The Effects of Auditor Changes on Shareholder Voting Patterns

Ankita Singhvi PhD
Visiting Assistant Professor of Accounting
College of Business Administration, Texas A&M University - Central Texas
1001 Leadership Place, Killeen, TX 76549, USA
Email: a.singhvi@tamuct.edu

ABSTRACT

This study examines the association between shareholders' vote on the selection of an external auditor and the choice of auditor industry specialists. For a sample of publicly listed U.S. firms for years 2005-2011, I explore whether the types of switches i.e. specialist (from one specialist to another), nonspecialist lateral (from one non-specialist to another), downward (industry specialist to a non-industry specialist) and upward (non-industry specialist to an industry specialist) affects shareholder vote on the ratification of incumbent auditor. The findings show that shareholder vote differs significantly across these categories of switches. Lateral switches among specialist auditors elicit the most dissatisfaction among investors. Both upward and downward switches are less likely to be rejected by the shareholders. This brings to light an important aspect of the perceived audit quality differences between industry specialist auditors.

Keywords: shareholder ratification, auditor industry specialization, auditor switches

INTRODUCTION

The purpose of this study is to examine whether shareholding voting patterns are associated with the categories of auditor changes. This study is motivated in part by the report of the Advisory Committee on the Auditing Profession (ACAP), established by the U.S. Department of the Treasury, which notes that:

> Although not statutorily required, the majority of public companies in the United States-nearly 95 percent of S&P 500 and 70 percent to 80 percent of smaller companies put auditor ratification to an annual shareholder vote. Even though ratification of a company's auditor is non-binding, the committee learned that corporate governance experts consider this is a best practice serving as a "check" on the audit committee (ACAP 2008).

In addition, the Securities and Exchange Commission (SEC) issued a final rule (SEC 2009) requiring companies to disclose the results of the shareholder vote in Form 8-K within four days of the annual meeting. This ruling requires companies to report, among other things, the role of the board in risk oversight, the backgrounds of directors and nominees, and stock and option awards, to "enhance the information provided to shareholders so they are better able to evaluate the leadership of public companies."

In the presence of an information asymmetry between managers and shareholders, auditing serves as a good monitoring mechanism for shareholders to assess the

financial health of the firm. Employing high quality auditors is assumed to provide more credible information to investors (Dopuch and Simunic 1980; Kim, Chung, and Firth 2003). Considering that auditor choice imparts a signal of credibility, firms may be unwilling to change auditors owing to the costs associated with employing a new auditor (Abbott, Parker, Peters, and Rama 2007), investor perceptions of undisclosed problems with financial reporting (Turner, Williams, and Weirich 2005) and the possibility of an unfavorable market reaction pursuant to an auditor change (Teoh 1992; Lu 2006; Knechel, Naiker, and Pacheco 2007). Therefore, to the extent that an external auditor mitigates agency conflicts, investors may expect the firm to employ quality auditors who can attest to the financial reporting quality. Since larger audit firms have "deeper pockets", they are deemed to be a better form of investment protection than small or medium size audit firms. Sainty, Taylor, and Williams (2002, 114) elaborate on investor perception of audit quality:

> While audit quality and insurance protection are not directly observable by investors, one can argue that investors develop observable proxies such as audit firm size, audit firm's market share in the client industry and firm reputation as a measure of audit quality and insurance.

Auditor industry expertise is associated with positive firm attributes such as better earnings quality (Krishnan, Li, and Wang 2013), lower abnormal accruals (Balsam, Krishnan, and Yang 2003), lower incidences of fraud (Carcello and Nagy 2004), and fewer restatements (Dao, Raghunandan, and Rama 2012). I examine auditor industry expertise using the market-share approach (Francis, Reichelt, and Wang 2005; Huang, Liu, Raghunandan, and Rama 2007; Cenker and Nagy 2008) by calculating proportion of total sales audited in the given industry-year. For an audit firm to be designated as a specialist, it must have the largest market share or at least 1/3 of the client sales or 33 percent of the market share.[1]

In light of investor perception of audit quality, negative consequences of changing auditors and seeking shareholder approval of the incumbent auditor, this study aims to examine the association between auditor switches and the shareholder vote on the incoming auditor. Specifically, I examine shareholder voting patterns pursuant to the four categories of auditor switch decisions: (1) nonspecialist auditor to a specialist auditor (hereafter, upward switch) (2) specialist to a nonspecialist auditor (hereafter downward switch) and (3) specialist to specialist auditor (hereafter lateral nonspecialist switch) and (4) nonspecialist to nonspecialist auditor (hereafter lateral specialist switch). Using a sample of firms that made auditor changes during 2005 to 2011, I find evidence that shareholder voting patterns differ significantly between these categories of switches. Consistent with the findings of Knechel et al. (2017), results show that

---

[1] The cut off is determined by the fact that are 4 dominant audit firms, also called the Big 4, and therefore a specialist in an industry can be the firm that audits at least 1/3 = 33 percent of the client assets in that industry-year combination. This measure is most commonly used in prior studies (Krishnan 2003; Knechel et al. 2007; Huang et al. 2007; Gul, Fung, and Jaggi 2009).

shareholders are less likely to reject upward switches as they may view these as an opportunity to seek significantly better quality audit. There is a similar reaction when there is a downgrade from a specialist to a non-specialist auditor. Firms that experience a change that involves only non-specialist auditors also experience lesser shareholder dissatisfaction compared to those lateral switches in specialist auditors. Collectively, these findings suggest that investors perceive a switch from one specialist to another non-beneficial to the firm.

