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Do Audit Firms' Tarnished Reputations Influence Audit Firm Changes?

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Introduction

- According to Jensen and Meckling (1976)’s agency theory, an audit is an agent cost that helps reduce information asymmetry between an agent and a principal (Luypaert and Van Caneghem 2014).

- Theoretically, an audit can be viewed as an economic goods or a professional service process (Knechel et al. 2020).

Introduction

Economic goods viewpoint	Professional services viewpoint
An audit is similar to manufactured goods with a homogeneous outcome, and its quality is perceived to entrench in the brand value (Knechel et al. 2020).	An audit is an intangible product whose quality is rarely assessed by customers (Firth 1993). An audit service can be explained by three attributes: 1. credence good, 2. search good and 3. experience good (Causholli and Knechel 2012).

Introduction

Audit firms’ brand value or reputation is a prominent feature in explaining the audit service market. Mass media strongly impacts the market’s perception of an audit firm’s reputation (Cowle et al. 2021).

This study contributes evidence to the literature which challenges the two views of an audit as an economic good and a professional service. It explores the association between audit firm reputation and audit firm change.

Introduction

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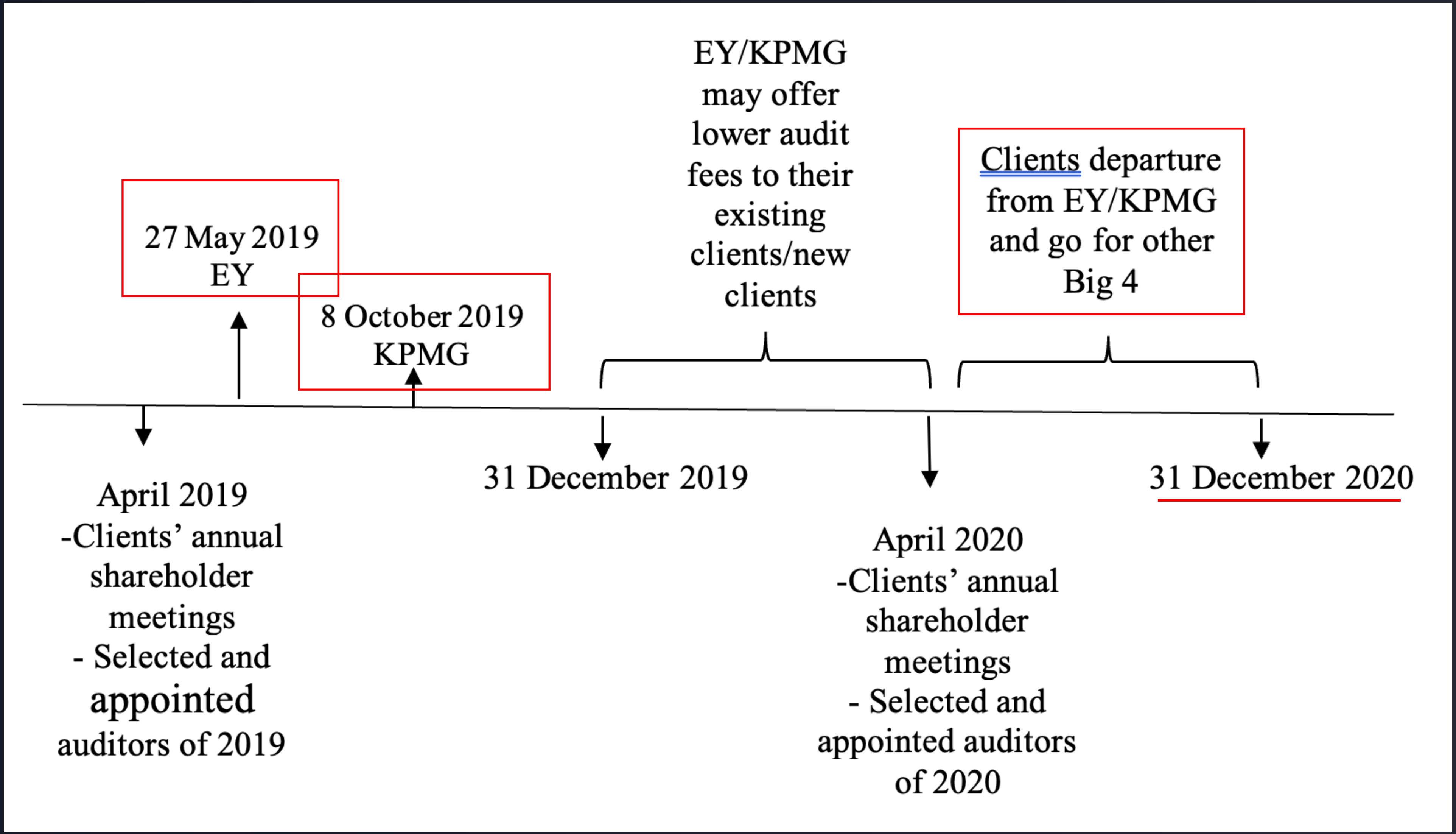
Our evidence is of interest as it comes from a setting with a quite limited number of approved audit firms. In Thailand, as of December 2020, there were 29 approved audit firms to serve 743 listed companies (SEC, 2021a).

