, senior managers dislike receiving unfavourable audit opinions. Second, managers have at least some control over audit firm dismissals and appointments. Third, auditors sometimes differ in the opinions they would issue to any given company.

There is little doubt about the validity of the first assumption. Unfavourable audit opinions are associated with falling share prices (Fleak and Wilson, 1994), which is costly to managers who retain shares or stock options in the companies they control. Unfavourable audit opinions make it harder to raise external capital (Firth, 1980), and they can act as a warning of impending bankruptcy (Chen and Church, 1996). This may also increase the likelihood of managerial dismissal or result in lower pay which is obviously undesirable to the manager. The evidence therefore suggests that managers have incentives to avoid unfavourable audit opinions.

The second assumption is more controversial as it goes to the heart of who is responsible for hiring and firing the audit firm. The legal fiction is that shareholders appoint audit firms, but in practice senior management exert considerable control over the hiring and firing of audit firms. Managerial control should be constrained by the presence of an audit committee, since auditor hiring and firing is one of its primary functions. Kalbers (1992) finds audit committee members and audit firms believe the audit committee can be an important influence on the company's choice of auditor.

The third assumption is also subject to debate. On the one hand, audit firms are required to follow professional auditing standards and they take examinations that ensure a minimum standard of competence. On the other hand, auditors are humans not machines, so they are likely to differ in terms of their ability, experience, and integrity. To the extent that auditors are not homogeneous and differ in the opinions

they would issue to a given company, there exists scope for managers to switch between different auditors in order to avoid unfavourable opinions.

The CPA Journal discusses management's incentives to avoid unfavourable audit opinions and the potential role of the audit committee in preventing opinion shopping (Hendrickson and Espahbodi, 1991):

Why do people seek second professional opinions on a wide variety of matters? A second opinion is standard procedure in medical practice when a patient is faced with major surgery, and this procedure is not uncommon in some aspects of dentistry ... Certainly, this scenario applies to the accounting profession as well ... Unfortunately, it is clear that the search for a second opinion is not always motivated by a desire to be right. Some managers have a preconceived objective in mind that can only be achieved by using a particular, and usually less desirable, accounting treatment. They will seek the views of successive accountants until they locate the one who will approve the desired treatment ... Several factors motivate managers to shop for opinions, including the desire to attain or exceed stated goals and objectives and, in extreme cases, the urgent need to survive. Managers want their audit reports to be positive (unqualified). Negative reports may affect their own compensation, their company's ability to market securities, and the value of their own holdings in the company. Motivation to shop for opinions can be enhanced by deteriorating economic conditions, trying to avoid hostile takeover attempts, and by having compensation plans tied to reported income ... Excluding management from auditor hiring-paying-firing could deter opinion shopping. This might possibly be accomplished through an effective audit committee. An audit committee should consist of outside board members that have no conflict of interest vis-à-vis management and that act as a watchdog for shareholders.

Aims of the research project

This project provides timely research on the interaction between company management, audit committees, and audit firms. The aim is to shed light on the role of audit committees when companies dismiss incumbent audit firms. The concluding chapter provides policy recommendations that draw not only upon the findings of this project, but also from extant research on audit firms and audit committees. The eight questions investigated in this project are as follows:

- (i) Do managers successfully engage in opinion shopping?
- (ii) What can regulators do to prevent opinion shopping?
- (iii) Which audit firms do opinion shopping companies hire?
- (iv) Is there a need for audit firms and audit committees to provide more informative and timely disclosures?
- (v) Are audit firm dismissals more likely to be motivated by opinion shopping when companies do not have audit committees?
- (vi) To what extent do audit committees participate in audit firm dismissal decisions?
- (vii) Are audit committees more likely to disapprove of dismissals that are motivated by opinion shopping?
- (viii) What happens to audit committee members when audit committees disapprove of opinion shopping?

The first question is addressed using a sample of 19,273 US company-year observations (1996–98). Within this sample there are 828 audit firm dismissals, which are used to investigate the other seven questions.

The remainder of this report is structured as follows. Chapter two discusses extant academic research on auditing, opinion shopping, and audit committees. It explains that the contribution of this project to the extant literature is two-fold. First, other researchers consider

the effectiveness of external auditing and of audit committees, but they generally treat auditors and audit committees in isolation and do not consider their interaction. In particular, there is very little evidence on the role of audit committees when companies change audit firms. Second, previous studies test for an association between financial reporting quality and *voluntary* audit committee characteristics (eg audit committee existence, audit committee independence). The results of prior research are mixed, but even if audit committees were unambiguously associated with better financial reporting, the implications for public policy would be unclear since there is little evidence that *mandated* corporate governance initiatives result in better financial reporting. The results of extant research might reflect either the direct benefits of better governance, or they might simply reflect the underlying incentives of management for high or low quality financial reports. This project addresses the causality issue by examining what audit committees actually do (*ie* do audit committees participate in and approve audit firm dismissals?). The findings suggest that audit committee effectiveness mainly reflects the underlying incentives of management. Therefore, it is concluded that mandated corporate governance standards are unlikely to reduce significantly the incidence of accounting scandals.

Chapter two explains that there is some disagreement amongst academics about whether companies successfully engage in opinion shopping. UK research suggests opinion shopping does occur (Lennox, 2000), whereas US studies conclude that opinion shopping is generally futile (Krishnan, 1994). Chapter three re-evaluates the US evidence and argues that companies do engage in opinion shopping. Some time is devoted to explaining why the testing methodology of prior US research is flawed. Chapter three goes on to investigate how opinion shopping dismissals differ from other dismissals in terms of: (i) the timing of the dismissals; and (ii) the size of incoming and outgoing audit firms.

Chapter four examines the role of audit committees when companies dismiss their audit firms. It first tests whether companies that have audit committees are less likely to engage in opinion shopping. It then investigates whether audit committees participate and approve auditor dismissals. US companies are required to disclose whether auditor dismissals are approved by audit committees and this information is used to test whether audit committees are more likely to disapprove of dismissals that are motivated by opinion shopping. If a dismissal is not approved by an audit committee, it is assumed that either: (i) the audit committee does not participate in the dismissal decision (it leaves the decision to senior management); or (ii) the audit committee does participate but it disapproves of auditor dismissal. Companies do not directly disclose whether non-approvals are due to non-participation or due to disapproval. Therefore, an important part of chapter four is the separate empirical identification of the audit committee's participation and approval decisions. Finally, chapter four investigates how audit committee disapproval of opinion shopping affects turnover amongst audit committee members.

Chapter five concludes by recommending how regulators can improve the quality of financial reporting using the results of this project and extant empirical research.

CHAPTER TWO

OPINION SHOPPING AND AUDIT COMMITTEES

This chapter first discusses the extant academic literature on opinion shopping, highlighting the different methodologies employed in prior US and UK studies and the effect of these methodologies on researchers' conclusions. The chapter then explains why the focus is on US rather than UK companies, and it describes the institutional background of auditor changes in the US. There is a critical review of the academic literature on audit committee effectiveness, particularly its relevance to policy-making. Finally, the chapter discusses empirical evidence regarding the relation between audit quality and audit firm size and the implication of this relation for opinion shopping.

Opinion shopping

Academics are currently divided on the question as to whether managers successfully engage in opinion shopping. US studies generally conclude that managers are unable to avoid unfavourable reports by changing audit firms (*eg* Krishnan, 1994). The methodology underlying this conclusion has two steps: (1) identify a sample of companies that change audit firms; and (2) compare the audit opinions issued by outgoing and incoming auditors. If incoming auditors issue fewer unfavourable audit opinions than outgoing auditors, then it is concluded that companies successfully engage in opinion shopping. Since researchers find incoming auditors do not issue favourable opinions more often than outgoing auditors (*eg* Krishnan, 1994), they conclude opinion shopping is futile.

Lennox (2000) does not dispute this evidence, but he does dispute the inference drawn about whether companies successfully engage in opinion shopping. He argues that the above methodology causes two problems because it focuses only on companies that change audit firms, ignoring companies that do not change. First, some companies shop around but retain their incumbent audit firms because they find other audit firms would be less compliant. For example, the Department of Trade and Industry's investigation of Atlantic Computers (1994) finds:

There is evidence that Atlantic decided to retain Spicers as auditors in 1988, rather than change to KPMG, because of a perception that Spicers were less assertive and critical than KPMG.

Second, audit opinions may not improve on average if an improvement in audit opinions for opinion shopping companies is offset by worse opinions for dismissals that are not motivated by opinion shopping. The US methodology is more reasonably interpreted as a test for whether the majority of audit firm changes are motivated by opinion shopping. It is not really a test for whether some auditor changes (perhaps a minority) are motivated by opinion shopping.

To overcome these two criticisms, Lennox (2000) collects UK data on both audit firm retentions and audit firm changes. The sample of audit firm retentions is necessary for two reasons. First, audit firm retentions are used to predict the opinions that dismissal companies would have received if they had not changed auditors. Second, it enables a test for whether some companies retain their incumbent audit firms in order to avoid unfavourable opinions.

In contrast to the methodology described in the opening paragraph, the methodology of this project is: (1) identify a sample of companies that dismiss their audit firms *and* another sample of companies that do not dismiss; and (2) use the audit opinions in both samples to predict the opinions that companies would have received had they

made opposite auditor dismissal (retention) decisions. If companies receive fewer unfavourable audit opinions as a result of their dismissal or retention decisions, then companies successfully engage in opinion shopping. Using this methodology, Lennox (2000) shows that UK companies successfully engage in opinion shopping.

One contribution of this project is to replicate the Lennox (2000) methodology using US data. It is possible that the UK and US audit environments create different incentives and scope for opinion shopping. US companies are required to disclose auditor changes promptly to the SEC and to disclose auditor-client disagreements and modified audit opinions in the two years prior to auditor changes – no such disclosures are required in the UK. It is therefore possible that US studies find no evidence of opinion shopping because the stricter disclosure requirements deter opinion shopping. In contrast, as argued by Lennox (2000), the different conclusions may be due to the testing methodologies employed.

Why a US study?

There are two reasons for undertaking a study of US rather than UK companies. First, prior US research concludes opinion shopping is futile and it is necessary to re-evaluate this conclusion applying the methodology of Lennox (2000) to US data. Second, it is important to investigate the role of audit committees when auditors are dismissed, and listed US companies are required to disclose more information about audit committees than is available in the UK.

When a listed US company changes its audit firm, it is required under Item 304 of Regulation S-K to disclose whether the change was recommended or approved by an audit committee (SEC, 1995). This disclosure is an important feature of the analysis undertaken in chapter four. Companies' 8-K filings are searched for the words 'recommended' or 'approved' as evidence that the audit committee approves the auditor

dismissal. Data on this disclosure are used to identify whether audit committees are more likely to disapprove of audit firm dismissals that are motivated by opinion shopping. To the extent that these disclosures are useful for interpreting why companies dismiss audit firms, they have information content for shareholders and should perhaps be introduced in the UK. US companies are not required to disclose why auditors are dismissed but they sometimes disclose voluntarily. The information content of such voluntary disclosures is assessed by investigating whether the opinion shopping motive affects the company's decision to disclose why the audit firm is dismissed.