This study is motivated by several factors. Firstly, there is growing regulatory interest in shareholder voting and related disclosures (SEC 2009, 2010, 2011). Secondly, this study aims to extend the shareholder voting literature by providing insights into the effects of auditor change on shareholder voting patterns. Thirdly, although there is exhaustive literature on auditor selection, there is no evidence of shareholder voting patterns on auditor selection.

The remainder of the study is organized as follows; the next section presents a discussion of prior literature related to shareholder ratification and auditor changes followed by development of the hypothesis. Lastly, I present a description of the sample selection, results, and conclusion.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT
Auditor Industry Specialization
Audit firms market themselves as industry specialists offering domain expertise through years of accumulating a unique knowledge-base and providing specialized training. KPMG, one of the Big Four audit firms were the first to align their audit practices according to the industry classifications of their clients. They put forth the following on their website:

> This industry focused approach helps us provide an informed perspective on the industry issues and complex market challenges our clients face. What's more, it helps enable us to identify and respond to key business and performance issues and provide the Audit, Tax, and Advisory services that take into account their unique industry-specific processes, risks, and accounting and reporting practices.

Extant academic research in this area support the industry oriented growth strategy. The development of technology, training and knowledge base creates a potential for higher quality audits (Simunic and Stein 1996). Furthermore, several studies attest to higher quality audits provided by industry specialists (Craswell, Francis, and Taylor 1995; Francis, Maydew, and Sparks 1999; Defond, Francis, and Wong 2000; Beasley and Petroni 2001). Industry experts are further shown to be associated with: 1) providing better risk assessments (Low 2004), 2) lower incidence of financial fraud (Carcello and Nagy 2004), 3) lower discretionary accruals and higher earnings response coefficients (Balsam et al. 2003), 4) positive market reactions (Knechel et al. 2007), 5) higher earnings quality such as accurate analyst earnings forecasts (Behn, Choi, and Kang 2008), 6) lower earnings management (Zhou and Elder 2002; Krishnan 2003), 7)

greater likelihood of reporting internal control weaknesses (Rose-Green, Huang, and Lee 2011), 8) lower abnormal accruals (Balsam et al. 2003), 9) lower incidences of fraud (Carcello and Nagy 2004), and 10) fewer restatements (Dao et al. 2012).

Shareholder Voting
Voting on ratification of an incumbent auditor is one of ways for shareholders to express their assessments of current auditors and indicate their expectations on audit quality (Sainty et al. 2002). Shareholders may express dissatisfaction when a firm hires an auditor with lesser industry expertise and lesser brand name than the outgoing auditor. Hence, investors are less inclined to ratify the selection of an auditor who is unfamiliar in name, reputation, and resources. Given that seeking ratification is voluntary, when firms anticipate that shareholders would be dissatisfied with management, they may be less likely to put their selection of the auditor for shareholder vote. Krishnan and Ye (2005) present evidence to support this view by examining a sample of Standard & Poor's (S&P) firms for year 2001. They posit and find that Arthur Andersen clients were less likely to seek ratification of the auditor.

Prior research documents the consequences of seeking ratification of an external auditor. For example, Mayhew and Pike (2004), in an experimental setting, find that investors' involvement in selection of the auditor leads to greater independence. Dao et al. (2012) corroborate the findings from Mayhew and Pike (2004) by using archival data to posit and find that firms seeking ratification pay nine percent higher audit fees and have better quality audits than those that do not seek ratification.

Auditor Changes
Studies that examine investor dissatisfaction pursuant to auditor changes have primarily explored two perspectives: 1) shareholder voting on management proposals and, 2) stock market reactions. For instance, using a sample of 1997 fiscal year end audits, Sainty et al. (2002) show that shareholders disapprove of an auditor pursuant to an auditor change. They also find a negative correlation between votes against ratification and 1) hiring an auditor with lesser industry expertise and, 2) the issuance of going concern opinions. In an examination of shareholder voting patterns, Raghunandan (2003) examines 172 of the *Fortune* 1,000 companies and provides evidence that in the presence of high non-audit to audit fee ratios, a large proportion of shareholders vote against auditor ratification. Raghunandan and Rama (2003) further document shareholder dissatisfaction in firms with high non-audit fee to audit fee ratios with solely independent directors on the audit committees. This clearly suggests that investors are observant of auditor independence and consider audit committee effectiveness (presence of independent directors on the audit committee) as a substitute corporate governance mechanism.

