Client/Auditor Loyalty, Embeddedness, and Adverse Internal Control Opinions

Linda A. Hall & Valerie L. Bennett

Section 404 of the Sarbanes Oxley Act requires management and external auditors to report on the adequacy of companies' internal controls over financial reporting (ICOFR). This aspect of the Act is one of the most costly to implement. This study examines client companies that do not switch auditors when faced with adverse ICOFR opinions and compares them to clients that switch auditors under similar circumstances. We find that clients that stay with existing auditors after receiving an adverse opinion have longer prior engagement relationships with their auditors than clients that switch auditors under similar circumstances. These clients are more likely to experience an increase in audit fees in the year they receive a clean opinion, and are more likely to be larger than clients that switch auditors under similar circumstances. We also find that clients that stay with existing auditors after receiving an adverse opinion are likely to have fewer material weaknesses in ICOFR (both account-specific and entity-level). The results are supported by embeddedness theory, in that over time, clients and auditors develop relationship-specific assets; their relationships exhibit positive duration dependence; and based on this, audit fees may be considered investments in stronger internal controls and future relationships.

Keywords: auditor changes, internal controls, Sarbanes-Oxley, embeddedness

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Section 404 of The Sarbanes Oxley Act requires that auditors determine whether client companies have material weaknesses in internal controls over financial reporting (ICOFR). Since the enactment of SOX, several

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studies have examined characteristics of clients receiving adverse internal control opinions and the relationships among audit fees, types of adverse opinions, auditor switching, company performance and stock price. It has been shown that companies expecting to or receiving an adverse report on internal controls are more likely to switch auditors—either by dismissing them or by the auditors resigning. This study is unique in that it focuses on the characteristics of client companies that have received adverse internal control opinions in the past and have remained with the same audit firm (loyal), and then compares these companies to clients that switched auditors under similar circumstances. Our analysis identifies companies that received an adverse opinion on ICOFR in one reporting year, followed by an unqualified opinion on ICOFR in the next year(s). Next we identify the firms that did not, from the adverse to unqualified reporting period, switch auditors. We then present data on length of engagement prior to adverse ICOFR opinion, audit fees, type of auditor, and the number and types of entity-level and account-specific material weaknesses in internal controls at the time of receiving the adverse opinion. We examine the similarities among and differences between firms that stayed with their auditors, and those that switched auditors. This study makes a unique contribution to the literature in that it frames a study of client/auditor loyalty in embeddedness theory. Specifically, we pull from sociology and management literature in an effort to explain why clients companies, when faced with increasing audit fees and relatively few weaknesses in ICOFR would choose to stay with their existing auditors rather than switch. Our findings are supported by embeddedness theory which holds that over time, clients and audit firms develop relationship-specific assets that further strengthen and lengthen the relationship, without consideration of fees, and that relationships have positive duration dependence. The results of this study contribute to the accounting and management literature because they frame the professional and contractual relationship between clients and auditors in terms of loyalty rather than pure economic motives.

Background and Hypothesis Development

Companies' and auditors' assessments of internal controls have been the subject of much research since the enactment of the Sarbanes Oxley Act in 2002. More specifically, Section 404(b) of the Act requires auditors to attest to and report on management's assessment of the company's internal controls over financial reporting (ICOFR). While auditors have always considered clients' internal controls in designing the nature and extent of substantive work necessary in conducting audits of financial statements, Sarbanes Oxley Section 404(b) adds an extra level of assurance that material weaknesses in internal controls are disclosed in order to warn investors, financial statement users, (and auditors) of potential weaknesses that may affect a company's ability to prepare reliable financial statements currently and in the future. This extra level of assurance comes with a high price tag, increasing audit fees, and thus causing companies to examine the cost/benefit of compliance under Section 404(b). The Sarbanes Oxley Act itself has added so many additional tasks, players, and resulting costs to the audit process that the behaviors of firms and the impact on companies and auditors have been studied intently since its inception. Although the impact of Sarbanes Oxley and especially Section 404(b) is relatively recent (the first audits affected were for year-ends in 2004), researchers recognize the vast opportunities to discover and predict the impact of this Act on several different levels (Asare, Cunningham & Wright, 2007; Hall & Gaetanos, 2006).

