KAMs Disclosure and Auditor Switches

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Abstract

This study investigates the effect of expanded audit report rules on the client-auditor relation. Taking advantage of the fact that in the U.K. these rules were implemented in several stages, I apply difference-in-differences methodology to study this question. The results show that companies affected by the new auditing regime experienced an increase in the probability of auditor switch when compared to the companies in the control group. I hypothesize that such change in auditor turnover rate is due to increased tension between companies and their auditors. Firms want to minimise the number of KAMs which can be perceived as a bad signal by users of financial statements. At the same time, auditors prefer to report more KAMs in order to reduce their accountability and escape potential reputation losses. The results of the cross-sectional analysis support this hypothesis: the probability of auditor switch is positively associated with number of the reported KAMs. These results are stronger for the client-initiated auditor switches: the probability of auditor change raises regardless of the nature of the received KAMs. The probability of auditor resignation instead increases only when clients receive KAMs which are atypical for their industry.