Another group of studies concentrate on stock market reaction surrounding auditor switches, examining cumulative abnormal returns for the days surrounding the switch. Knechel et al. (2007) report that capital market participants react more favorably when a firm switches from a non-specialist to a specialist auditor versus a switch from a Big 4 to

a nonspecialist auditor. Moreover, they show that market reacts even more negatively when firms switch from a specialist Big 4 firm to a nonspecialist non-Big4 firm. Other studies examine stock market reactions to firms switching from Arthur Andersen (Asthana, Balsam, and Kim 2009) or Laventhol & Horwarth (Menon and Williams 1994) and these studies document that the market reacts positively pursuant to switch from a firm perceived to be lower quality to that of one perceived to be of high quality.

Extending the work of Knechel et al. (2007), I analyze whether investor dissatisfaction with auditor switches is reflected in auditor ratification voting outcomes. Therefore, this study focuses on investor perceptions of satisfaction with changes in firms' external auditor, assessed through shareholder voting patterns. Although there is voluminous literature showing that specialist auditors are quality differentiated from nonspecialists, a recent study by Minutti-Meza (2013) questions prior findings. Using discretionary accruals, discretionary revenue and propensity to issue going concern reports as proxies for audit quality, he finds no difference in audit quality of clients of nonspecialist versus specialist auditors. For a sample of firms that switched auditors after the demise of Arthur Andersen in 2002, he finds no evidence of better audit quality as a result of switching to industry expert auditors. His findings pertain to specialists recognized using the market share based measures of specialization, however, experimental evidence shows that there is value in attaining specialization (Owhoso, Messier, and Lynch 2002). However, this study is not about actual audit quality differences between specialist and nonspecialist auditors rather it is about the investor perception of audit quality. In the U.S., investors cannot observe the individual auditor in any event. In addition, Lawrence, Minutti-Meza, and Zhang (2011) propose that Big 4 and non-Big 4 auditors provide comparable audit quality to clients because both must adhere to the same regulatory and professional standards. Further, non-big4 auditors know much more about local markets and could keep effective relationships with their clients which make them detect irregularities (Louis 2005).

Although prior research on shareholder ratification is sparse, it is considered important as it "enhances competition in the audit industry" (ACAP, U.S. Department of the Treasury 2008) and "can also be viewed as aligning the auditor's incentives more with the shareholders than in cases where the audit committee or management makes the auditor hiring decision without shareholder approval" (Dao et al. 2012, 168).

In light of the conflicting evidence related to audit quality surrounding specialists and given the paucity of evidence of shareholder voting regarding switches quality differentiated auditors; I test the following non-directional hypothesis (stated in the null form):
> *H1: The proportion of shareholders voting against, or abstaining from, auditor ratification is not associated with type of switches*

Empirical Model
I examine the association between types of auditor change and the shareholder voting on ratification of the external auditor using the following regression model:

$$Reject = \beta_0 + +\beta_1 * SNS + \beta_2 * NSS + \beta_2 * NSNS + \beta_3 * ROA + \beta_4 * DirVote + \beta_5 * CEOCHR + \beta_6 * InOwn + \beta_7 * ACFE + \beta_8 * Loss + \beta_9 * NASRatio + \beta_{10} * ICW + \beta_{11} * Restate + \beta_{12} * Resign + error \quad (1)$$

The variables are defined as follows:
Dependent Variable:

Reject[2] = number of votes against or abstaining from auditor ratification;
Independent Variables:
SNS = 1 if the firm switches to a non-specialist auditor, 0 otherwise;
NSS = 1 if the firm switched to a specialist auditor, 0 otherwise;
NSNS = 1 if the firm switches from a non-specialist to another non-specialist auditor, 0 otherwise;
SS =1 if the firm switches from a specialist to another specialist auditor and, 0 otherwise.
Control Variables:
LogAT = natural logarithm of the total assets of the firm prior to the switch;
ROA = return on assets prior to the switch (net income divided by total assets);
DirVote = minimum percent of votes against the election of a director;
Return = one-year common stock return prior to the switch;
CEOCHR = 1 if the CEO also serves as the chairman of the Board, 0 otherwise;
InOwn = proportion of shares owned by officers and directors;
NASRatio = ratio of non-audit fees to audit fees;
ACFE = proportion of financial experts on the audit committee;
Lev = ratio of total debt to total assets in the year prior to the switch;
Loss = 1 if the firm had a loss in the year prior to the switch, 0 otherwise;
ICW = 1 if the firm reported a material weakness in the internal controls in the year prior to the switch, 0 otherwise;
Restate = 1 if the firm restated their financial statements in the prior year, 0 otherwise;
Resign = 1 if the predecessor auditor resigned from the engagement, 0 otherwise.

In the regression model, *Reject* is the dependent variable and is measured as the percentage of votes against and abstaining from the selection of the auditor (Dao, Mishra, and Raghunandan 2008; Hermanson, Krishman, and Ye 2009). [3]
Consistent with prior research, I use the market share approach to identify specialists in an industry-year combination (Francis et al. 2005; Huang et al. 2007; Cenker and Nagy 2008). First, the auditor industry market share is calculated as a proportion of industry specific sales audited to the total sales of clients in a two-digit SIC code in a given year.

---

[2] Consistent with prior research (Barua et al. 2017; Dao et al. 2012; Dao et al. 2008; Sainty et al. 2002) I calculate REJECT = (Votes against +Votes abstain)/ (Votes for + Votes against + Votes abstain).