US companies are only required to disclose whether audit committees approve audit firm dismissals. They are not required to disclose whether audit committees disapproved and they are not required to disclose the reasons for disapproval. It is assumed that an absence of audit committee approval is *not* the same as disapproval. Rather audit committee non-approval is assumed to occur for one of two reasons. First, an audit committee might not approve dismissal if it does not participate in the auditor dismissal decision. Second, an audit committee that does participate may disapprove of the auditor dismissal decision. Since companies do not directly disclose audit committee participation or disapproval, chapter four employs data on audit committee meeting activity in order to predict whether audit committees participate in auditor dismissal decisions. The reasons for using audit committee meeting data to predict participation and the limitations of meeting data are discussed further in chapter four.

Extant research on audit committee effectiveness

There is a rapidly growing literature on audit committee effectiveness, much of which is based on US evidence. Some studies argue there is a positive association between audit committees and financial reporting quality, while others find little evidence in favour

of audit committees. The following discussion first considers studies that are consistent with audit committees improving financial reporting quality.

DeFond and Jiambalvo (1991) examine the association between earnings over-statements and audit committees. They find companies that have audit committees are less likely to overstate earnings, which is consistent with audit committees acting as a constraint on opportunistic reporting. Dechow *et al.* (1996) examine the association between corporate fraud and audit committees. They find companies with audit committees are less likely to commit fraud compared to a control sample of companies matched by size and industry. Wild (1994) investigates the correlation between reported accounting earnings and stock prices before and after companies voluntarily form audit committees. He finds the correlation is significantly greater after audit committee formation, indicating that audit committees are associated with more credible accounting numbers.

The above studies test the association between audit committee *existence* and financial reporting quality. Nowadays most listed companies have audit committees, so the issue of audit committee existence is less important. Recent studies therefore focus on the association between audit committee *independence* and financial reporting quality. Klein (2000a) examines how audit committee independence affects the correlation between accounting earnings and stock prices. She finds the correlation is stronger for audit committees that are composed of independent directors, which suggests more independent audit committees are associated with more credible accounting numbers. Chtourou *et al.* (2001) investigate the effect of audit committee independence and activity on management's opportunistic manipulation of reported earnings. They find less evidence of income-increasing earnings management when audit committees meet more than twice a year and when committees are composed entirely of independent directors. They also find less evidence of income-decreasing earnings

management (*ie* a ‘big bath’) when audit committees have at least one member with financial experience.

The above research is consistent with audit committees improving the quality of financial reporting, particularly when committees are composed of members who are independent of senior management. It is therefore unsurprising that bodies such as the Cadbury Committee (1992) emphasise the formation and independence of audit committees. It is necessary however to recognise that the above studies are concerned with *voluntary* audit committee formation and with the *voluntary* appointment of independent members. It is an open question whether regulators can improve financial reporting by *mandating* independent audit committees.

The problem is that there are two competing explanations for the results described in the above studies. First, managers that have no intention of producing misleading financial statements or engaging in fraud might have more incentive to set up independent audit committees. In contrast, managers who lack integrity would probably avoid forming effective audit committees. Second, audit committees might directly improve the quality of financial reporting, for example by monitoring senior management or by improving communication between internal and external auditors. The main justification for regulatory intervention is that audit committees directly improve financial reporting. If the association between audit committees and financial reporting quality simply reflects the underlying incentives of management, regulators cannot expect mandated corporate governance initiatives to improve financial reporting quality. Forcing companies to form independent audit committees is unlikely to have significant benefits for managers who are unwilling to be monitored.

There is therefore a need for studies that consider what audit committees actually *do*, rather than simply testing for an association between audit committee characteristics (*eg* existence, independence) and proxies for financial reporting quality. This study addresses the

causality issue by testing whether audit committees participate in audit firm dismissal decisions, and by testing whether audit committees disapprove of dismissals that are motivated by opinion shopping.

In contrast to the above studies, some researchers find little or no association between financial reporting quality and audit committees. This casts further doubt on the benefits of mandated corporate governance initiatives. Beasley (1996) finds no association between the existence of an audit committee and financial statement fraud (in contrast to the findings of Dechow *et al.* (1996)). Klein (2000b) finds a negative relation between earnings management and the degree of audit committee independence at low levels of independence (consistent with Chtourou *et al.* (2001)), but she finds no relation between earnings management and 100% audit committee independence. As already discussed, audit committee effectiveness likely depends on the incentives of management to produce high quality financial reports. Consistent with this argument, Klein (1998) finds companies that have dominant CEOs are more likely to appoint audit committee members that lack independence, and such audit committees meet less regularly. Even when audit committees are formed voluntarily, Menon and Williams (1994) find committees meet infrequently, and they conclude audit committees are often formed for the sake of appearance rather than because managers have a genuine wish to improve financial reporting.

In summary, the empirical evidence is mixed regarding the association between audit committees and financial reporting quality. Even if an association can be established, it is unclear whether audit committees actually improve the quality of financial reporting. The documented association between audit committees and financial reporting quality may simply capture the underlying integrity and incentives of management to produce high or low quality financial statements.

Extant research on audit quality

There is an extensive academic literature on the determinants of audit quality. One research stream tests whether audit quality is compromised by a lack of auditor independence. It is obviously difficult for the researcher to identify circumstances in which auditor independence is under threat, since independence is partly a state of mind. One approach is to measure auditor independence using data on audit and non-audit fees (see Lennox (1999) for UK evidence, and Craswell *et al.* (2002) for Australian evidence). These studies hypothesise that incumbent audit firms are less willing to lose clients who generate significant income, and so these audit firms may have less incentive to issue unfavourable audit opinions. However, the studies find no association between audit opinion reporting and the fees that clients pay (either in absolute terms, or as a proportion of total income). A similar lack of association is found in studies that measure auditor independence using the length of auditor-client tenures (*eg* Louwers, 1998) and audit partners' compensation schemes (Carcello *et al.* 2000). There is therefore little hard evidence that audit firms lack independence. This suggests recent US moves towards prohibiting the joint provision of audit and non-audit services will do little to reduce the incidence of accounting scandals.

Another research stream investigates whether there is an association between audit quality and audit firm size. The overwhelming finding from this research is that large audit firms (the Big 4/5/6) supply higher quality audits compared to smaller audit firms. Teoh and Wong (1993) show the association between reported accounting earnings and stock prices is greater for large auditors' clients than for small auditors' clients. This suggests large auditors' clients produce more credible earnings numbers than small auditors' clients. Similarly, Becker *et al.* (1998) find large auditors' clients are less likely to engage in earnings management compared to small auditors' clients. Large audit firms

earn fee premiums compared to small audit firms (*eg* Ireland and Lennox, 2002), indicating that some companies are prepared to pay higher fees for higher quality audit services. Companies involved in initial public offerings experience less under-pricing when they are audited by large audit firms (*eg* Willenborg, 1999), which shows audit quality helps reduce the uncertainty associated with investing in newly listed companies.

If opinion shopping companies have a preference for low audit quality, one would expect that opinion shopping companies dismiss large audit firms and appoint small audit firms. Chapter three therefore compares the size of incoming and outgoing audit firms for opinion shopping dismissals and for dismissals not motivated by opinion shopping.

Key issues

Academic researchers employ different empirical methodologies when testing for opinion shopping and they arrive at very different conclusions. The US approach samples companies that change auditors, finds that incoming audit firms are no more likely than outgoing auditors to issue favourable opinions, and concludes that opinion shopping is generally futile. However, this approach is more reasonably interpreted as a test for whether the majority of audit firm dismissals are motivated by opinion shopping, not whether some companies (perhaps a minority) engage in opinion shopping. A better approach is employed by Lennox (2000), who samples both companies that change auditors and companies that do not change. He compares the two groups to test whether opinion shopping influences companies' dismissal decisions, and his results show that UK companies do successfully engage in opinion shopping. One contribution of this report is to test whether the methodology of Lennox (2000) overturns the conventional wisdom that US companies do not engage in opinion shopping. A second

contribution is to use the auditor change disclosures required of US companies to investigate the role of audit committees.

The extant literature on audit committees typically correlates proxies for financial reporting quality (*eg* fraud, earnings management) with audit committee characteristics that are under management control (*eg* existence, independence). This research is of limited value since policy-makers are more interested to know whether financial reporting quality is correlated with mandated audit committee characteristics. This report provides policy-relevant evidence as it investigates what audit committees actually do, thereby providing an assessment of the interaction between senior management, audit firms, and audit committees.

CHAPTER THREE

EMPIRICAL EVIDENCE ON OPINION SHOPPING

This chapter assesses the evidence on whether US companies successfully engage in opinion shopping. It first describes how the sample of 19,273 company-year observations (1996–98) is collected. It then explains and employs the methodology of Lennox (2000) to test for opinion shopping. The results indicate that opinion shopping is an important determinant of companies' decisions to dismiss their auditors. It is then explained why the methodology of prior US research results in an incorrect inference that opinion shopping is futile. The empirical results are used to identify which auditor dismissals are motivated by opinion shopping and which are motivated by other factors. Finally, the opinion shopping dismissals and other dismissals are compared in terms of the timing of the dismissal decisions, and the size of the incoming and outgoing audit firms.

The sample and descriptive statistics

The sample of audit opinions is obtained from Compustat and from companies' 10-K filings on EDGAR (the SEC's electronic database). There are five broad types of audit opinion: (1) unqualified and unmodified; (2) unqualified but modified; (3) qualified 'except for'; (4) opinion disclaimers; and (5) adverse opinions. The modified opinions, qualified opinions, and opinion disclaimers are collected by hand from EDGAR in order to identify the different types of modified opinions and the auditors' disclosures.

Table 3.1 reports frequencies for these five audit opinion types. Most audit opinions are unqualified and unmodified (87.40%), but a

significant number are modified (12.47%). There are very few ‘except for’ qualifications (0.06%) or opinion disclaimers (0.07%), and there are no adverse opinions in the sample.

Table 3.1 Five types of audit opinions (N = 19,273)		
Type of audit opinion	Observations	% of sample
1. Unqualified and unmodified	16,844	87.40
2. Unqualified but modified	2,405	12.47
3. Qualified ‘except for’ ¹	11	0.06
4. Opinion disclaimers ²	13	0.07
5. Adverse	0	0.00
¹ Six ‘except for’ qualifications are issued for reporting disagreements, and five are issued for limitations on audit scope (three of the scope limitations mention going concern uncertainty, and the other two mention both going concern and litigation uncertainties) ² Two opinion disclaimers that disclose no fundamental uncertainty; there are eight that disclose going concern uncertainties alone; and there are three that disclose going concern + litigation uncertainty + significant related party transactions.		

Unqualified but modified audit opinions differ in the US compared to the UK. In the UK, modified opinions typically disclose one or more fundamental uncertainties (*eg* going concern, litigation). In the US, audit opinions are modified for these and other reasons including:

- disclosure that the financial statements comply with SEC regulations
- the audit opinion is shared with another audit firm

- there is a change in accounting principles
- disclosure of certain events (*eg* mergers) that affect the comparability of current and prior year financial statements
- other emphases of matter that the auditor feels should be brought to the attention of investors.