A broad area of research based in management and sociology that has implications for Section 404(b) is that of auditor/client relationships and loyalty to firms and professionals. A second theme in current research on Sarbanes Oxley Section 404(b) is the effect of increased audit fees on the behaviors of companies, audit firms, and the market. The resulting behaviors of auditor dismissal, auditor resignation, and the type of audit firm employed comprise a third stream of recent research. A fourth theme recently investigated is the levels and types of internal control weaknesses in companies, and their effects on company and audit

firm behaviors, and the perceptions and behaviors of investors. Each of these four streams of literature will be expanded upon in the following sections.

Auditor/Client Relationships and Embeddedness

Sociologists and management theorists have studied professional service provider/client relationships in an effort to understand the dynamics affecting behaviors exhibited between and within the exchange agents. It is apparent that the ties between audit firms and clients go beyond the contractual relationship. Professional accountants have specific training in a body of knowledge outside the technical capacity of the client, whose output is intangible but quite valuable. These ties depend upon human and social capital to survive and thrive. Relationships between accounting firms and their clients firms are strong because one or both parties make investments in human and social capital to enhance the longevity of the relationship (Levinthal & Fichman, 1988). Embeddedness theory holds that the various economic actors or exchange agents are imbedded in social affiliations that provide the opportunity for value creation. There is economic consequence as the relationship carries value. This value is enhanced as the parties build trust and share private information. Embeddedness theory acknowledges that people often guide their choices based on past actions with other people and continue to deal with those they trust, while economic theory holds that behavior is affected primarily by the forces of the market (Granovetter, 1985; Uzzi & Lancaster, 2004).

Embeddedness also affects the dynamics of auditor/client ties to the extent that the movement of individual professionals to new firms may lead to dissolution of a relationship. An example of such an effect occurs when clients follow audit managers or partners to another accounting firm (Broschak, 2004; Granovetter, 1985). In other situations, clients may defect as a result of status anxiety, as was found with former Andersen clients. Client firms that are accountable to important audiences, surrounded by similar firms defecting, and that are committed to audit quality are more likely to experience status anxiety and defect when their high status audit firm's reputation is compromised or comes under

professional scrutiny. However, evidence also shows that some clients followed their former Andersen managers or partners to their new firms (Jensen, 2006). While management theorists have been studying the ties between professionals and clients long before the age of accounting scandals, this line of theories support many of the firm behaviors observed during the post-Enron and Sarbanes Oxley era as well (Filip, 1994; Hope, Kang, Thomas & Yoo, 2008).

Auditor/client attachments are found to have positive duration dependence, that is, the rate at which relationships end decreases over time. The complexity of the task faced in the professional relationship is also positively associated with the length of the commitment. The opportunity for the development of relation-specific assets is greater, thus strengthening the persistence of the relationship (Levinthal & Fichman, 1988). An audit firm's experience, expertise, responsiveness, and overall level of service provided are key factors leading to satisfaction and loyalty among clients of the largest audit firms (without consideration of fees) (Behn, Carcello, Hermanson & Hermanson, 1999; Hong & Goo, 2004). This leads to our first hypothesis:

> H1: Clients that stay with existing auditors after receiving an adverse ICOFR opinion are more likely to have a longer relationship with their auditors than clients that switch auditors under similar circumstances.