[3] I perform additional analyses with alternate measures of the dependent variable, calculating a ratio as: [votes against/ (votes for + against)]. I find that the results are qualitatively the same.

The auditor with the largest market share or 33 percent of the market share is designated as an industry expert.

SNS, NSS, NSNS and SS are indicator variables indicating the category of switch the observation belongs to. As per H1, I do not make any predictions for these variables.

LogAT is measured as the natural logarithm of total assets. Following the findings of Krishnan and Ye (2005), I expect the coefficient of *LogAT* to be positive since larger firms may be more likely to be the target of investor dissatisfaction. I obtain this information from North American Compustat.

ROA is a measure of the financial condition of the company. Larger *ROA*s signify better performance—therefore, I expect this to have a negative impact on shareholder rejecting the selection of an auditor.

Consistent with Dao et al. (2008), I gathered information on the *DirVote* from the proxy filings by calculating the minimum percent of votes against the election of a director in the year. I expect this coefficient to be positive and significant (Raghunandan 2003; Dao et al. 2008). The other control variables in the regression are *CEOCHR* and *InOwn*. *CEOCHR* is a measure of CEO duality. When the same individual is both the Chairman of the Board and the CEO, investors may be concerned about lack of independence (Raghunandan 2003). Therefore, shareholders may even be more interested in voting favorably pursuant to a switch to a high quality auditor. This variable takes the value of one if the CEO is also the Chair of the Board of Directors, zero otherwise. Consistent with prior studies (Dao et al. 2008; Dao et al. 2012), I expect the coefficient of *CEOCHR* to be positive. *InOwn* is measured as the proportion of common stock held by officers and directors. Evidence from prior research (Raghnandan 2003; Mishra, Raghunandan, and Rama 2005; Krishnan and Ye 2005; Dao et al. 2008) suggests that when insiders are owners of a corporation, shareholders may be less inclined to vote against management proposals. Therefore, I expect this variable to be negative. I hand collected *CEOCHR* and *InOwn* from the proxy filings available on SEC website.

I define *NASRatio* as the ratio of non-audit to audit fees (Raghunandan 2003; Mishra et al. 2005; Dao et al. 2008). Higher non-audit to audit fee ratios may imply lack of independence and therefore I expect the coefficient to be positive. This data is available from Audit Analytics.

I measure *ACFE* as the proportion of audit committee directors who are accounting or auditing experts. Krishnan and Ye (2005) found that audit committees with a higher proportion of experts seek ratification and therefore, it is more likely that shareholders ratify the selection of the auditor in the presence of an audit committee that consists of experts. Therefore, I expect the coefficient of *ACFE* to be negative.

Loss is an indicator variable taking the value of one if the firm incurred a loss in the year prior to the switch, zero otherwise. Firms that incurred loss in the prior year may be the

target of investor dissatisfaction. Therefore, I expect the coefficient to be positive. This is available from data in North American Compustat.

Lastly, I include indicator variables, *ICW*, *RESTATE and RESIGN. ICW* takes the value of one if a company received an adverse opinion on the effectiveness of internal control (indicating the existence of material weaknesses), and zero otherwise (Ye, Hermanson, and Krishnan 2013). *RESTATE* is a dichotomous measure taking the value of one if from the firm restated their financial statements in the year prior to the switch, zero otherwise. *RESIGN* denotes resignation by the auditor. This data is available from Audit Analytics.

SAMPLE, DATA AND DESCRIPTIVE STATISTICS

My initial sample includes all firms that switched their auditors per the Audit Analytics database for the years 2005 to 2011. My main objective is to measure whether changes between specialist auditors affect the shareholder voting outcomes. Therefore, I measure the specialization variables and the control variables in the year immediately prior to the switch. I hand collect information on 1) audit committee financial expertise, 2) whether CEO is also the chairman of the board, 3) percentage of shares owned by the directors of the company from the DEF 14A, Lexis Nexis, and other SEC filings. I then hand collected the voting details of those firms who sought ratification of the external auditor and provided results of the voting from 10-Q, 10-K, and 8-K filings. I obtain the following information from the filings: 1) votes cast for, against, abstaining from auditor selection; 2) minimum votes cast against the election of a director; and 3) maximum votes cast against the election of a director. Finally, I obtain data for the control variables from *Compustat and Audit Analytics*.

There are four dyads of auditor changes in my sample: 1) Upward switch: Specialist Auditor to a nonspecialist auditor (S->NS), 2) Downward switch: Nonspecialist to a specialist auditor (NS->S), and 3) Lateral specialist switch: specialist to specialist auditor (S->S), and 4) Lateral nonspecialist switch: nonspecialist to nonspecialist auditor (NS->NS). While it is possible to combine lateral switches, I am interested in the differences between the different levels of switches[4]. I start by collecting information for all S->NS and NS->S observations. I am able to obtain relevant voting, audit committee characteristics, ownership by insiders, minimum votes against a director, duality of CEO and chairman of the board role for 51 NS->S switches. I then match these firm years by industry, fiscal year and total assets to create a matched sample of NS->NS firms. Shareholder voting data was available for 50 observations. My final sample consists of 85 downward switchers (S->NS), 51 upward switchers (NS->S), 40 lateral specialist switchers (S->S) and 50 lateral nonspecialist switchers (NS->NS) for a total of 226 firm years. This sample size is smaller yet comparable to Knechel et al. (2007) who obtain a sample of 318 switches. There are a total of 36 industries represented by the observations in my sample. Table 1 presents the industry distribution analysis.