Table 3.2 shows the types of disclosures given in the 2,405 unqualified but modified audit opinions. There are 1,175 opinions (6.10%) that disclose going concern uncertainty, and 40 (0.21%) that disclose some other fundamental uncertainty (usually litigation). There are 1,108 opinions (5.75%) that contain ‘harmless’ explanatory language. Explanatory language is assumed to be harmless if it contains one or more of the following statements: the financial statements comply with SEC regulations; the audit opinion is shared with another audit firm; there is a change in accounting principles; or, certain events (*eg* mergers) affect the comparability of current and prior year financial statements. There are only 82 audit opinions (0.43%) that disclose other emphases of matter. These most commonly disclose financial problems (*eg* bond covenant defaults), significant related party transactions, illegal acts, and correction of accounting errors relating to previous years.

Table 3.2 The different types of unqualified but modified audit opinions (N = 2,405)

	Observations	% of sample
1. Going concern uncertainty ¹	1,175	6.10
2. Other fundamental uncertainty ²	40	0.21
3. 'Harmless' explanatory language ³	1,108	5.75
4. Other emphases of matter ⁴	82	0.43

¹ There are 1,138 going concern opinions that contain a single going concern uncertainty disclosure, and 37 that contain multiple uncertainty disclosures (*eg* going concern + litigation).

² Other fundamental uncertainties include: litigation, foreign exchange losses, value of mining assets, value of accounts receivable, and contractual uncertainties.

³ Opinions with harmless explanatory language include: disclosure that the financial statements comply with SEC regulations, the audit opinion is shared with another audit firm, there is a change in accounting principles, and disclosure of certain events (*eg* mergers) that affect the comparability of current and prior year financial statements.

⁴ Other emphases of matter include: financial restructuring, bond covenant defaults, development stage companies, significant related party transactions, illegal acts, and correction of accounting errors relating to previous years.

Audit opinions that contain emphases of matter disclose problems even though the accounts comply with GAAP (if they did not comply the auditors would be expected to give qualified opinions). Thus, in contrast to the comments of the former Arthur Andersen chief, auditors *can* disclose problems even when accounts comply with

GAAP, but it is clear that they rarely do so. It would appear that audit firms need greater economic incentives to disclose problems to shareholders. More generally, there is a need for regulatory action to improve communications between audit firms and shareholders. Currently audit firms often resign quietly rather than disclose problems in their audit opinions. Audit firms might be encouraged to disclose corporate wrongdoing if they were given legal protection and/or financial incentives.

Table 3.3 subjectively classifies the 19,273 audit opinions as either favourable or unfavourable. The favourable group consists of unmodified audit opinions (16,844), and opinions that are modified with ‘harmless’ explanatory language (1,108). The unfavourable group consists of going concern uncertainties (1,175), other fundamental uncertainties (40), other emphases of matter (82), ‘except for’ qualifications (11), and opinion disclaimers (13).

Table 3.3 Classification of audit opinions as either ‘favourable’ or ‘unfavourable’ (N = 19,273)		
	Observations	% of sample
Favourable audit opinions:		
Unqualified and unmodified	16,844	
‘Harmless’ explanatory language	1,108	
Total	17,952	93.15
Unfavourable audit opinions:		
Going concern uncertainty	1,175	
Other fundamental uncertainty	40	
Other emphases of matter	82	
Qualified ‘except for’	11	
Opinion disclaimers	13	
Total	1,321	6.85

There are three possible objections to Table 3.3’s classification of favourable and unfavourable audit opinions. First, the classification is necessarily subjective and some emphases of matter might not be regarded as unfavourable (*eg* related party transactions). Some disclosures classified as harmless might be unfavourable, for example voluntary changes in accounting principles might be viewed by investors as an attempt by managers to window-dress earnings. In unreported results, several different classifications are used and all are found to give qualitatively the same conclusions. The robustness of the results is unsurprising since most of the unfavourable opinions are going concern

modifications, and most of the favourable opinions are unmodified. Changing the classification of other opinions has little effect on the overall results. Second, it might be argued that opinion disclaimers are worse than qualified 'except for' opinions, which in turn are worse than unqualified but modified opinions. This argument makes sense but, as a practical matter, there are few very serious opinions (only 11 except for opinions, and 13 disclaimers), so a separate analysis of these is not feasible. Finally, some opinions contain multiple bad news disclosures (eg 37 going concern opinions mention an additional problem such as litigation uncertainty). In practice, a ranking of multiple and single bad news disclosures is not feasible. For example, is a 'going concern uncertainty plus litigation uncertainty' worse than a 'going concern uncertainty plus prior accounting errors'? A ranking would be too subjective and so is avoided. In any case, there are only 53 reports that have multiple bad news disclosures so this makes little difference to the overall results.

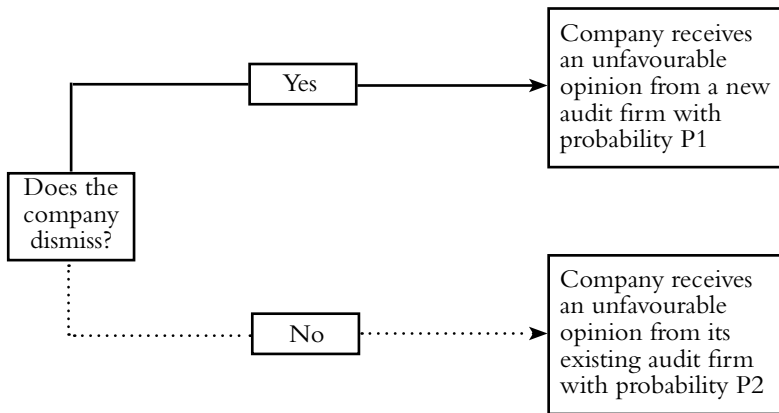
Audit firm dismissals are identified using two data sources - Compustat and Auditor-Trak - and dismissals are verified using companies' 8-K filings on EDGAR. Audit firm resignations are omitted from the analysis because opinion shopping relates to companies' dismissal decisions not auditors' resignation decisions. Audit firm mergers are classified as non-dismissals. The largest audit firm merger during the sample period (1996-98) involves Price Waterhouse and Coopers and Lybrand. Other audit firm mergers are identified by reading 8-K filings to see why the change occurs. There are 828 audit firm dismissals and 18,445 audit firm retentions in the sample. The sample dismissal frequency is 4.3% ($= 828 / 19,273$), similar to the 3.6% frequency found in the UK (Lennox, 2000).

The methodology underlying the analysis of opinion shopping

The analysis of opinion shopping is undertaken in two steps (Lennox, 2000). First, it is tested whether scope exists for opinion shopping. There would be no scope for opinion shopping if all auditors would issue the same report to a given company. Therefore, a necessary condition for opinion shopping is that new and retained audit firms report differently. The opinions issued to dismissal and non-dismissal companies are compared to determine whether reporting differences exist between new and retained audit firms. If reporting differences exist, one would expect audit opinions to change more often when there is a change in audit firm.

Second, it is tested whether companies exploit reporting differences between new and retained audit firms in order to avoid unfavourable audit opinions. This is examined by predicting the opinions each company would receive if it retains its incumbent audit firm or if it hires a new audit firm. These predicted opinions are then compared with companies' observed dismissal decisions as a test for opinion shopping.

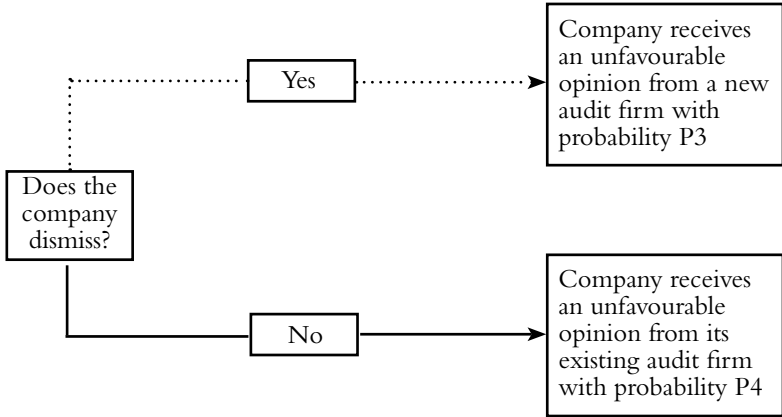
Figures 3.1 and 3.2 illustrate the methodology employed to test for opinion shopping. There are two types of company – one company dismisses its auditor and the other does not dismiss. The solid line indicates the company's decision (it either dismisses or retains) and the broken line indicates the decision not taken. In Figure 3.1, the company dismisses and it expects to receive an unfavourable opinion with probability P_1 from the new audit firm; if it did not dismiss it would expect to receive an unfavourable opinion with probability P_2 . This dismissal is more likely to be motivated by opinion shopping if $P_1 < P_2$.

Figure 3.1 A company that dismisses its audit firm

In Figure 3.2, the company does not dismiss and it expects to receive an unfavourable audit opinion with probability P_4 from its existing audit firm; if it dismissed it would expect to receive an unfavourable opinion with probability P_3 . This non-dismissal is more likely to be motivated by opinion shopping if $P_4 < P_3$.

The academic paper from this project uses statistical models of audit opinion reporting to predict P_1 , P_2 , P_3 , and P_4 (Lennox, 2002). There are significant reporting differences between new and retained audit firms that create scope for opinion shopping if $P_1 \neq P_2$, and $P_3 \neq P_4$. The predicted probabilities are then compared with companies' dismissal decisions in order to test whether companies engage in opinion shopping.

Figure 3.2 A company that does not dismiss its audit firm



Do companies engage in opinion shopping?

It is beyond the scope of this professional report to give the full statistical results of the academic paper (Lennox, 2002). Instead, Tables 3.4 and 3.5 provide an intuitive explanation for the statistical findings of the academic paper. Table 3.4 shows current and prior year audit opinions for 18,445 observations in which incumbent audit firms are retained. Table 3.5 shows current and prior year opinions for 828 observations in which audit firms are dismissed.

The first step is to investigate whether significant reporting differences exist between retained and newly appointed audit firms (*ie* is there scope for opinion shopping?). Table 3.4 shows that of 18,445 observations in which incumbent audit firms are retained, audit opinions change in 756 reports ($756 = 541 + 215$). This represents a frequency of 4.1% ($= 756 / 18445$). Table 3.5 shows that of 828 observations in which incumbent audit firms are dismissed, audit opinions change in 115 reports ($115 = 55 + 60$). This represents a

frequency of 13.9% ($= 115 / 828$). Audit opinions change significantly more often when audit firms are dismissed rather than retained (13.9% *versus* 4.1%). This means there are significant reporting differences between new and retained audit firms. Therefore, a company would not generally expect to receive the same audit opinion from a new audit firm as from a retained incumbent audit firm – scope for opinion shopping does exist.