Compared to the United States and Germany, Thailand's audit market is more oligopoly. There are 1,707 (PCAOB, 2022) and 156 (Beroe, 2022) registered audit firms to serve 5,248 and 446 listed firms (Sustainable Stock Exchanges Initiative, 2022) in the United States and Germany, respectively.

The ratio of listed companies to registered audit firms is 25.6 for Thailand, which is much lower for the United States and Germany (3.1 and 2.9, respectively).


27 May 2019
EY
8 October 2019
KPMG
EY/KPMG may offer lower audit fees to their existing clients/new clients
Clients departure from EY/KPMG and go for other Big 4
April 2019
-Clients' annual shareholder meetings
- Selected and appointed auditors of 2019
31 December 2019
April 2020
-Clients' annual shareholder meetings
- Selected and appointed auditors of 2020
31 December 2020

Literature review- Audit firm change

Audit firm change occurs when a client dismisses its current audit firm or when its current audit firm does not want to continue the audit engagement (Blouin et al., 2007).

A client dismisses its current audit firm because of the following reasons:

- A bad relationship between a client and an auditor (Almer et al., 2014; Magri & Baldacchino, 2004)
- Opinion shopping (Davidson III et al., 2006; Gómez-Aguilar & Ruiz-Barbadillo, 2003; Hudaib & Cooke, 2005; Lennox, 2000)
- Errors in financial statements (Brocard et al., 2018)
- Financial restatements (Hennes et al., 2014)

Literature review- Audit firm change

Auditor resignations are caused by:

- the insufficient audit fees (Griffin & Lont, 2010)
- increased audit risk, business risk and litigation risk (Ghosh & Tang, 2015)
- the mismatch between an audit firm's and client's characteristics (e.g. client's additional demand for non-audit service) (Shu, 2000)
- the disagreement between a client and an auditor over accounting practices or internal control issues (Beneish et al., 2005)
- auditors' lack of industry expertise (Cenker & Nagy, 2008)
- clients' financial restatements regarding fraud or changing from reporting profit to reporting loss (Y. Huang & Scholz, 2012)

Literature review- Audit firm change

Pros: Improve auditor independence (Imhoff, 2003) and the quality of financial reporting (Blouin et al., 2007).

Cons:

- For clients: Increases transaction or changing costs (e.g. costs of processing new audit selection and costs arising from working with new audit firms) (Chu et al., 2018) and the risk of audit failure in the new audit firm’s first-year audit (Blouin et al., 2007).
- For audit firms: Start-up costs (Craswell, 1988) e.g., learning clients’ internal control and operations (Bleibtreu & Stefani, 2018) and performing a review of previous audit firms’ works (Kealey et al., 2007). These costs are higher, especially when there are a few large audit firms that can supply audits for them (Chu et al., 2018).

Literature review- Audit firm reputation and audit firm change

- From the United States regarding Enron’s accounting scandal and the demise of its audit firm, ‘Andersen’, Barton (2005) found that clients who were more attracted to investors’ attention moved from Andersen sooner to other Big 5 at that time.

- Chen and Zhou (2007) reported that existing clients left Andersen for other audit firms, and most of them chose the Big 4.

- Both Chen and Zhou (2007) and Asthana et al. (2010) found that existing clients with excellent corporate governance measured by CEO and board member characteristics left Andersen earlier. Andersen used both terms of ‘Big 5’ and ‘Big 4’ in their studies.