---

[4] Knechel et al. (2007) use an approach to combine switches in one category when observing market reactions to auditor switches categorizing them as upward, lateral and other.

Chemical and Allied products (16.37 percent), Instruments (11.06 percent) and Business Services (11.06 percent) are the most represented industries in the sample.

Table 1
Industry Composition

Industry	2-DIGIT SIC	%
Amusements, Recreations	79	2.21
Apparel	56	1.77
Auto Dealers, Gas Stations	55	0.88
Business Services	73	11.06
Chemicals & Allied Products	28	16.37
Coal	12	0.88
Communications	48	5.31
Eat & Drink	58	0.88
Educational Services	82	0.44
Electric, Gas, Sanitary Serv	49	4.42
Elec & Other	36	10.62
Engagement & Management	87	10.62
Fabr Metalt	34	0.44
Food	20	1.33
Food Store	54	0.44
Furniture	57	0.44
General Building Contractors	15	0.44
Heavy Construction	16	0.44
Health Services	80	0.88
Ind-Machin	35	4.42
Instruments	38	11.06
Legal Services	81	0.44
Metal Mining	10	0.44
Misc Manufacturing Ind	39	0.44
Misc Retail	59	3.54
Oil & Gas Extraction	13	4.42
Paper & Allied Products	26	0.44
Petroleum and Coal Products	29	1.33
Primary Metal Industries	33	0.88
Printing, Publishing & Allied	27	3.10
Social	83	0.44
Special Trade Contractors	17	0.44
Trucking and Warehousing	42	0.44
Transportation	37	1.77
Water Transportation	44	0.44
Wholetrade	51	3.54

RESULTS

Table 2 presents the descriptive data about the variables used in this study.

Table 2
Sample Description

Variables	Mean	S.D.	25th percentile	Median	75th percentile
Total Assets ($M)	2,854.10	9,681.60	120.50	369.50	1,676.30
Audit Fees ($K)	2,119.99	3,978.61	512.00	1,033.93	2,303.00
NonAudit Fees ($K)	477.60	1,582.05	18.00	89.50	354.76
DirVote	11.72	15.05	1.23	5.24	14.80
CEOCHR	0.50	0.50	0.00	0.50	1.00
InOwn	0.17	0.21	0.03	0.09	0.25
NASRatio	0.17	0.27	0.03	0.10	0.23
ACFE	0.43	0.27	0.25	0.33	0.60
Loss	0.50	0.59	9.00	1.00	1.00
ICW	0.34	0.47	0.00	0.00	1.00
Restate	0.10	0.30	0.00	0.00	0.10
Auditor Resignation	0.10	0.30	0.00	0.00	0.00
Dismissal	0.35	0.48	0.00	0.00	1.00
REJECT	1.76	5.27	0.21	0.57	1.45

This table depicts the correlation coefficients between the independent variables. The coefficients in bold are significant at p<0.10.

The variables are defined as follows:
DirVote = minimum percent of votes against the election of a director;
CEOCHR = 1 if the CEO also serves as the chairman of the Board, 0 otherwise;
InOwn = proportion of shares owned by officers and directors;
NASRatio = ratio of non-audit fees to audit fees;
ACFE = proportion of financial experts on the audit committee;
Loss = 1 if the firm had a loss in the year prior to the switch, 0 otherwise;
ICW = 1 if the firm reported a material weakness in the internal controls in the year prior to the switch, 0 otherwise;
Restate = 1 if the firm restated its financial statements, 0 otherwise;
Resign = 1 if the predecessor auditor resigned from the engagement, 0 otherwise.

The mean and median total assets for the sample firms are $2.85 billion and $369.5 million respectively. This indicates that the sample is skewed. I therefore use natural logarithm to transform total assets. About 50 percent of the firms in the sample had a net loss in the year prior to the switch. The mean proportion of financial experts on the

audit committees is forty three percent. On average, officers and directors own 17.39 percent of the shares in a firm. The mean proportion of shareholders voting against auditor ratification is 1.75 percent. This is in line with the numbers reported in recent studies (Dao et al. 2008), and continues to suggest that in general, a majority of the shareholders vote in favor of the auditor. Even though shareholder voting is a non-binding vote, it puts pressure on the auditor to perform better quality audits (Sainty et al. 2002; Dao et al. 2012).

The correlation matrix for the explanatory variables is presented in Table 3.