The second step is to test whether companies use audit firm dismissal decisions to avoid unfavourable opinions. In the first step, it was shown that audit opinions change more often when companies change audit firms. Therefore, a company that wishes to avoid an unfavourable opinion would dismiss an incumbent audit firm that previously gave an unfavourable opinion and it would retain an audit firm that gave a favourable opinion. The data support this hypothesis. Tables 3.4 and 3.5 show there are 1,000 ($= 858 + 142$) unfavourable prior year opinions and 18,273 ($= 17,587 + 686$) favourable prior year opinions. For the unfavourable prior year opinions 14.2% ($= 142 / 1,000$) are followed by dismissal, whereas for the favourable prior year opinions only 3.8% ($= 686 / 18,273$) are followed by dismissal. The frequency of audit firm dismissal is significantly higher when prior opinions are unfavourable (14.2% *versus* 3.8%). The evidence is therefore consistent with companies using auditor dismissal decisions to avoid unfavourable audit opinions. In other words, companies do successfully engage in opinion shopping.

Table 3.4 Prior and current year audit opinions when companies retain their incumbent audit firms ¹				
		Current audit opinions		
		Favourable	Unfavourable	Total
Prior audit opinions	Favourable	17,046	541	17,587
	Unfavourable	215	643	858
	Total	17,261	1,184	18,445
¹ See Table 3.3 for the classification of favourable and unfavourable audit opinions. Both the current year and prior year audit opinions are issued by the retained incumbent audit firm.				

Table 3.5 Prior and current year audit opinions when companies dismiss their incumbent audit firms ¹				
		Current audit opinions		
		Favourable	Unfavourable	Total
Prior audit opinions	Favourable	631	55	686
	Unfavourable	60	82	142
	Total	691	137	828
¹ See Table 3.3 for the classification of favourable and unfavourable audit opinions. The current year audit opinion is issued by the newly appointed audit firm. The prior year opinion is issued by the outgoing audit firm.				

There is a very simple explanation for these findings. First, it is necessary to appreciate that auditors (like all human beings) are heterogeneous. They differ in terms of their experience, ability, prior beliefs, evidence-gathering strategies, integrity, *etc.* Changing audit firm increases the likelihood of a change in audit opinion because different firms may report differently for a given company. The rational strategy for a company wishing to avoid an unfavourable opinion is therefore to retain (dismiss) an audit firm that previously gave a favourable (unfavourable) opinion.

It is rather like a patient who visited his doctor last year for a check-up and the doctor said the patient should lose weight. In the following year, the patient must go for another check-up, but does not wish to be told again that he is over-weight. Since doctors are not identical and the first doctor has already expressed his opinion the patient is over-weight, the patient increases the likelihood of receiving a favourable opinion on his weight by choosing a different doctor.

Of course, the patient's weight could change in the period between the two doctor appointments. Similarly, circumstances can change for companies during the period between their prior and current year audit opinions. The above explanation is an over-simplification because Tables 3.4 and 3.5 do not control for other factors that influence audit firm dismissals and audit reporting. For example, academic research shows that when a company becomes financially distressed it is more likely to dismiss its audit firm, and it is also more likely to receive an unfavourable audit opinion.

The academic version of this report uses statistical models that include controls for company size (total assets), company growth (the percentage change in total assets), financial health (profitability, liquidity, leverage, and corporate default), and growth opportunities (book-to-market ratio). The results from these statistical models are consistent with the conclusions drawn from the simplified analysis of Tables 3.4 and 3.5. Namely, there is scope for opinion shopping, and

companies make audit firm dismissal decisions that are consistent with opinion shopping. The remainder of this report uses the results from the statistical models when discussing opinion shopping dismissals and dismissals that are motivated by other reasons.

Why are there conflicting conclusions in prior academic research?

The previous section argued that US companies do successfully engage in opinion shopping. However, this conclusion differs from prior US studies that conclude opinion shopping is futile. Since there are conflicting conclusions, it is important to understand the reason for the difference. Is the conflict due to the vagaries of statistical sampling or is it because of a fundamental difference in methodology? This section argues the difference arises because the methodology of prior US research is flawed.

Prior US research tests for opinion shopping by drawing a sample of audit firm dismissals and investigating whether the audit opinions of incoming audit firms are more favourable than those of outgoing audit firms. What happens if we apply this alternative methodology? Consistent with prior US research, Table 3.5 shows there is no significant improvement in audit opinions after companies dismiss their auditors. There are 60 companies that experience improved audit opinions (from unfavourable to favourable), but 55 companies experience worse audit opinions (from favourable to unfavourable). The remaining companies experience no change in opinion (either favourable to favourable, or unfavourable to unfavourable). The difference between the improved and worse audit opinions (60 *versus* 55) is not statistically significant. Therefore, prior US research correctly identifies no general improvement in audit opinions for companies that dismiss their auditors. But, as already demonstrated, this does not imply that opinion shopping is futile.

In order to understand this apparent anomaly, it is important to recognise that opinion shopping does not explain the majority of audit firm dismissals. The statistical models predict that 142 of the 828 audit firm dismissals (*ie* 17.1%) are motivated by opinion shopping, whereas the remaining dismissals are motivated by other factors. There is a significant improvement in audit opinions for opinion shopping dismissals, but audit opinions become slightly worse for the other dismissals. The statistical models are used to estimate P1 and P2 for each of the 828 auditor dismissal companies (see Figure 3.1). The models indicate a mean predicted audit opinion improvement ($= P2 - P1$) of 17.99% for the 142 opinion shopping dismissals, but a deterioration of -1.73% for the remaining dismissals. There is no general improvement in audit opinions in Table 3.5 because opinion shopping motivates only a minority of dismissals (*ie* 17.1%), and because there is a small offsetting deterioration in opinions for the other dismissals.

Opinion shopping and the voluntary disclosure of reasons for audit firm dismissals

US companies are not required to disclose in their 8-K filings why auditors are dismissed but they are allowed to disclose voluntarily their reasons. Relatively few companies (19.7%) voluntarily disclose why auditors are dismissed and the most common reason given is the need for lower audit fees. It can be noted that US companies were not required to disclose audit fees during the sample period so there is no way of verifying whether fee reduction was the real reason for dismissal. Moreover, no significant association was found between the opinion shopping motive and the voluntarily disclosure of reasons given for audit firm dismissals. This suggests that voluntarily disclosed reasons may lack candour (*ie* companies who dismiss because of opinion shopping cite other reasons for auditor dismissals). This suggests that regulators might consider whether companies should be required to

disclose the reasons for audit firm changes, and how such disclosures can be made informative rather than 'boiler-plate'. US companies (like UK companies) are now required to disclose fees paid to auditors. This requirement will help ensure that companies do not falsely disclose that the reason for the auditor change was to obtain a lower cost audit. Regulators might also require companies to disclose whether the new audit firm was appointed after the company put the audit out to tender, and the criteria considered for dismissing the audit firm and appointing the new audit firm.

Opinion shopping and the timing of audit firm dismissals

This section investigates whether there are significant timing differences between opinion shopping dismissals and other dismissals. The timing is calculated by counting the number of days from the date of auditor dismissal to the year-end reported on by the incoming audit firm. A dismissal before the next year-end gives a positive number of days and a dismissal after the year-end gives a negative number of days. Lennox (2000) did not investigate the timing issue using UK data because UK companies are not required to disclose the dates that audit firms are dismissed.

Table 3.6 shows the mean and median numbers of days for opinion shopping dismissals and other dismissals. When dismissals are motivated by opinion shopping the mean (median) number of days is 49 (28), but when dismissals are not motivated by opinion shopping the mean (median) number of days is 105 (85). The mean (and median) timing differences are statistically significant, showing that on average opinion shopping dismissals occur nearly two months later than other dismissals.

Table 3.6 Opinion shopping and the timing of audit firm dismissals

	Is the audit firm dismissed because of opinion shopping? ¹	
	Yes (N = 142)	No (N = 686)
Mean number of days from date of auditor dismissal to the year-end reported on by the incoming audit firm	49	105
Median number of days from date of auditor dismissal to the year-end reported on by the incoming audit firm	28	85
Number of dismissals on or before the year-end reported on by the new auditor	90	560
Number of dismissals after the year-end reported on by the new auditor	52	126
¹ Statistical models of auditor dismissal and audit reporting are used to predict whether dismissals are motivated by opinion shopping.		

There are three possible explanations for the timing difference between opinion shopping dismissals and other dismissals. First, opinion shopping companies wait until the incumbent audit firm has already begun some of the audit work in order to judge more accurately whether the incumbent firm is likely to give an unfavourable opinion. Second, opinion shopping companies delay the appointment of a new audit firm in order to make it harder for the new firm to uncover

underlying problems. A newly appointed audit firm is under greater time pressure when appointed after the year-end. Table 3.6 shows 36.6% ($= 52 / 142$) of opinion shopping dismissals occur after the year-end, but only 18.4% ($= 126 / 686$) of other dismissals occur after the year-end. Third, opinion shopping companies spend more time trying to find compliant audit firms.

This finding should be of interest to accounting regulators. It suggests regulators can make it harder for companies to engage in opinion shopping if they limit the period during which companies are allowed to dismiss their audit firms. For example, regulators could stipulate that a company can only change its audit firm during the first nine months after the previous year-end. Chapter five therefore concludes that regulators should limit the window of opportunity for opinion shopping by placing time constraints on audit firm changes.

Opinion shopping and audit firm size

Chapter one has already discussed academic evidence that large audit firms supply higher quality audits compared to small audit firms. One might therefore expect that opinion shopping companies dismiss large audit firms and appoint small incoming audit firms.

Table 3.7 reports the size of incoming and outgoing audit firms for opinion shopping dismissals and for other dismissals. There is no significant association between opinion shopping and the size of the outgoing audit firm. The outgoing auditor is a large audit firm in 64.7% ($= 23.2\% + 41.5\%$) of opinion shopping dismissals and in 68.5% ($= 52.5\% + 16.0\%$) of other dismissals. However, there is a significant association between opinion shopping and the size of the incoming audit firm. The incoming auditor is a large audit firm in 38.7% ($= 23.2\% + 15.5\%$) of opinion shopping dismissals and in 73.8% ($= 52.5\% + 21.3\%$) of other dismissals. The difference (38.7% *versus* 73.8%) is statistically significant and it remains significant after

including controls for company size, growth, and financial health. This finding suggests that opinion shopping companies prefer to appoint lower quality (small) audit firms.

Table 3.7 Opinion shopping and audit firm size

		Does the audit firm dismissal occur due to opinion shopping? ¹	
Outgoing audit firm	Incoming audit firm	Yes (N = 142)	No (N = 686)
Big 5 ²	Big 5	33 (23.2%)	360 (52.5%)
Big 5	Non-big 5	59 (41.5%)	110 (16.0%)
Non-big 5	Non-big 5	28 (19.7%)	70 (10.2%)
Non-big 5	Big 5	22 (15.5%)	146 (21.3%)
¹ Statistical models of auditor dismissal and audit reporting are used to predict whether dismissals are motivated by opinion shopping. ² The Big 5 audit firms are KPMG, PricewaterhouseCoopers (Price Waterhouse or Coopers & Lybrand prior to the merger), Arthur Andersen, Ernst & Young, and Deloitte Touche.			