Audit Fees

Section 404(b) compliance has been a time consuming and costly undertaking for companies and auditors alike. The most significant portion of these costs is reflected in audit fees, as the auditors' assessment of, and opinion on internal controls is a necessary component of the financial statement audit. Auditors' assessment of weaknesses in internal controls has a direct impact on the nature and extent of substantive testing that must be performed in order to render an opinion on a client's financial statements as a whole. The positive relationship between internal control deficiencies and higher audit fees suggests that audit firms exert more

effort on clients with weak internal controls. Some of the earliest filers subject to Section 404(b) compliance experienced drastic increases in audit fees, with fees more than doubling from the previous audit year in many cases (Raghunandan & Rama, 2006). Firms that assess weaknesses in their own internal control systems may experience increases to a lesser extent than firms that do not disclose weaknesses prior to auditor assessment. It stands to reason that the more material weaknesses in internal controls, the more audit work necessary to correct the weaknesses, and/or the more auditor resources needed to substantiate the opinion on the financial statements (Hogan & Wilkins, 2008). The resources necessary to raise internal controls up to an acceptable level can be viewed a long-term investment into the company, an investment that will benefit future periods (Hall & Gaetanos, 2006). The increase in audit work and fees has had a more significant impact on smaller companies than larger companies, because on average, smaller companies report more material weaknesses than larger companies, which implies that larger firms on average can afford to dedicate more company resources to internal controls (Bryan & Lilien, 2005). Interestingly, though, once companies' audit fees increase, they may tend to remain high even after the initial compliance year (Foster, Ornstein & Shastri, 2007; Hoitash, Hoitash, & Bedard, 2007). This leads to our second hypothesis:

> H2: Clients that stay with existing auditors after receiving an adverse ICOFR opinion are more likely to experience an increase in audit fees in the year they receive a clean opinion than clients that switch auditors under similar circumstances.

Auditor Switching

The implementation of Sarbanes Oxley Section 404(b) has done more than just raise audit fees; auditors are often dismissed by clients if the costs of compliance are prohibitive (Ettredge, Li, & Scholz, 2007). The realignment of auditors and client companies is an area that has received much attention since Sarbanes Oxley. Auditor realignments can take two forms: either the client company dismisses the audit firm, or the audit

firm resigns from the client audit. Since the initial round of audit reports complying with Sarbanes Oxley have been filed, alignments of either form have been more frequent than in the past (Owens-Jackson, Robinson & Shelton, 2008). Prior to 2005, the largest realignments were attributed to the reassignment of former Andersen clients after Enron. Also, since accounting firms are now limited to the breadth of services they can provide for a client, they may find it difficult to differentiate themselves from their peers based on audit services provided. Fees may become a competitive tool, and clients may threaten to switch auditors, whether they actually switch or not (Hinings, Greenwood & Cooper, 1999). Some clients have been found to dismiss audit firms based on fees alone (Owens-Jackson, et al., 2008). Consistent with the audit risk model, the presence of internal control deficiencies indicates higher levels of control risk and has been linked to higher audit fees and dismissals (Hogan & Wilkins, 2008).

Several researchers have seized the opportunity to examine the behaviors of firms after their first post-Sarbanes Oxley reports—finding that in terms of clients dismissing auditors, clients are more likely to dismiss incumbent auditors after they receive an adverse Section 404(b) opinion—which is, that there are material weaknesses in the clients' internal controls. Also, clients are more likely to dismiss their auditors if they expect the auditor to render an adverse opinion (Ettredge, Heintz, Li & Scholz, 2007). Smaller client firms are more likely than large clients to dismiss their auditors when faced with an adverse opinion, and as was mentioned in the previous section, smaller client firms are more likely to have material weaknesses in internal controls (Ashbaugh-Skaife, Collins & Kinney Jr., 2007; Bryan & Lilien, 2005; Ettredge et al., 2007). On top of this, adverse opinions usually go hand in hand with increases in audit fees, thus exacerbating an already negative situation for smaller clients (Beneish, Billings & Hodder, 2005). This leads to our third hypothesis:

> H3: Clients that stay with existing auditors after receiving an adverse ICOFR opinion more likely to be larger than clients that switch auditors under similar circumstances.