Table 3
Correlation Analysis

Variables	Reject	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
LogAT (1)	0.07										
ROA (2)	0.05	**0.37**									
DirVote (3)	0.01	**-0.20**	-0.05								
CEOCHR (4)	-0.01	0.11	0.04	0.07							
InOwn (5)	-0.08	**-0.21**	-0.03	0.04	-0.08						
NASRatio (6)	**0.25**	0.00	0.09	0.04	-0.01	0.07					
ACFE (7)	-0.01	**0.14**	0.06	-0.05	-0.00	0.04	-0.02				
Loss (8)	**-0.11**	**-0.29**	**-0.50**	0.11	**-0.14**	0.08	-0.09	-0.04			
ICW (9)	-0.04	-0.08	-0.00	0.06	0.01	-0.01	**-0.15**	-0.02	**0.13**		
Restate (10)	0.01	-0.01	-0.02	0.00	0.07	**0.15**	**0.13**	0.09	0.07	**0.28**	
Resign(11)	-0.01	**-0.19**	-0.02	0.03	-0.04	0.03	-0.02	-0.02	**0.19**	-0.02	0.03

This table depicts the correlation coefficients between the independent variables. The coefficients in bold are significant at p<0.10.

The variables are defined as follows:
LogAT = natural logarithm of the total assets of the firm prior to the switch;
ROA = return on assets prior to the switch (net income divided by total assets);
DirVote = minimum percent of votes against the election of a director;
CEOCHR = 1 if the CEO also serves as the chairman of the Board, 0 otherwise;
InOwn = proportion of shares owned by officers and directors;
NASRatio = ratio of non-audit fees to audit fees;
ACFE = proportion of financial experts on the audit committee;

Loss = 1 if the firm had a loss in the year prior to the switch, 0 otherwise;	

ICW = 1 if the firm reported a material weakness in the internal controls in the year prior to the switch, 0 otherwise;

Restate = 1 if the firm restated its financial statements, 0 otherwise;

Resign = 1 if the predecessor auditor resigned from the engagement, 0 otherwise.

I examined the correlations and none of them exceed 0.5, which is considerably less than the 0.80 threshold above which multi-collinearity threats could arise (Gujarati 2003). I also test for multi-collinearity and find that the variance inflation factors for the variables in the regression model are all less than 1.9, indicating that multi-collinearity is unlikely to be an issue (Belsley, Kuh, and Welsh 1980).

I perform a cross-sectional regression model with robust standard errors as it yields more efficient estimates (Rousseeuw and Leroy 1987). When the assumptions of OLS are met, robust regression produces estimates identical to OLS (Western 1995). Table 4 presents the results of the regression with *Reject* as the dependent variable and categories of switches (*SNS, NSS and NSNS)* as variables of interest along with other control variables.[5] The control variables such as *InOwn (-0.449)* and *ROA (-0.138)* are negative and significant. This is consistent with prior literature which finds that shareholders are less likely to vote against management proposals when there is greater insider ownership and when firms are performing well (Raghunandan 2003; Dao et al. 2008). The results show that shareholder votes against ratification are significantly different for all categories of switches as compared to the reference category of SS switches. The coefficient of NSNS is -0.315 (p = 0.019 while SNS is -0.2461 (p=0.043) and NSS is -0.249 (p=0.049). This suggests that investors are least likely to reject the ratification when there is a lateral nonspecialist switch followed by upward switch. Thus, there is evidence to reject the null hypothesis presented as H1. The lower proportion of votes against ratification of the incumbent auditor for all categories of switches versus lateral specialist switches can be explained by the following. Firstly, Knechel et al. (2007) note that "when a company changes auditors, the market may react for two non-mutually exclusive reasons: (1) they expect a change in audit quality and/or (2) they expect a change in audit fees" (Knechel et al. 2007, 33). Given their argument, since lateral specialist switchers do not bring about any perceived incremental audit quality, investors are more likely to be dissatisfied. Overall the findings show that as compared to specialist lateral switches, shareholders are less likely to reject other types of switches indicating that the perceived audit quality between the two specialist auditors is not observed by the shareholders. Alternatively, perhaps the shareholders want to show dissatisfaction with the firm's decision to switch from one specialist to another as an unnecessary financial burden on the company as specialization has been associated with higher audit fee premiums (Ferguson and Stokes 2002).

---

[5] Lateral specialist switches serve as the base category of my regressions. Since any firm year can be categorized as either one of the four categories: NSS, SNS, NSNS and SS, I exclude one category to avoid multi-collinearity.

CONCLUSIONS AND LIMITATIONS

Prior literature has examined various factors affecting shareholder ratification of the external auditor. These factors include presence of high non-audit fee ratios, issuance of going concern opinion, engaging a less credible auditor (e.g., Raghnandan and Rama 2003; Sainty et al. 2002). This study contributes to this stream of literature by providing evidence that auditor changes affect shareholder voting patterns. Specifically, to the extent that specialists are perceived to provide higher quality audit, switches to a higher quality specialist auditor from a nonspecialist auditor elicits fewer votes against ratification of the incumbent auditor. Moreover, compared with downgrade switches, there is evidence to prove that lateral auditor switches between same levels of specialization escalate investor dissatisfaction. In the absence of any regulatory requirements, firms continue to submit the selection of the auditor for a vote. This presents an opportunity to increase competition in the audit market (ACAP 2008). In addition, PCAOB (2015) addresses audit quality indicator (AQI) project, which allows engagement level information to be directly or indirectly available to shareholders before vote on auditor ratification. The purpose is to provide insight to vote on the auditors selection, improve audit quality and enhance competitive ability of smaller auditing firms. With the limited research in this area, this study attempts to expand on the factors that affect the way shareholders perceive an auditor switch.