Key issues

Prior US research shows that incoming audit firms do not issue favourable audit opinions more often than outgoing audit firms, and concludes from this that opinion shopping is futile. Lennox (2000) argues that the approach of US studies actually tests whether the majority of audit firm dismissals are motivated by opinion shopping – it does not test whether opinion shopping is a motivating factor in

some auditor dismissals. The results in this chapter show that opinion shopping motivates approximately 17% of audit firm dismissals, and for these dismissals there is a significant improvement in audit opinions. For the remaining 83% of audit firm dismissals (those not motivated by opinion shopping), audit opinions are slightly worse after dismissal. Prior US research incorrectly concludes that opinion shopping is futile because it mixes up the dismissal motives of companies that engage in opinion shopping with the dismissal motives of other companies.

The opinion shopping dismissals and other dismissals are compared in terms of: (i) the voluntary disclosure of reasons for dismissal; (ii) the timing of audit firm dismissals; and (iii) the size of incoming and outgoing audit firms. No significant association is found between opinion shopping and the voluntary disclosure of reasons for dismissal. This suggests that opinion shopping companies do not candidly disclose why auditors are dismissed. On average, opinion shopping dismissals are found to occur nearly two months later than other dismissals. This suggests that a regulatory ban on late audit firm changes could help to deter opinion shopping. Finally, opinion shopping companies are significantly more likely to hire small audit firms after dismissal, and this is consistent with the view that such companies opt for lower audit quality.

CHAPTER FOUR

THE ROLE OF AUDIT COMMITTEES

This chapter focuses on the role of audit committees when companies dismiss their audit firms. It is first tested whether companies that have audit committees are less likely to engage in opinion shopping compared to companies that do not. The remainder of the chapter focuses on companies that have audit committees and seeks to answer four questions:

- How frequent is audit committee participation when companies dismiss their auditors?
- Is audit committee participation affected by the company's dismissal motives?
- When audit committees participate in audit firm dismissal decisions, do audit committees disapprove of auditor dismissals that are motivated by opinion shopping?
- What happens to audit committee members that disapprove of opinion shopping?

Opinion shopping and audit committee existence

This section tests whether companies that have audit committees are less likely to engage in opinion shopping compared to companies that do not have audit committees. The rationale for the test is that audit committees may prevent opinion shopping, and managers that engage in opinion shopping may have less incentive to form audit committees.

It is determined whether an audit committee exists at the auditor dismissal date by reading companies’ 10-K and proxy forms filed before and after auditor dismissals. It is not possible to determine whether an audit committee exists for 52 dismissals because of inadequate disclosure. In most of these cases it is likely that no audit committee exists (*ie* the company does not bother to disclose that it has no committee). In another 92 dismissals, companies disclose affirmatively that no audit committee exists. In the remaining 684 dismissals, companies disclose that audit committees do exist.

Table 4.1 shows the association between audit committee existence and opinion shopping. The frequency of opinion shopping is 14% in companies that have audit committees, 30% in companies that do not have audit committees, and 31% in companies that do not disclose whether they have audit committees. The smaller opinion shopping frequency in companies that have audit committees (14% *versus* 30-31%) is statistically significant.

Table 4.1 The association between opinion shopping and audit committee existence			
		Does the audit firm dismissal occur due to opinion shopping? ¹	
		Yes (N = 142)	No (N = 686)
Does the company have an audit committee?	Yes	98 (14%)	586 (86%)
	No	28 (30%)	64 (70%)
	Undisclosed	16 (31%)	36 (69%)
¹ Statistical models of auditor dismissal and audit reporting are used to predict whether dismissals are motivated by opinion shopping.			

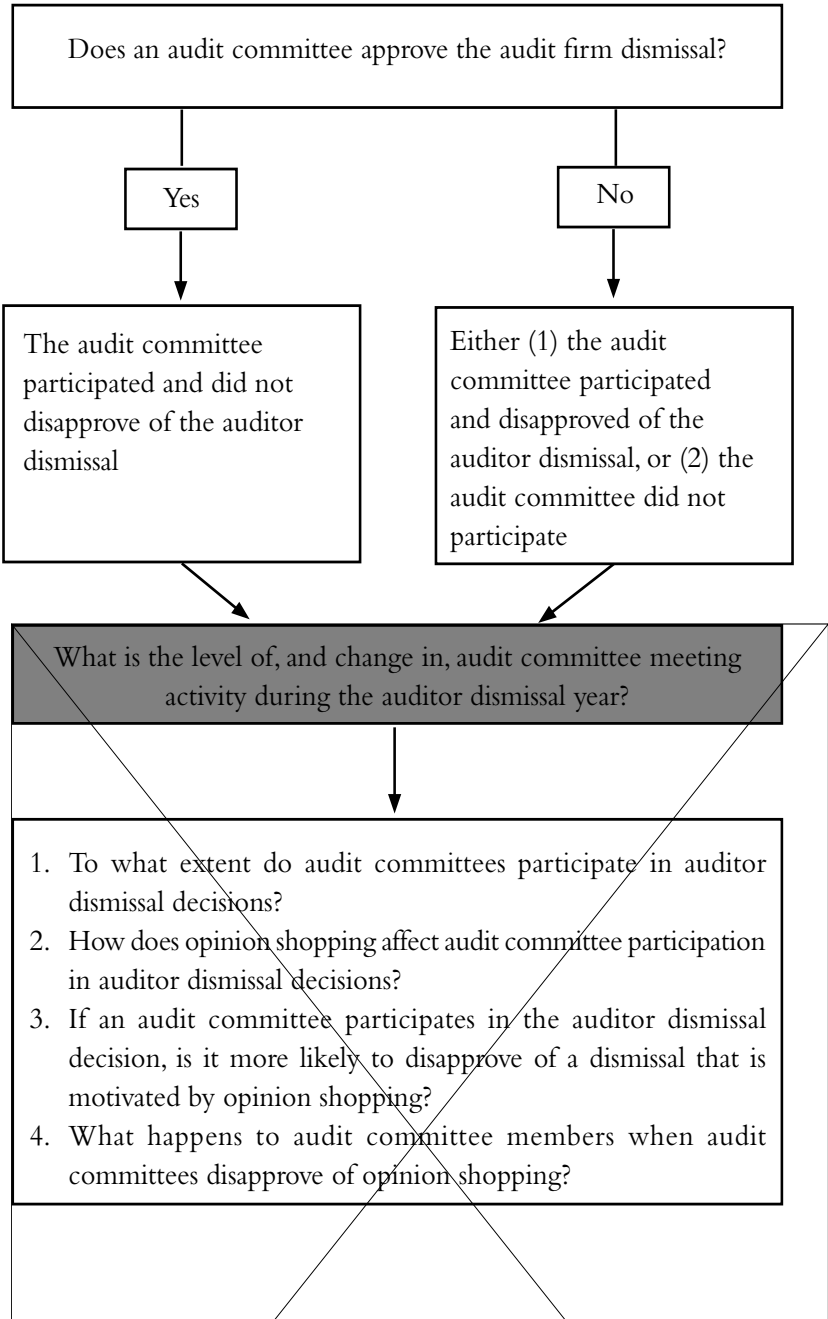
In statistical tests company size is included as a control variable and, although opinion shopping remains less frequent in companies that have audit committees, the difference is no longer statistically significant. The fall in statistical significance occurs because small companies are more likely to engage in opinion shopping and small companies are less likely to form audit committees. For the remainder of this project, the focus is on companies that have audit committees ($N = 684$).

The methodology for examining audit committee participation and approval

This section explains how the role of audit committees is examined when companies dismiss their incumbent audit firms. Companies that do not dismiss are not considered because the role of audit committees in auditor retentions is not disclosed (there are no 8-K filings).

The audit committee is hypothesised to have two decisions. It first decides whether to participate in the auditor dismissal decision. Next, if the audit committee does participate, the audit committee decides whether to approve or disapprove the auditor dismissal decision. The methodology is illustrated in Figure 4.1. First, each company's 8-K filing is examined to determine whether the audit committee approves dismissal. If an audit committee approves, it is assumed that the committee participates in the auditor dismissal decision and it does not disapprove. If the audit committee does not approve, it is assumed that the committee either: (1) does not participate in the decision; or (2) it participates and disapproves.

Figure 4.1 Audit committee participation in, and approval of, audit firm dismissals



It is important to note that audit committee non-approval is not assumed to be equivalent to audit committee disapproval. Rather, an audit committee may not approve an audit firm dismissal because it does not participate in the dismissal decision. It is important to account for audit committee non-participation since prior research indicates some audit committees are inactive and they leave important decisions to senior management (Menon and Williams, 1994).

Companies do not disclose the manner in which audit committees participate in audit firm dismissals. At one extreme, an audit committee might participate by simply rubber-stamping a decision that is already taken by senior management. At the other extreme, an audit committee might play an active role in all the key decisions (deciding that the incumbent audit firm will not be re-appointed, soliciting bids from potential audit firms, hiring the new audit firm). This caveat should be borne in mind when reference is made to audit committee participation in the following sections.

Audit committee participation in auditor dismissal decisions is predicted using data on the level of, and increase in, audit committee meeting activity in the auditor dismissal year. The level of audit committee activity captures the possibility that an already active committee discusses the audit firm dismissal as part of its regular meeting schedule. The change in audit committee activity captures the possibility that a committee arranges extra meetings to discuss the audit firm dismissal. It is therefore expected that audit committees with high levels of activity, or audit committees that show an increase in activity, are more likely to participate in auditor dismissal decisions.

The final step in the methodology is to use the data on opinion shopping, audit committee approval, and audit committee meetings to address the remaining four questions:

- To what extent do audit committees participate in auditor dismissal decisions?

- How does opinion shopping affect audit committee participation in auditor dismissal decisions?
- If an audit committee participates in the auditor dismissal decision, is it more likely to disapprove of a dismissal that is motivated by opinion shopping?
- What happens to audit committee members when audit committees participate and disapprove of opinion shopping?

Answers to the above questions are discussed in the remaining sections of this chapter.

Three results support the empirical use of audit committee meeting data to predict whether audit committees participate in auditor dismissal decisions. First, there is a significant increase in audit committee meeting activity in the auditor dismissal year. This is consistent with audit committees arranging additional meetings in order to discuss audit firm dismissals. Second, audit committee non-approval is more frequent when audit committees have low levels of meeting activity, and when there is no increase in audit committee activity during the auditor dismissal year. This suggests that some non-approvals are due to non-participation. Third, there is a significant increase in audit committee meeting activity even when auditor dismissals are not approved. This suggests that some non-approvals are due to disapproval rather than non-participation. The next section discusses the limitations with using meeting data to predict audit committee participation, and how these limitations are addressed.

To what extent do audit committees participate in auditor dismissal decisions?

The number of audit committee meetings is obtained from 10-K and proxy filings for the auditor dismissal year and a non-dismissal year. The auditor dismissal year is the financial year during which the audit firm is dismissed. The non-dismissal year is the financial year prior

to audit firm dismissal, or the year afterwards if meeting data for the prior year are unavailable.