Literature review- Audit firm reputation and audit firm change

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There is also evidence from Germany (Weber et al., 2008) and Japan (Skinner & Srinivasan, 2012), where auditors had lower litigation risk than those in the United States.

Weber et al. (2008) observed the event in the period surrounding the case of ComROAD/KPMG in Germany. They reported that some of KPMG's clients left for other audit firms in the year when ComROAD's accounting scandal was uncovered.

Skinner and Srinivasan (2012) observed the events between 2004 and 2006 surrounding the revelation of Kabebo's accounting scandal and the failure of its audit firm 'ChuoAoyama', which was PwC's Japanese affiliation. They found that ChuoAoyama's existing clients moved to new audit firms after ChuoAoyama's defective audit was revealed.

Hypotheses

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H1: EY's existing clients are more likely to leave EY in 2020.

H2: KPMG's existing clients are more likely to leave KPMG in 2020.

H3: EY's existing clients are more likely to leave EY for other Big 4 companies in 2020.

H4: KPMG's existing clients are more likely to leave KPMG for other Big 4 companies in 2020.

Data collection and analysis

- Our sample covers the period from 2016 to 2020 of 584 Thai non-financial listed companies.

Sample and data collection

	Companies	Firm-year observations
Number of listed companies	841	
Less: Companies under rehabilitation	(3)	
Less: Companies in finance industry	(77)	
Less: Companies with insufficient data	(169)	
	592	**2,960**
Less: Observations with insufficient data		(432)
Less: Outliers as we winsorized all continuous variables at 1% and 99%	(8)	(358)
Total Sample	**584**	**2,170**

Model specification: A logistic regression model

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$$AFC_{it} = \alpha_i + \beta_1(BIG4_{it-1}) + \beta_2(EY_{it-1}) + \beta_2(KPMG_{it-1}) + \beta_4(RFEE_{it}) + \beta_5(Y2020) + \beta_6(BIG4_{it-1} * Y2020) + \overset{H1}{\boxed{\beta_7(EY_{it-1} * Y2020)}} + \overset{H2}{\boxed{\beta_8(KPMG_{it-1} *}} Y2020) + \beta_9(RFEE_{it} * Y2020) + \beta_{10}(BIG4_{it-1} * RFEE_{it}) + \beta_{11}(EY_{it-1} * RFEE_{it}) + \beta_{12}(KPMG_{it-1} * RFEE_{it}) + \beta_{13}(BIG4_{it-1} * Y2020 * RFEE_{it}) + \beta_{14}(EY_{it-1} * Y2020 * RFEE_{it}) + \beta_{15}(KPMG_{it-1} * Y2020 * RFEE_{it}) + Control\ Variables + \varepsilon_{it}. \quad (1)$$

Model specification : A logistic regression model

$$
BIG4_{it} = \text{å}_i + \text{À}_1(BIG4_{it-1}) + \text{À}_2(EY_{it-1}) + \text{À}_3(KPMG_{it-1}) + \text{À}_4(RFEE_{it}) + \text{À}_5(Y2020) + \text{À}_6(BIG4_{it-1} * Y2020) + \overset{H3}{\boxed{\text{À}_7(EY_{it-1} * Y2020)}} + \overset{H4}{\boxed{\text{À}_8(KPMG_{it-1} *}} Y2020) + \text{À}_9(RFEE_{it} * Y2020) + \text{À}_{10}(BIG4_{it-1} * RFEE_{it}) + \text{À}_{11}(EY_{it-1} * RFEE_{it}) + \text{À}_{12}(KPMG_{it-1} * RFEE_{it}) + \text{À}_{13}(BIG4_{it-1} * Y2020 * RFEE_{it}) + \text{À}_{14}(EY_{it-1} * Y2020 * RFEE_{it}) + \text{À}_{15}(KPMG_{it-1} * Y2020 * RFEE_{it}) + Control\ Variables + \varepsilon_{it}. \quad (2)
$$

Results : Sample distribution

Panel D: Sample distribution by market and audit firm type

	SET		MAI		Total	
	Freq.	Percent	Freq.	Percent	Freq.	Percent
Non-Big 4	604	35%	262	56%	866	40%
Big 4	1,101	65%	203	44%	1,304	60%
Total	1,705	100%	465	100%	2,170	100%