This study is subject to several limitations. Firstly, since I examine auditor changes across different categories of switches, sample size is relatively smaller than prior studies. Given the difficulty of hand collection and availability of voting information, the results should be interpreted with caution. Moreover, one cannot ignore that most shareholders are passive investors and are less likely to be involved with the auditor ratification process. Lastly, these results may be affected by correlated omitted variables which were not addressed by the matched sample approach.

REFERENCES

Abbott, L. J., Parker, S., Peters, G. F., and Rama, D. V. 2007. Corporate governance, audit quality, and the Sarbanes-Oxley Act: Evidence from internal audit outsourcing. *The Accounting Review* 82 (4): 803–835.

Advisory Committee on the Auditing Profession (ACAP). 2008. *Final Report of the Advisory Committee on the Auditing Profession for the U.S. Department of the Treasury (October).* Available at: http://www. treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf

Asthana, S., Balsam, S., and Kim, S. 2009. The effect of Enron, Andersen, and Sarbanes-Oxley on the US market for audit services. *Accounting Research Journal* 22 (1): 4–26.

Balsam, S., Krishnan, J., and Yang, J. S. 2003. Auditor industry specialization and earnings quality. *Auditing: A Journal of Practice & Theory* 22 (2): 71–97.

Beasley, M.S., and K. Petroni. 2001. Board independence and audit firm type. *Auditing: A Journal of Practice & Theory* 20 (1): 97-114.

Behn, B. K., Choi, J.-H., and Kang, T. 2008. Audit quality and properties of analyst earnings forecasts. *The Accounting Review* 83 (2): 327-349.

Belsley, D., Kuh, E., and Welsh, R. 1980. *Regression diagnostics: Identifying influential data and sources of collinearity*. New York, NY: Wiley.

Carcello, J. V. and Nagy, A. L. 2004. Audit firm tenure and fraudulent financial reporting. *Auditing: A Journal of Practice & Theory* 23 (2): 55–69.

Cenker, W. J. and Nagy, A. L. 2008. Auditor resignations and auditor industry specialization. *Accounting Horizons* 22 (3): 279–295.

Craswell, A. T., J. R. Francis, and S. L. Taylor. 1995. Auditor brand name reputations and industry specializations. *Journal of Accounting and Economics* 20 (3): 297–322.

Dao, M., Mishra, S., and Raghunandan, K. 2008. Auditor tenure and shareholder ratification of the auditor. *Accounting Horizons* 22 (3): 297–314.

Dao, M., Raghunandan, K., and Rama, D. V. 2012. Shareholder Voting on Auditor Selection, Audit Fees, and Audit Quality. *The Accounting Review* 87 (1): 149–171.

DeFond, M. L., J. R. Francis, and T. J. Wong. 2000. Auditor industry specialization and market segmentation: Evidence from Hong Kong. *Auditing: A Journal of Practice & Theory* 19 (1): 49–66.

Dopuch, N., and Simunic, D. 1980. The nature of competition in the auditing profession: a descriptive and normative view. *Regulation and the Accounting Profession* 34 (2): 283–289.

Ferguson, A., and D. Stokes. 2002. Brand name audit pricing, industry specialization, and leadership premiums post-Big 8 and Big 6 mergers. *Contemporary Accounting Research* 19 (Spring): 77– 110

Francis, J. R., Maydew, E. L. and Sparks, H. C. 1999. The role of Big 6 auditors in the credible reporting of accruals. *Auditing: A Journal of Practice & Theory* 18 (2): 17-34.

Francis, J. R., Reichelt, K., and Wang, D. 2005. The pricing of national and city-specific reputations for industry expertise in the US audit market. *The Accounting Review* 80 (1): 113–136.

Gujarati, D. 2003. *Basic Econometrics* (4th ed.). New York: McGraw-Hill.

Gul, F. A., S. Y. K. Fung, and B. Jaggi. 2009. Earnings quality: Some evidence on the role of auditor tenure and auditors' industry expertise. *Journal of Accounting and Economics* 47 (3): 265–287.

Hermanson, D. R., Krishnan, J., and Ye, Z. 2009. Adverse Section 404 opinions and shareholder dissatisfaction toward auditors. *Accounting Horizons* 23 (4): 391–409.
Huang, H.-W., Liu, L.-L., Raghunandan, K., and Rama, D. V. 2007. Auditor industry specialization, client bargaining power, and audit fees: Further evidence. *Auditing: A Journal of Practice & Theory* 26 (1): 147–158.

Kim, J., Chung, R., and Firth, M. 2003. Auditor Conservatism, Asymmetric Monitoring, and Earnings Management. *Contemporary Accounting Research* 20 (2): 323–359.

Knechel, W. R., Naiker, V., and Pacheco, G. 2007) Does auditor industry specialization matter? Evidence from market reaction to auditor switches. *Auditing: A Journal of Practice & Theory* 26 (1): 19–45.