The level of audit committee meeting activity is measured using the number of audit committee meetings during the auditor dismissal year. The change in audit committee meeting activity equals the difference between the number of audit committee meetings in the auditor dismissal and non-dismissal years. The level of, and change in, audit committee meeting activity is used to predict whether audit committees participate in auditor dismissal decisions.

Information on audit committee meetings is disclosed for 517 of the 684 companies that have audit committees. Table 4.2 shows the number of audit committee meetings in the auditor dismissal and non-dismissal years. The evidence suggests a significant proportion of audit committees are inactive. During the non-dismissal year, 10.2% of audit committees have zero meetings, 37.7% have just one meeting, and 52.1% have two or more meetings. In comparison, the American Bar Association (1978) recommends a minimum of two meetings per year, and more recently the Blue Ribbon Committee (1999) recommends a minimum of four.

Most of the companies in Table 4.2 are listed on stock exchanges that require audit committees, and the rest are listed on exchanges which strongly recommend audit committees. It is interesting to compare the level of audit committee meeting activity in Table 4.2 with that of voluntary audit committees. Menon and Williams (1994) find 6% of voluntary audit committees have zero meetings, 32% meet once, and 62% have two or more meetings. Voluntary audit committees are therefore more active than the mandated audit committees shown in Table 4.2. The difference in meeting frequencies between Table 4.2 and Menon and Williams (1994) suggests audit committees are more active when they are set up voluntarily. This is consistent with the view that audit committee effectiveness partly reflects the underlying incentives of management to permit good corporate governance.

The other main finding of Table 4.2 is that there is a significant increase in meeting activity between the non-dismissal year and the dismissal year. The mean number of meetings in the non-dismissal year is 1.90, which is significantly lower than the mean number of meetings in the dismissal year (2.35). This suggests some audit committees arrange extra meetings in order to discuss audit firm dismissals.

Table 4.2 Number of audit committee meetings in auditor dismissal and non-dismissal years

Number of meetings in dismissal years	Observations (%)	Number of meetings in non-dismissal years	Observations (%)
0	28 (5.4%)	0	53 (10.2%)
1	169 (32.7%)	1	195 (37.7%)
2	130 (25.2%)	2	127 (24.6%)
3	84 (16.2%)	3	68 (13.2%)
4	54 (10.4%)	4	51 (9.9%)
5	31 (6.0%)	5	12 (2.3%)
6 or more	21 (4.1%)	6 or more	11 (2.1%)
Total	517	Total	517
Mean number of meetings = 2.35		Mean number of meetings = 1.90	
Notes: The sample consists of 517 audit firm dismissals where audit committees exist and audit committee meeting activity is disclosed. The non-dismissal year is the year prior to auditor dismissal or, if meeting data for that year are unavailable, the year after dismissal.			

Table 4.3 reports the association between audit committee meeting activity and audit committee approval of audit firm dismissals. The mean number of audit committee meetings during the auditor dismissal year is 2.65 when audit firm dismissals are approved and 1.84 when dismissals are not approved. The difference (2.65 *versus* 1.84) is statistically significant and shows audit committees meet more often when they approve audit firm dismissals. The mean number of audit committee meetings during the non-dismissal year is 2.10 when audit firm dismissals are approved and 1.57 when dismissals are not approved. This difference (2.10 *versus* 1.57) is also statistically significant, confirming that more active audit committees are more likely to participate in audit firm dismissal decisions.

The mean change in audit committee meeting activity is 0.55 when audit firm dismissals are approved and 0.26 when dismissals are not approved. The difference (0.55 *versus* 0.26) is statistically significant, which suggests that some non-approvals are due to non-participation rather than disapproval. Both 0.55 and 0.26 are significantly greater than zero, indicating that some audit committees arrange extra meetings to discuss audit firm dismissals. The fact that 0.26 is significantly greater than zero suggests that some non-approvals are due to disapproval rather than non-participation.

Table 4.3 Audit committee meeting activity and audit committee approval of audit firm dismissals ¹

	Does an audit committee approve the audit firm dismissal?	
	Yes (N = 328)	No (N = 189)
Mean number of audit committee meetings during the auditor dismissal year	2.65	1.84
Mean number of audit committee meetings during a non-dismissal year.	2.10	1.57
Mean increase in audit committee meeting activity during the auditor dismissal year.	0.55	0.26
¹ The sample consists of 517 audit firm dismissals where audit committees exist and audit committee meeting activity is disclosed.		

In summary, Table 4.3 indicates that the level of, and increase in, audit committee meeting activity are strongly correlated with audit committee participation in auditor dismissal decisions. In fact, the statistical models show that approximately 85% of audit committees participate in audit firm dismissals. This result is remarkably robust – three different model specifications give mean predicted audit committee participation rates of 85.9%, 85.4%, and 85.4%. Of audit committees that participate, 71.5% approve audit firm dismissals and 28.5% disapprove. The remaining 15% of audit committees do not participate and so do not approve audit firm dismissals.

The frequency of audit committee non-participation (15%) is worryingly high given that auditor dismissal should be a primary responsibility of the audit committee. It is not unreasonable to question

what these audit committees are doing if they do not even perform this most basic function. The answer appears to be they are not doing very much. As shown in Table 4.2, approximately 10% of audit committees have no meetings during a typical (non-dismissal) year.

There is a potentially important limitation with using meeting data to predict audit committee participation in auditor dismissal decisions. Audit committees meet to discuss issues other than audit firm dismissals (*eg* the issuance of financial results, compliance with SEC reporting requirements), and this might be thought to cause two problems. First, audit committee meetings are not perfectly correlated with audit committee participation, which increases the imprecision of the statistical results and therefore reduces statistical significance. Notwithstanding this imprecision, the results *are* statistically significant so this is not a major problem. Second, audit committee meetings might be correlated with other factors associated with audit firm dismissals (*eg* accounting disagreements). This is a more important problem because it is a potential cause of bias. The academic version of this report uses statistical techniques to investigate the bias issue. Little evidence of bias is found, and implementing a control for bias actually strengthens rather than weakens the conclusions drawn (see Lennox, 2002).

Audit committee meeting activity and disclosure bias

Recall that only 517 of the 684 companies that have audit committees disclose the number of meetings held. This raises the question as to whether the disclosed number of audit committee meetings is an unbiased estimate of average meeting frequency in the sample. In particular, there might be a concern that companies are less likely to disclose the number of audit committee meetings held if audit committees rarely meet.

This argument is tested by estimating a statistical model of audit committee meeting activity for companies that disclose the number of

audit committee meetings. The estimated coefficients from this model are used to predict the number of audit committee meetings held by companies that do not disclose. The predicted number of meetings held by companies that do not disclose is then compared with the predicted number held by companies that do disclose.

Interestingly, the results indicate that companies are more likely to disclose the number of audit committee meetings if the number was higher than average. The mean number of audit committee meetings is 2.35 for the 517 companies that disclose meeting activity, but the mean is predicted to be only 2.00 for the 167 companies that do not disclose meeting activity. The difference (2.35 *versus* 2.00) is statistically significant, indicating that audit committees are less likely to disclose the number of meetings when meeting activity is low. This suggests that even when disclosures are mandatory (as in the case of audit committee meetings), companies do not always provide investors with unbiased information. It is worth noting that the audit committee participation rate of 85% estimated in the previous section takes into account this disclosure bias.

How does opinion shopping affect audit committee participation in auditor dismissal decisions?

Since audit committee meetings are strongly correlated with audit committee participation, it is possible to examine audit committee participation even though participation is not directly disclosed by companies. Statistical models of audit committee meetings are used to investigate whether opinion shopping affects audit committee participation. The expected direction of the association between opinion shopping and audit committee participation is ambiguous because of two potentially offsetting effects.

A negative association would indicate that audit committees are less likely to participate when auditor dismissals are motivated

by opinion shopping. For example, an audit committee might be unwilling to oppose a decision by senior management to change its auditor. A positive association would indicate that audit committees are more likely to participate when dismissals are motivated by opinion shopping. For example, an audit committee might be unwilling to let senior management make the dismissal decision if it believes the dismissal is motivated by opinion shopping.

The empirical results (reported in the academic paper) indicate no significant association between opinion shopping and audit committee participation in auditor dismissal decisions. The lack of association may seem uninteresting, but it turns out to be vitally important in interpreting the results of the next section, which tests whether participating audit committees disapprove of opinion shopping.

Are audit committees more likely to disapprove of audit firm dismissals that are motivated by opinion shopping?

This section tests the association between opinion shopping and the audit committee's decision whether to approve or disapprove the audit firm dismissal, *conditional on the audit committee deciding that it will participate in the audit firm dismissal decision*. It is hypothesised that participating audit committees are more likely to disapprove of dismissals that are motivated by opinion shopping than dismissals that are motivated by other reasons.

Table 4.4 reports the association between audit committee approval and opinion shopping. Audit committees approve only 37.8% (= 37 / 98) of opinion shopping dismissals but they approve 64.7% (= 379 / 586) of other dismissals. The difference (37.8% *versus* 64.7%) is statistically significant and it is consistent with audit committees disapproving of dismissals that are motivated by opinion shopping.

Recall that 8-K filings disclose only audit committee approval or non-approval (not participation or disapproval). This means the

268 non-approvals in Table 4.4 occur either because audit committees do not participate or because they participate and disapprove. This raises a question as to whether the association reported in Table 4.4 reflects a non-participation effect or a disapproval effect. This is where the result of the previous section becomes vitally important. Since no significant association is found between opinion shopping and audit committee participation, the association reported in Table 4.4 is driven by disapproval rather than by non-participation. In other words, audit committees that participate in auditor dismissal decisions are more likely to disapprove of dismissals that are motivated by opinion shopping. In contrast, the opinion shopping motive does not affect the audit committee’s decision to participate in the auditor dismissal decision.

Table 4.4 Opinion shopping and audit committee approval of audit firm dismissals ¹				
		Do audit firm dismissals occur due to opinion shopping? ²		
		Yes	No	Total
Does an audit committee approve dismissal?	Yes	37	379	416
	No	61	207	268
	Total	98	586	684
¹The sample consists of 684 audit firm dismissals where an audit committee exists at the auditor dismissal date. ²Statistical models of auditor dismissal and audit reporting are used to predict whether dismissals are motivated by opinion shopping.				

What happens to audit committee members when audit committees disapprove of opinion shopping?

The previous section showed audit committees are more likely to disapprove when audit firm dismissals are motivated by opinion shopping. It is therefore reasonable to wonder what happens to audit committee members who object to auditor dismissals. Companies do not disclose how individual audit committee members vote – they only disclose approval (or non-approval) by the audit committee as a whole. Nevertheless, it is hypothesised that audit committee members are more likely to leave committees that disapprove of opinion shopping for two reasons. First, an audit committee member might resign if he/she objects to the company's decision to dismiss the incumbent audit firm. Second, senior management might remove obstructive audit committee members in order to exert greater control over the audit committee and therefore over the auditor dismissal decision.