Types of Internal Control Weaknesses

Several researchers have investigated the nature of internal control weaknesses reported by management and auditors, and the effects of this reporting on the behaviors of firms and investors. In general, investors perceive the benefit of strong internal controls as producing higher quality financial statements (Ashbaugh-Skaife et al., 2007), and disclosures of control weaknesses have a negative effect on stock prices (Hammersly, Myers & Shakespeare, 2007; Ogneva, Subramanyam & Raghunandan, 2006). Also, companies disclosing material weaknesses tend to be smaller, are less profitable, and have more complex operations (Bryan & Lilien, 2005; Foster, et al., 2007; Ge & McVay, 2005). Internal control weaknesses can be classified as account-specific (affecting specific accounts such as inventory, accruals, intangibles, or intercompany accounts) and entity-level (weaknesses in broader areas such as training, period-end policies, revenue recognition, and segregation of duties). Deficiencies in entity-level controls may indicate a weak control environment or "tone at the top". Managers, audit firms and investors recognize entity-level control deficiencies as more serious and more difficult and costly to remedy (Asare & Wright, 2008; Ashbaugh-Skaife, Collins, Kinney Jr. & LaFond, 2006). Accordingly, greater fees increases and auditor switching have been linked to more severe, entity-level control weaknesses rather than account-specific control weaknesses (Hogan & Wilkins, 2008; Hoitash, et al., 2007). This leads to our fourth hypothesis:

> H4: Clients that stay with existing auditors after receiving an adverse ICOFR opinion are likely to have fewer material weaknesses in ICOFR (both account-specific and entity-level) than clients that switch auditors under similar circumstances.

Data Collection and Methodology

The sample used in this study was drawn from *Audit Analytics* on February 4, 2009, yielding 18,010 separately reported auditor opinions on internal controls over financial reporting between the years 2004 and 2007. In each of these cases, the client company agreed with the auditors'

opinion on internal controls. The sample was sorted by reporting company (client), and the final sample comprised of companies that received an adverse internal control opinion in one reporting year, followed in the next year by an unqualified opinion. Companies that were exempt from ICOFR reporting removed, leaving a final sample of 723 companies that met these requirements. The sample was then split into two groups, those with opinions rendered by the same audit firm over the two-year period and those that switched auditors after the adverse opinion was received. The two categories of firms are labeled "loyal" and "switcher". Other relevant data gathered for each of the sample cases include (for each of the two reporting years covered): audit firm name, audit, non-audit, and audit-related fees, company book value, total assets, and market capitalization. Company SIC and NAICS code was identified. Company information by SIC will be discussed in the analysis as there were no meaningful differences that would make it necessary to look into the more detailed NAICS coding at this time. For the year in which the company received the adverse ICOFR opinion, detailed lists of internal control weaknesses identified by the audit firm were gathered. The length of the relationship between company and auditor was determined by first reported engagement event date reported on *Audit Analytics.*

Initial Analysis of Sample Characteristics

The sample of companies that met the criteria for this study was drawn from three sets of fiscal years: 2004–2005, 2005–2006, and 2006–2007. Data initially gathered included a limited sample covering the period 2007–2008. However, complete 2008 fiscal reporting was not available at the time of sampling, so the 2007–2008 set was removed from the sample to prevent any bias based on the timing of releases. Had we chosen to leave those companies in regardless of completeness, we found no significant bearing on the hypotheses tested without factoring in timing. See Table 1 for sample characteristics. Overall, the three sets of years represented 30.6%, 38.8%, and 30.6% of the sample population in 2004–2005, 2005–2006, and 2006–2007, respectively. When the sets of

TABLE 1. Sample Characteristics.

	Loyal			Switcher			Total	
Opinion Years Examined	**n**	**% Row**	**% Col.**	**n**	**% Row**	**% Col.**	**n**	**% Col.**
2004-2005	179	81.0%	29.3%	42	19.0%	37.8%	221	30.6%
2005-2006	237	84.3%	38.7%	44	15.9%	39.7%	281	38.8%
2006-2007	196	88.7%	32.0%	25	11.3%	22.5%	221	30.6%
Total	612	84.6%	100.0%	111	15.4%	100.0%	723	100.0%