Krishnan. G. 2003. Audit quality and the pricing of discretionary accruals. *Auditing: A Journal of Practice & Theory*, 22 (1): 109-126.

Krishnan, J., Li, C., and Wang, Q. 2013. Auditor Industry Expertise and Cost of Equity. *Accounting Horizons* 27 (4): 667–691.

Krishnan, J. and Ye, Z. 2005. Why some companies seek shareholder ratification on auditor selection. *Accounting Horizons* 19 (4): 237–254.

Lawrence, A., Minutti-Meza, M., and Zhang, P. 2011. Can Big 4 versus Non-Big 4 differences in audit-quality proxies be attributed to client characteristics? *The Accounting Review*, 86 (1): 259-286

Louis, H. 2005. Acquirers' abnormal returns and the non-Big 4 auditor clientele effect. *Journal of Accounting and Economics*, 40 (1-3): 75-99.

Low, K.Y. 2004. The Effects of Industry Specialization on Audit Risk Assessments and Audit-Planning Decisions. *The Accounting Review* 79 (1): 201–19.

Lu, T. 2006. Does opinion shopping impair auditor independence and audit quality? *Journal of Accounting Research* 44 (3): 561–583.

Mayhew, B. W. and Pike, J. E. 2004. Does investor selection of auditors enhance auditor independence? *The Accounting Review* 79 (3): 797–822.

Menon, K. and Williams, J. D. 1994. The use of audit committees for monitoring. *Journal of Accounting and Public Policy* 13 (2): 121–139.

Minutti-Meza, M. 2013. Does Auditor Industry Specialization Improve Audit Quality? *Journal of Accounting Research*.

Mishra, S., Raghunandan, K., and Rama, D. V. 2005. Do investors' perceptions vary with types of nonaudit fees? Evidence from auditor ratification voting. *Auditing: A Journal of Practice & Theory, 24*(2): 9–25.
Owhoso, V. E., Messier Jr, W. F., and Lynch Jr, J. G. 2002. Error Detection by Industry-Specialized Teams during Sequential Audit Review. *Journal of Accounting Research* 40 (3): 883–900.

Public Company Accounting Oversight Board (PCAOB). 2015. Concept release and audit quality indicators (Release No. 2015-005). Washington, D.C. Available at: http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf

Raghunandan, K. 2003. Nonaudit services and shareholder ratification of auditors. *Auditing: A Journal of Practice & Theory* 22 (1): 155–163.

Raghunandan, K. and Rama, D. V. 2003. Audit committee composition and shareholder actions: Evidence from voting on auditor ratification. *Auditing: A Journal of Practice & Theory* 22 (2): 253–263.

Rose-Green. E., Huang, H.-W., and Lee, C.-C. 2011. The association between auditor industry specialization and firms' disclosure of internal control weaknesses. *International Journal of Auditing* 15 (2): 204-216.

Rousseeuw, P. J. and Leroy, A. M. 1987. *Robust Regressions and Outlier Detection*. New York, NY: Wiley.

Sainty, B. J., Taylor, G. K., and Williams, D. D. 2002. Investor dissatisfaction toward auditors. *Journal of Accounting, Auditing & Finance* 17 (2): 111–136.

Securities and Exchange Commission (SEC). 2009. *Proxy disclosure enhancements* (No. Release Nos. 33-9089; 34-61175). Washington, D.C. Available at: http://www.sec.gov/rules/final/2009/33-9089.pdf

Securities and Exchange Commission (SEC). 2010. *Facilitating shareholder director nominations* (Release Nos. 33-9136, 34-62764). Washington, D.C. Available at: http://www.sec.gov/rules/final/2010/33-9136.pdf

Securities and Exchange Commission (SEC). 2011. *Facilitating shareholder director nominations (Corrected to conform to Federal Register version,* (No. Release Nos. 33-9259; 34-65343). Washington, D.C. Available at: http://www.sec.gov/rules/final/2011/33-9259.pdf

Simunic, D., and M. Stein. 1996. The impact of litigation risk on audit pricing: A review of the economics and the evidence. *Auditing: A Journal of Practice & Theory Supplement* 15 (2): 119-134.

Teoh, S. H. 1992. Auditor independence, dismissal threats, and the market reaction to auditor switches. *Journal of Accounting Research* 30 (1): 1–23.

Turner, L.E., Williams, J. P., and Weirich, T. R. 2005. An inside look at auditor change. *The CPA Journal*, 12-21Western, B. (1995). Concepts and suggestions for robust regression analysis. *American Journal of Political Science*: 786–817.

Western, B. 1995. Concepts and suggestions for robust regression analysis. *American Journal of Political Science* 39(3): 786–817.

Ye, Z. S., Hermanson, D. R., and Krishnan, J. 2013. Shareholder Voting in Director Elections and Initial SOX Section 404 Reports. *Journal of Accounting, Auditing & Finance*, *28*(2), 103–127.

Zhou, J. and Elder, R. 2002. *Audit Firm Size, Industry Specialization, and Earnings Management by Initial Public Offering Firms.* Working paper, State University of New York, Syracuse University: 91-102.