Two points should be noted in connection with this hypothesised relation. First, companies do not disclose whether audit committee member departures are due to dismissal or resignation, so it is not possible to discriminate between the two above explanations. This does not really matter in terms of the motivation for the tests since both explanations are consistent with opinion shopping resulting in a weaker audit committee. Nevertheless, there appears to be a need for more informative and timely disclosures so that investors can determine whether audit committee member departures occur as a result of conflicts with management. Whether or not regulators can design rules that ensure companies make truthful disclosures about such conflicts is debatable. Second, the hypothesis is silent on whether a member who leaves the audit committee also leaves the company. Senior management may or may not allow a dissenting audit committee member to assume an alternative role within the company. Similarly, an audit committee member who objects to the company's dismissal

decision may or may not be willing to continue serving the company in a different capacity.

The number of audit committee members prior to auditor dismissal, and the number of members that leave during the auditor dismissal year are obtained from companies' proxy and 10-K filings. The departure rate is calculated as the number of member departures divided by the number of original audit committee members. Table 4.5 reports the association between audit committee turnover and opinion shopping. The mean departure rate is 38.4% for opinion shopping dismissals and only 22.1% for other dismissals. The difference is statistically significant, showing that audit committee members are more likely to depart when companies engage in opinion shopping.

Table 4.5. Opinion shopping and the departure of audit committee members ¹		
	Do audit firm dismissals occur due to opinion shopping? ²	
	Yes (N = 52)	No (N = 405)
Mean departure rate of audit committee members during the auditor dismissal year ³	38.4%	22.1%
Mean departure rate of affiliated audit committee members during the auditor dismissal year ⁴	10.9%	7.8%
Mean departure rate of unaffiliated audit committee members during the auditor dismissal year	27.5%	13.9%
¹The sample consists of 457 audit firm dismissals where audit committees exist and audit committee members' names are disclosed. ²Statistical models of auditor dismissal and audit reporting are used to predict whether dismissals are motivated by opinion shopping. ³The departure rate equals the number of audit committee members that leave during the auditor dismissal year, divided by the number of audit committee members prior to auditor dismissal. ⁴An audit committee member is 'affiliated' if he/she is an employee of the company, a former employee, a relative of senior management or has other business relations with the company.		

Table 4.6 reports the association between audit committee member departures and audit committee approval of audit firm dismissals. The mean departure rate is only 19.2% when auditor

dismissals are approved and 32.1% when dismissals are not approved. The difference is statistically significant, showing that members are more likely to depart when audit committees do not approve audit firm dismissals. The statistical models show this association reflects the effect of audit committee disapproval rather than non-participation. In other words, audit committee members are more likely to depart when audit committees disapprove of opinion shopping. This result continues to hold even when controls are added for company size and financial health.

Extant research suggests audit committee composition is associated with the effectiveness of the audit committee (*eg* Carcello and Neal, 2000). In particular, audit committees are more effective if members are not affiliated with senior management. Like prior research, an audit committee member is assumed to be affiliated if he/she is a current or former employee, a relative of senior management, an advisor to the company, an officer of a significant supplier or customer, or an interlocking director. This assumption may be criticised because companies are required to disclose only the above affiliations. Companies are not required to disclose affiliations such as personal friendships or other financial ties. For example, chapter one noted that two of Enron's audit committee members were associated with organisations that had received charitable payments, but the payments were not disclosed in Enron's proxy filings. Moreover, there is a danger that devious senior management might appoint an audit committee member that appears to be unaffiliated but actually is not (Byrd and Hickman, 1992). It would appear desirable that companies disclose more information about outside directors' backgrounds and their affiliations with management so that investors can determine whether outside directors are truly independent.

Table 4.6 Audit committee approval and the departure of audit committee members ¹

	Do audit committees approve audit firm dismissals?	
	Yes (N = 284)	No (N = 173)
Mean departure rate of audit committee members during the auditor dismissal year ²	19.2%	32.1%
Mean departure rate of affiliated audit committee members during the auditor dismissal year ³	7.4%	9.5%
Mean departure rate of unaffiliated audit committee members during the auditor dismissal year	11.4%	22.4%
¹ The sample consists of 457 audit firm dismissals where audit committees exist and audit committee members' names are disclosed. ² The departure rate equals the number of audit committee members that leave during the auditor dismissal year, divided by the number of audit committee members prior to auditor dismissal. ³ An audit committee member is 'affiliated' if he/she is an employee of the company, a former employee, a relative of senior management or has other business relations with the company.		

Notwithstanding this measurement problem, prior studies find the information disclosed in proxy filings helps to identify whether audit committee members are affiliated with senior management. Following their approach, it is tested whether the departure rates are different for affiliated compared to unaffiliated audit committee members. The results are shown in rows two and three of Tables 4.5 and 4.6.

Table 4.5 shows the mean departure rate of affiliated members is 10.9% for opinion shopping dismissals and it is only a little lower (7.8%) for other dismissals. In contrast, the mean departure rate of unaffiliated members is 27.5% for opinion shopping dismissals and 13.9% for other dismissals. The association between audit committee turnover and opinion shopping is therefore driven by the departure of independent rather than affiliated audit committee members.

Table 4.6 reports similar results for audit committee approval. The mean departure rate of affiliated members is 9.5% when audit committees do not approve auditor dismissals, and it is only a little lower (7.4%) when dismissals are approved. The mean departure rate of unaffiliated members is 22.4% when dismissals are not approved and 11.4% when dismissals are approved. It is therefore concluded that audit committees are significantly more likely to lose unaffiliated members when audit committees disapprove of opinion shopping.

Key issues

The results of this chapter suggest that senior management have considerable influence over auditor dismissal decisions. First, companies that do not have audit committees are more likely to engage in opinion shopping compared to companies that have audit committees. Senior managers therefore have more control over auditor dismissal decisions if they do not form audit committees (or if they form ineffective committees). Second, a significant proportion of audit committees (15%) do not participate in auditor dismissal decisions. This rate of non-participation is conservatively estimated, since it takes no account of cases where audit committee participation is limited to rubber-stamping management decisions. The lack of audit committee participation is also highlighted by the infrequent holding of audit committee meetings. In a typical year, nearly half the audit committees hold fewer than the recommended minimum of two meetings and 10% hold no meetings

at all. This measure of inactivity is also conservatively estimated since it is found that companies are less likely to disclose the number of audit committee meetings when the number is low. Third, audit committees that participate are more likely to disapprove of auditor dismissals that are motivated by opinion shopping. Although this is consistent with audit committees helping to maintain the integrity of the audit reporting process, it should be noted that companies still dismiss their auditors even when audit committees disapprove. Finally, there is a higher rate of member turnover when audit committees disapprove of opinion shopping, and the higher turnover rate is more pronounced for audit committee members that are unaffiliated with management. This suggests that either senior management dismiss independent audit committee members in order to exert greater control over the auditor dismissal decision, or that independent audit committee members resign when the audit committee's authority is compromised by management. In either case, the findings imply that opinion shopping weakens the role of the audit committee as well as the integrity of the audit reporting process.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS FOR PUBLIC POLICY

This section discusses the main findings of the report and makes recommendations for public policy. Recall from chapter one that eight questions are addressed in the report:

Do managers successfully engage in opinion shopping? – It is found that US companies do successfully engage in opinion shopping. This result is consistent with UK evidence but contradicts prior US studies. The difference in conclusions is attributable to differences in the testing methodology rather than institutional differences between the UK and US. In particular, it is necessary to sample auditor retentions as well as auditor dismissals and it is necessary to compare the two samples in order to test for opinion shopping.

What can regulators do to prevent opinion shopping? – Opinion shopping dismissals occur significantly later in the reporting period compared to other dismissals. This is a potentially useful finding as it suggests that regulators can deter opinion shopping by limiting the window of opportunity for audit firm dismissals. For example, regulators could prevent companies from changing auditors more than nine months after the prior year-end. This would provide managers with less time to assess the opinion that would be issued by the incumbent audit firm; it would provide the incoming audit firm with more time to uncover

underlying problems; and, it would give the company less time to search out a compliant auditor.

Which audit firms do opinion shopping companies hire? – Opinion shopping companies are significantly more likely to appoint small audit firms as incoming auditors rather than large audit firms. This result is consistent with evidence that large audit firms provide higher quality audits than small audit firms. It suggests that opinion shopping companies are more likely to find favourable opinions by searching amongst the pool of small audit firms. However, it is important not to emphasise this result too strongly, since no significant association is found between opinion shopping and the size of outgoing audit firms.

Is there a need for audit firms and audit committees to provide more informative and timely disclosures? – When financial statements comply with GAAP but are misleading, audit firms are able to disclose their concerns by giving “emphases of matter” audit opinions. The evidence indicates that auditors very rarely disclose such problems and so there appears to be a need for greater communication between auditors and investors. US companies are required to disclose more detailed information than UK companies about audit committees and audit firms. These disclosures are found to be useful for assessing why companies dismiss audit firms and for assessing the role of audit committees when auditors are dismissed. There may therefore be a case for introducing such disclosures in the UK. Although the disclosures are found to be useful, there are a number of deficiencies in the US disclosure system. Companies are not required to disclose why audit firms are dismissed, and it may be very difficult to ensure that companies are honest when making these disclosures. Companies are required to disclose the number of audit committee meetings, but a large number of companies fail to disclose this information, and it is found that companies are less likely to disclose the number of meetings when audit committees

meet infrequently. Although audit committees are required to disclose whether they approve audit firm dismissals, they are not required to explain whether or why they disapprove. The evidence suggests that disagreements between management and audit committee members about audit firm dismissals are associated with the departure of audit committee members. However, companies are not required to disclose why audit committee members depart and departures are not disclosed on a timely basis.

Are audit firm dismissals more likely to be motivated by opinion shopping when companies do not have audit committees? – Companies that have audit committees are less likely to engage in opinion shopping compared to companies that do not have audit committees. This association is statistically significant before controlling for company size, but it loses significance when size is included as a control variable.

To what extent do audit committees participate in audit firm dismissal decisions? – There is a disturbing lack of audit committee activity and of audit committee participation in auditor dismissal decisions. In a typical (non-dismissal) year, 10% of audit committees have zero meetings and nearly half the sample hold fewer than two meetings (the recommended minimum during the sample period). It is estimated that 15% of audit committees do not participate in auditor dismissal decisions. This implies that senior managers have significant control over auditor dismissal decisions, and it is consistent with the finding that companies engage in opinion shopping. This conclusion is strengthened when one considers that audit committee ‘participation’ includes cases where audit committees simply rubber-stamp the auditor dismissal decisions of senior management.

Are audit committees more likely to disapprove of dismissals that are motivated by opinion shopping? – It is found that audit committees are more likely to disapprove of opinion shopping dismissals than other dismissals, and this is consistent with the view that audit committees try to maintain the integrity of financial reporting. However, audit committees are ineffective in the sense that audit firms are dismissed even when audit committees disapprove. This suggests that senior managers have rather more control than audit committees over the hiring and firing of audit firms.