Results : Sample distribution

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Panel C: Sample distribution by characteristics of audit firm change

Audit firm	2016			2017			2018			2019			2020			Total		
	Total	Win	Loss	Total	Win	Loss	Total	Win	Loss	Total	Win	Loss	Total	Win	Loss	Total	Win	Loss
Non-Big 4	148	8	24	164	13	12	163	20	15	167	17	22	224	23	22	866	81	95
Big 4:																		
EY	114	8	2	127	4	2	129	7	12	130	5	10	157	8	12	657	32	38
KPMG	47	3	1	51	2	1	57	3	3	56	5	1	79	10	1	290	23	7
PwC & DT	60	12	4	63	2	6	72	8	8	76	9	3	86	5	11	357	36	32
	221	23	7	241	8	9	258	18	23	262	19	14	322	23	24	1304	91	77
	369	31	31	405	21	21	421	38	38	429	36	36	546	46	46	2170	172	172

Results : A logistic regression model

H1: No evidence that EY's existing clients were more likely to leave EY in 2020.

H2: No evidence that KPMG's existing clients were more likely to leave KPMG in 2020.

H3: No evidence that EY's existing clients are more likely to leave EY for other Big 4 companies in 2020.

H4: No evidence that KPMG's existing clients are more likely to leave KPMG for other Big 4 companies in 2020.

Results : A logistic regression model 1

The coefficient of $RFEE_{it}$ (β_4= 0.354, P < 0.05) is statistically significant with a positive sign. This indicates that clients generally pay higher audit fees when they change their audit firms.

The coefficient of $LNASSETS_{it}$ (β_{21}= -0.217, P < 0.05) is statistically significant with a negative sign. This affirms that large clients are less likely to change their audit firms.

Results : A logistic regression model 2

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The coefficient of $RFEE_{it}$ ($\grave{A}_4$= 0.668, P < 0.05), the coefficient of interaction between $RFEE_{it}$ and the coefficient of $Y2020$ ($\grave{A}_9$= 1.790, P < 0.10) and $AUFINDEXP_{it}$ ($\grave{A}_{20}$= 2.490, P < 0.01) are statistically significant with a positive sign. In contrast, the coefficient of interactions among $BIG4_{it-1}$, $Y2020$ and $RFEE_{it}$ ($\grave{A}_{13}$= -5.438, P < 0.01) is statistically significant with a negative sign.

It is evident that when clients move to the Big 4, they pay higher audit fees, especially in 2020. Clients are more likely to select one of the Big 4 firms with specific industry expertise. Some existing clients of the Big 4 are more likely to move to the non-Big 4 in 2020 and still pay higher audit fees.

Discussion and Implication

- After the defective audits of EY and KPMG in Thailand found by the SEC were spotlighted by the mass media in 2019, there is no evidence that EY’s and KPMG’s existing clients were more likely to leave these two Big 4 firms in 2020.

- Clients might initially view an audit as an economic goods. However, with time, they view it as a professional service. The experience good attribute of an audit dominates other attributes and even audit firm reputation, as clients are concerned more with the quality of service than audit firm reputation and audit fees.

Discussion and Implication

- With limited choices of registered audit firms, audit firm change is less likely to occur. This might be because of clients’ concerns that audit firm change creates transactions or switching costs for them.

- In addition, both EY and KPMG promptly responded to their defective audits. EY improved its quality control system and client confidentiality protection system (SEC, 2019a), whilst KPMG conducted a root cause analysis and submitted its remediation plan to the Thailand SEC (SEC, 2019b). This would have helped them to quickly regain their reputation, win new clients and maintain existing clients.

Discussion and Implication

Our evidence supports Pratoomsuwan (2017)'s finding that the Big 4 has great market power in Thailand. However, we add to evidence that each Big 4 somewhat differentiates itself from each other to attract clients' specific needs (Keune et al., 2016), especially by possessing specific industry expertise (Chin & Chi, 2009; Krishnan, 2003). With specific industry expertise, the Big 4 can earn high audit fee premiums (Carson & Fargher, 2007).

Discussion and Implication

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- Our evidence cautions regulators to pay attention to whether a limited number of approved audit firms leads to market concentration, which might result in clients unnecessary paying higher audit fees.

- Standardised audit fees and joint audits might be interesting mechanisms to mitigate market concentration; however, further evidence is required to verify this.

Thank you