	Loyal			Switcher			Total	
Average Market Capitalization	**n**	**% Row**	**% Col.**	**n**	**% Row**	**% Col.**	**n**	**% Col.**
< $250 million	154	76.6%	27.0%	47	23.4%	45.2%	201	29.8%
$250 – $500 mill.	104	80.0%	18.3%	26	20.0%	25.0%	130	19.3%
$500 - $750 mill.	69	88.5%	12.1%	9	11.5%	8.6%	78	11.6%
> $750 million	243	91.7%	42.6%	22	8.3%	21.2%	265	39.3%
Total	570	84.6%	100.0%	104	15.4%	100.0%	674	100.0%

	Loyal			Switcher			Total	
Average Balance Sheet Book Value	**n**	**% Row**	**% Col.**	**n**	**% Row**	**% Col.**	**n**	**% Col.**
< $50 million	181	83.4%	30.1%	36	16.6%	33.6%	217	30.6%
$50 - $150 mill.	144	78.7%	24.0%	39	21.3%	36.5%	183	25.9%
$150 - $300 mill.	104	86.0%	17.3%	17	14.0%	15.9%	121	17.1%
> $300 million	172	92.0%	28.6%	15	8.0%	14.0%	187	26.4%
Total	601	84.9%	100.0%	107	15.1%	100.0%	708	100.0%

	Loyal			Switcher			Total	
Average Balance Sheet Assets	**n**	**% Row**	**% Col.**	**n**	**% Row**	**% Col.**	**n**	**% Col.**
< $250 million	143	75.3%	24.1%	47	24.7%	44.3%	190	27.2%
$250 – $500 mill.	102	85.7%	17.2%	17	14.3%	16.1%	119	17.0%
$500 - $750 mill.	72	85.7%	12.2%	12	14.3%	11.3%	84	12.0%
> $750 million	276	90.2%	46.5%	30	9.8%	28.3%	306	43.8%
Total	593	84.8%	100.0%	106	15.2%	100.0%	699	100.0%

fiscal years are examined with respect to the behavior of clients (loyal versus switcher) a tendency toward loyalty among clients emerges. From 2004–2005 to 2006–2007, the percent of firms experiencing first an adverse and then an unqualified opinion on ICOFR that remained with their existing auditors increased from 81.0% to 88.7%.

Three variables were chosen to represent the size of sample firms. These are: average market capitalization, average balance sheet book value, and average balance sheet assets. These variables are tested in our third hypothesis. In addition, size variables were divided into quartiles to better understand the relative makeup of the sample. When the percentage of total loyal companies is examined based on average market capitalization, we find that client companies in the smallest bracket (less than $250 million) and the largest bracket (more than $750 million) comprise 69.6% of loyal clients sampled. On a bracket by bracket basis, the percent of loyal firms increased as the brackets increased (76.6%, 80.0%, 88.5%, and 91.7% from lowest to highest bracket). Similar results are found on a bracket by bracket basis for both of the other size variables, average book value and average total assets. For both average book value and average total assets variables, sample companies in the higher brackets demonstrated higher levels of loyalty than firms in the lower brackets. A full 86% and 92% of companies with the highest book values did not switch auditors when faced with an adverse ICOFR opinion. Similar percentages exist among the two largest brackets of clients with respect to average total assets, showing a trend toward loyalty to auditor among larger client companies faced with adverse ICOFR opinions.

Table 2 presents the client company sample by industry under the SIC code system. We analyze this information to determine whether loyalty to auditor varies by industry. It was noted earlier that firms with more complex operations are more likely to have material weaknesses in ICOFR (Ge & McVay, 2005), and based on our fourth hypothesis, we would expect to see loyalty among firms within industries with less complex operations. We are not in the position to assess industry complexity, but some interesting industry trends emerge from our sample. First, the level of analysis by industry code breaks the sample into several small

Table 2. Sample Industry Information.