What happens to audit committee members when audit committees disapprove of opinion shopping? – It is found that audit committee members are more likely to leave committees that disapprove of opinion shopping. This finding is particularly pronounced for audit committee members that are independent of senior management and it is consistent with two explanations. First, senior management remove dissenting audit committee members in order to exert greater control over the audit committee and over the auditor dismissal decision. Second, audit committee members resign in protest at the company's practice of opinion shopping. Both explanations suggest opinion shopping results in a weaker audit committee.

Recommendations for public policy

The results of this project suggest managers have significant control over audit firm dismissal decisions and audit committees are relatively weak. Many audit committees are not only inactive, but they run the risk of having their decisions over-ruled by management and of being dismissed. The rational choice for an audit committee member who objects to management policy is therefore to resign quietly. There is little incentive for audit committee members to act as whistle-blowers to investors.

The same is true of audit firms. Audit firms very rarely disclose problems in financial statements beyond issues relating to going concern. Some auditors, such as the former chief of Arthur Andersen, argue that auditors can do little to disclose problems if accounts comply with GAAP. Nevertheless audit firms can, if they wish, use 'emphasis of matter' audit opinions to disclose problems even when accounts comply with GAAP. Audit opinions very rarely contain emphases of matter, so it would seem that auditors need more incentives to communicate problems to shareholders. For example, Enron used Special Purpose Entities (SPEs) to keep a large portion of its debt off balance sheet. Enron's accounts actually did not comply with GAAP since some of its SPEs should have been consolidated (they did not meet the minimum 3% outside equity requirement). However, even if Enron's accounts had complied with GAAP, its use of SPEs would still have resulted in very misleading financial statements. Auditors should be expected to disclose in their audit opinions when financial statements are materially misleading even if they comply with the letter of GAAP.

There is considerable scope for regulators to improve this situation. It would appear desirable to set up an incentive system that aligns the incentives of audit firms and audit committee members with those of investors so that audit firms and audit committees voluntarily disclose credible information. Investors need information to evaluate managerial integrity but all too often, those who are best informed (auditors and audit committee members) resign quietly or they are dismissed rather than disclose what they know. Regulators could encourage audit committee members and audit firms to go public when they uncover problems with management. A necessary condition for this would likely be statutory protection from libel laws. It might also be helpful to provide financial incentives to audit committee members and audit firms to act as whistle-blowers. Interestingly, the Chinese Government has recently proposed a financial incentive scheme that rewards audit firms who disclose evidence of fraud or accounting irregularities (if

the disclosure leads to successful prosecution). The US has recently moved in this direction with its introduction of the Corporate and Criminal Fraud Accountability Act (2002), which extends 'whistle-blower protection', special damages, and attorney's fees to auditors and company employees who disclose managerial wrong-doing.

With respect to opinion shopping, it is undesirable that companies are allowed to discuss reporting issues with potential audit firms since such discussions likely help managers to predict the type of opinion the audit firm would issue if appointed. If audit firms could be given more incentive to disclose publicly the reasons for dismissals and resignations, it would help both investors and incoming auditors to judge the integrity of management and the audit risk associated with new audit engagements.

The UK disclosure system is rather deficient compared to the US. Regulators might consider whether UK companies should be required to disclose to shareholders whether: (1) auditor changes are due to dismissal or resignations; (2) audit committees participate in, and approve of, auditor changes; and (3) why auditor changes occur. The US disclosure system is more demanding than in the UK, but even the US system appears not to be wholly effective. US companies are not required to disclose why auditors are dismissed and the evidence suggests that voluntary disclosures of reasons are not entirely candid. US companies are not required to disclose audit committee membership changes on a timely basis, and they are not required to disclose whether audit committee members leave due to dismissal or resignation. Moreover, not all companies comply with the requirement to disclose the number of audit committee meetings. In fact, the evidence suggests there is a disclosure bias, namely companies are less likely to disclose the number of audit committee meetings when audit committees are relatively inactive. Thus, it is not enough for regulators to mandate corporate disclosures; they also need to monitor companies' compliance with disclosure requirements.

The above proposals would likely improve financial reporting quality, but they do not get at the core problem – the fact that some managers do not perceive it to be in their interests to behave honestly. Recent regulatory efforts have tried to prescribe better systems of corporate governance, for example the separation of audit and non-audit services, and the mandatory formation of independent audit committees. As discussed in chapter two, there is very little evidence that accounting scandals occur because audit firms lack independence. There is also little convincing evidence that mandated audit committees significantly improve the quality of financial reporting. For example, the Blue Ribbon Committee (1999) recommends that all audit committee members be ‘independent’, but it would not be hard for an errant manager to recruit someone who appears from the proxy filing to be independent but actually is not (*eg* a close personal friend). Perhaps regulators should pay more attention to the core problem of managerial incentives. There is a strong case for considering whether senior management can be given more incentives to be honest, perhaps with the threat of long-term imprisonment.

Senior managers need to perceive a greater likelihood of being caught and stiffer penalties for dishonesty. Investors’ watchdogs (*eg* audit firms, audit committees) need more incentives to disclose managerial wrongdoing in order to increase the likelihood of successful prosecution. A culture of whistle-blowing rather than silent resignations and dismissals needs to be encouraged and cultivated. This may be more effective in preventing corporate scandals than high-profile recommendations such as banning audit firms from supplying non-audit services, or insisting that all audit committee members are nominally independent. It would seem that the considerable number of corporate governance initiatives over the last 15 years have done little to diminish the incidence of accounting scandals. A change in regulatory emphasis is needed, from forcing audit firms and audit committees to comply with mandated standards, to improving the flow

of information from audit firms and audit committees to investors. If more informative and timely disclosures carry a credible threat of prosecution and imprisonment for errant managers, they would go a long way to preventing future corporate scandals.

REFERENCES

- American Bar Association (1978), *Corporate Director's Guidebook*, Chicago, IL: ABA.
- Auditing Practices Board (1994), *The Audit Agenda*, London.
- Beasley M S (1996), 'An empirical analysis of the relation between the board of director composition and financial statement fraud', *The Accounting Review*, Vol.71, pp.443-65.
- Becker C, M DeFond, J Jiambalvo and K Subramanyam, (1998), 'The effect of audit quality on earnings management', *Contemporary Accounting Research*, Vol.15, pp.1-24.
- Blue Ribbon Committee (1999), *Report and recommendations of the Blue Ribbon committee on improving the effectiveness of corporate audit committees*, Stamford, CT.
- Braiotta L Jr, R S Hickok and J C Biegler, (1999), *The Audit Committee Handbook (3rd edition)*, Wiley Europe.
- Byrd J W and K A Hickman (1992), Do outside directors monitor managers? *Journal of Financial Economics*, Vol.19, pp.589-606.
- Cadbury Committee (1992), *Report of the committee on the financial aspects of corporate governance*, Gee, London.
- Carcello J V, D Hermanson and H Huss (2000), Going concern opinions: the effects of partner compensation plans and client size, *Auditing: A Journal of Practice and Theory*, Vol.19, pp.67-77.
- Carcello J V and T L Neal (2000), Audit committee composition and audit reporting, *The Accounting Review*, Vol.75, pp.453-67.
- Chen K C and B K Church (1996), 'Going concern opinions and the market's reaction to bankruptcy filings', *The Accounting Review*, 71, 117-128.
- Chtourou S M, J Bédard and L Courteau (2001), Corporate governance and earnings management, *Working Paper*.

- Collier P (1997), Corporate governance and audit committees, *Current issues in Auditing*, eds. Sherer M and S Turley, Paul Chapman Publishing.
- Craswell A T, D J Stokes and J Loughton (2002), Auditor independence and fee dependence, *Journal of Accounting and Economics*, Vol.33(3): forthcoming.
- Dechow P, R Sloan and A Sweeney (1996), Causes and consequences of earnings manipulation: An analysis of firms subject to enforcement actions by the SEC, *Contemporary Accounting Research*, Vol.13, pp.1-36.
- DeFond M L and J Jiambalvo (1991), Incidence and circumstances of accounting errors, *The Accounting Review*, Vol.66, pp.643-655.
- Department of Trade and Industry (1994), *Atlantic Computers Plc/Atlantic Computer Systems: Investigation under S432(2) of The Companies Act*, London.
- Firth M (1980), A note on the impact of audit qualifications on lending and credit decisions, *Journal of Banking and Finance*, Vol.4, pp.257-67.
- Fleak S K and E R Wilson (1994), The incremental information content of the going concern audit opinion, *Journal of Accounting, Auditing and Finance*, Vol.9, pp.149-66.
- Hendrickson H and R Espahbodi, (1991), Second opinion, opinion shopping and independence, *The CPA Journal*, Vol.61, pp.26-29.
- Ireland J and C Lennox (2002), The large audit firm fee premium: A case of selectivity bias? *Journal of Accounting, Auditing and Finance*, Vol.17, pp.73-91.
- Kalbers L P (1992), An examination of the relationship between audit committees and external Auditors, *The Ohio CPA Journal*, (December), pp.19-27.
- Klein A (1998), Economic determinants of audit committee composition and activity, *Working paper*.

- Klein A (2000a). Causes and consequences of variations in audit committee composition, *Working paper*.
- Klein A (2000b). Audit committee, board of director characteristics, and earnings management. *Working Paper*.
- Krishnan J (1994), Auditor switching and conservatism, *The Accounting Review*, Vol.69, pp.200-15.
- Lennox C (1999), Non-audit Fees, disclosure and audit quality, *The European Accounting Review*, Vol.8(2), pp.239-252.
- Lennox C (2000), Do companies successfully engage in opinion shopping: Evidence from the UK? *Journal of Accounting and Economics*, Vol.29, pp.321-37.
- Lennox C (2002), Opinion shopping and audit committees, *Working paper*.
- Louwers T (1998), The relation between going concern opinions and the auditor's loss function, *Journal of Accounting Research*, Vol.36, pp.143-156.
- Macdonald Commission (1988), *Report of the Commission to study the public's expectations of audits*, Canadian Institute of Chartered Accountants, Toronto.
- Menon K and J Williams (1994), The use of audit committees for monitoring, *Journal of Accounting and Public Policy*, Vol.13, pp.121-39.
- Securities and Exchange Commission (1995), *SEC Guidelines: Rules and Regulations*, Warren, Gorham and Lamont.
- Securities and Exchange Commission (1988), *Disclosure Amendments to Regulation S-K, Form 8-K and Schedule 14A regarding changes in accountants and potential opinion shopping situations*, SEC Financial Reporting Release No.31, Washington, D.C.
- Teoh S H and T J Wong (1993), Perceived auditor quality and the earnings response coefficient, *The Accounting Review*, Vol.68, pp.346-66.

- Treadway Commission (1987), *Report of the National Commission on Fraudulent Financial Reporting*, New York.
- Watts R L and J L Zimmerman (1983), Agency problems, auditing, and the theory of the firm: Some evidence, *The Journal of Law and Economics*, Vol.26, pp.613-633.
- Willenborg M (1999), Empirical analysis of the economic demand for auditing in the Initial Public Offerings Market, *Journal of Accounting Research*, Vol.37(1), pp.225-238.
- Wild J J (1994), The audit committee and earnings quality, *Journal of Accounting, Auditing and Finance*, Vol.9, pp.247-276.