SIC Code by Division	Loyal			Switcher			Total	
	n	% Row	% Col.	n	% Row	% Col.	n	% Col.
Agric., Forestry, Fishing 01-09	-	0.0%	0.0%	2	100%	1.8%	2	.3%
Mining 10-14	28	90.3%	4.5%	3	9.7%	2.7%	31	4.3%
Construction 15-17	6	75.0%	1.0%	2	25.0%	1.8%	8	1.1%
Manufacturing 20-39	221	84.0%	36.1%	42	16.0%	37.9%	263	36.4%
Trans, Comm, Electric, Gas 40-49	57	86.4%	9.3%	9	13.6%	8.1%	66	9.1%
Wholesale Trade 50-51	14	87.5%	2.3%	2	12.5%	1.8%	16	2.2%
Retail Trade 52-59	58	92.1%	9.5%	5	7.9%	4.5%	63	8.7%
Finance, Ins., Real Estate 60-67	110	84.6%	18.0%	20	15.4%	18.0%	130	18.0%
Services 70-89	118	81.9%	19.3%	26	18.1%	23.4%	144	19.9%
Total	612	84.6%	100.0%	111	15.4%	100.0%	723	100.0%

industry groups. Only the largest groups for our purposes will be discussed. Client companies in manufacturing represent the largest portion (36.4%) of the sample. Within manufacturing, 84% of clients were loyal, which is consistent with the sample average of 84.6%. The second largest sample group rests in the services industries, where loyalty appears to be slightly below average at 81.9%. Clients in the finance, insurance, and real estate industry comprise the third largest group, showing average loyalty at 84.6% of companies staying with their auditors after adverse ICOFR opinions. Clients companies with above average loyalty percentages (although the n-size is relatively small) are reported in the mining, transportation, communication, electric and gas, wholesale trade and retail trade industries. However, none are significantly higher than average and comprise only 25.6% of the loyal sample.

RESULTS OF HYPOTHESIS TESTING

Hypothesis 1

Hypothesis 1 tests the relationship between length of client-auditor engagement and the likelihood of the client switching auditors when faced with an adverse internal control opinion. We hypothesize that clients that stay with existing auditors after receiving an adverse ICOFR opinion are more likely to have a longer engagement relationship with their auditors than clients that switch auditors. Independent-samples t-test procedures were performed to test the significance of the difference between the two sample means for the variable "length of engagement in months". Table 3 shows that the mean length of engagement for loyal clients was reported as 64.5 months, while the mean length of engagement before adverse opinion for switchers was only 49.6 months. T-test results show that this difference is significant at the .01 level, in support of hypothesis 4.

Hypothesis 2

Hypothesis 2 conjectures that clients that stay with existing auditors after receiving an adverse ICOFR opinion are more likely to experience an increase in audit fees in the year they receive a clean opinion than clients

TABLE 3. Descriptive Statistics of Loyal versus Switcher Clients.

	Loyal Clients			Switcher Clients		
Variable	**Mean**	**Std Error**	**Predicted Difference**	**Mean**	**Std Error**	**Two-tailed p-value**
Length of Relationship in Months	64.5	1.09	>	49.6	2.18	.000
Percent Change in Audit Fees	13.7	.027	>	-7.4	.082	.016
Percent Change in Total Fees	10.7	.026	>	-17.9	.046	.000
Percent Change in Total Fees Including Audit-Related Fees	10.6	.026	>	-19.1	.047	.000
Average Market Capitalization*	2,437	681	>	949	207	.037
Average Balance Sheet Book Value*	448	97	>	153	29	.004
Average Balance Sheet Assets*	8,033	2,302	>	1,810	461	.008
Number of Account-Specific Weaknesses	2.0	.06	<	2.4	.17	.081
Number of Entity-Level Weaknesses	3.1	.05	<	3.5	.16	.011

* In millions, U.S. dollars, rounded.

that switch auditors under similar circumstances. Independent-samples t-test procedures were performed to test the significance of the difference between the two sample mean percent changes in audit fees, total fees (including non-audit fees) and total fees (including non-audit and audit-related fees). Of the 723 sample cases, only 713 reported fee amounts for both the adverse and unqualified ICOFR opinion years (606 loyal clients and 107 switchers). Table 3 shows the means, standard errors, predicted difference, and the significance of the difference in means for both groups for each of the three audit fees variables. On average, loyal companies experienced an average of 13.7% increase in audit fees over the two-year period, while switchers on average experienced a 7.4% decrease in audit fees. In addition, loyal companies experienced and increase in total (audit and non-audit) fees averaging 10.7% over the two-year period, while switchers' average total fees decreased 17.9%. When total fees were expanded to include audit-related fees, similar results were found. Loyal companies experienced an increase in total fees averaging 10.6% while switchers' average fees decreased 19.1%. For audit fees alone, the increase in fees is significantly higher at the .05 level, while for the two combined fees variables the difference in means is significant at the .01 level. It can safely be concluded that the difference in the percentage change in audit, total, and audit-related fees is significantly higher for loyal firms than switching firms under the same circumstances. Therefore, it can be assumed that clients that stay with existing auditors after receiving an adverse ICOFR opinion are more likely to experience an increase in audit fees in the year they receive a clean opinion than clients that switch auditors under the same circumstances, in support of hypothesis 2.

Hypothesis 3

Hypothesis 3 posits that clients that stay with existing auditors after receiving an adverse ICOFR opinion more likely to be larger than clients that switch auditors under similar circumstances. To test this hypothesis, independent-samples t-test procedures were performed to test the significance of the difference between the two sample means for average market

capitalization value, average balance sheet book value, and average total balance sheet assets. Of the 723 sample cases, only 674 reported beginning and ending (to calculate average) market capitalization values, 708 reported beginning and ending book values, and 699 reported beginning and ending total assets for the two-year periods covered. Table 3 shows that the mean values for all three measures are higher for loyal clients versus switchers, but the difference varied more around the average for loyal clients than switchers. The results of the t-tests show that loyal clients are significantly larger based on all three size variables than switchers. The difference in average market capitalization is significant at the .05 level, while the differences of the other two size variables are significant at the .01 level. These results support hypothesis 3.

Hypothesis 4

In hypothesis 3 we surmise that clients that stay with existing auditors after receiving an adverse ICOFR opinion are likely to have fewer material weaknesses in ICOFR (both account-specific and entity-level) than clients that switch auditors under similar circumstances. To test this hypothesis, independent-samples t-test procedures were performed to test the significance of the difference between the two samples' mean number of account-specific and entity-level weaknesses reported by auditors in their adverse ICOFR opinion (in the first year of the two-year periods studied). In all cases there were no weaknesses in the second, unqualified ICOFR opinion year. Account-specific weaknesses were determined as those coded in *Audit Analytics* as "Accounting rule (GAAP/FASB) application failure noted in assessment of internal controls". The five most prevalent codes in this category were related to accounting for tax expense, revenues, receivables, investments and cash, inventory and cost of sales, and property, plant and equipment and intangibles. Entity-level weaknesses were determined as those coded in *Audit Analytics* as "Material weaknesses identified in assessment of internal controls". The five most prevalent codes in this category were for weaknesses in accounting documentation, policy and procedures, material and/or numerous auditor

adjustments, restatement or non-reliance of company filings, accounting personnel resources, competency/training, and untimely or inadequate account reconciliations. The results of the t-tests show that loyal clients have significantly fewer material weaknesses in ICOFR (account-specific at the .10 level, and entity-level at the .05 level) than clients that switch auditors under the same circumstances, in support of hypothesis 3. See Table 3.

ADDITIONAL ANALYSIS

Table 4 introduces some additional analysis that is not included in the hypotheses tested above. We find that 77.5% of loyal firms and 78.3% of all firms in our sample employed Big Four auditors when they received an adverse ICOFR opinion. Of these clients, 16.3% switched auditors in the following year. There was a greater movement among switchers to go from Big Four to non-Big Four ($n=56$) than to go from one Big-Four to another ($n=36$). Among clients that originally received adverse ICOFR opinions from non-Big Four firms, more switched to other non-Big Fours ($n=13$) than to Big Fours ($n=6$). Overall, Table 4 shows, obviously, that loyal clients did not change auditors, and that among switchers, over half moved from Big Four to non-Big Four audit firms, while only 5.4% moved up from non-Big to Big Four auditors. Nearly one-third of all switchers simply switched from one Big-Four auditor to another, and about 12% moved from a non-Big Four to another non-Big Four auditor. Overall, 77.5% of all loyal firms started and stayed with Big Four firms, and 22.5% started and stayed with non-Big Four auditors. These results lend support for hypothesis 2 as well as hypothesis 3, because larger audit firms are often associated with higher fees, and larger client firms typically select Big four auditors. Consequently, one might assume that the higher the fees, the higher the probability that the switcher client would move from a Big Four to a non-Big Four audit firm in order to lower its audit fees (Ettredge et al., 2007; Owens-Jackson et al., 2008). This is an interesting area that requires further analysis in more depth in a future study.

Table 4. Change in Auditor Size.

	Loyal			Switcher			Total	
Year to Year Auditor	**n**	**% Row**	**% Col.**	**n**	**% Row**	**% Col.**	**n**	**% Col.**
Big Four to Big Four	474	92.9%	77.5%	36	7.1%	32.4%	510	70.5%
Big Four to Non-Big Four	-	-	-	56	100.0%	50.5%	56	7.8%
Non-Big to Non-Big Four	138	91.4%	22.5%	13	8.6%	11.7%	151	20.9%
Non-Big to Big Four	-	-	-	6	100.0%	5.4%	6	.8%
Total	612	84.6%	100.0%	111	15.4%	100.0%	723	100.0%

CONCLUSIONS AND AREAS OF FURTHER RESEARCH

The objective of this study is to identify and examine companies that did not switch auditors when faced with adverse internal control opinions and compare and contrast them with companies that switch auditors under similar circumstances. We study three fiscal year sets of data that characterize companies receiving an adverse ICOFR opinion in one year, followed by an unqualified opinion in the next. We found loyalty to auditor (non-switching behavior) was more likely among larger clients with long-standing relationships with their auditors. Even though these firms face increasing audit fees, and exhibit relatively fewer weaknesses in ICOFR, they are morel likely to stay with their existing auditor rather than switch. Each of the hypotheses developed and tested in our study was supported by the data gathered. We tapped into sociology and management literature to support our finding that loyal clients had significantly longer engagement relationships (prior to adverse ICOFR opinion) than switchers. This supported our first hypothesis, which tested whether auditor/client relationships have positive duration dependence. Our findings support the contention that over time, clients and audit firms develop relationship-specific assets that further strengthen and lengthen the relationship, without consideration of fees. In fact, increases in fees may be seen to add value to the relationship as they are viewed as investments of financial and human capital in stronger internal controls, and ultimately better financial reporting. Embedded in this relationship is trust with confidential information, social affiliation, and the reliance on a specialized skills set, body of knowledge, and experience within a specific company. Based on literature on audit fees and auditor switching, we hypothesize that when firms decide to stay with their existing auditors in order to work toward an unqualified ICOFR opinion, fees are not the most important issue. In fact, we predict, based on the literature, that fees would increase, as client companies' audit fees represent an investment of time and energy by both the auditor and client in stronger internal controls. The results show that on average, loyal companies experienced

an average increase in fees of 10.7% to 13.7% in audit fees, compared to average decreases of 7.4% to 19.1% over the two-year period, in support of our second hypothesis. Literature on auditor switching supports the premise that smaller companies, because of the significance of audit fees and the increased likelihood of material weaknesses in ICOFR, are more likely to switch auditors. Therefore, we posit that loyal clients are more likely to be larger than switchers under the same circumstances. This hypothesis is supported when size is measured in terms of average market capitalization, average book value, and average total assets over the two-year period studied. From a similar stream of literature we predicted that loyal clients are likely to have fewer material weaknesses in ICOFR (both account-specific and entity-level) than clients that switch auditors under similar circumstances, which was duly supported by our data.

The results of this study make a unique contribute to the accounting and management literature because they frame the professional and contractual relationship between clients and auditors in terms of loyalty. In a subsequent paper, a model will be developed, using the various variables described below and others, to test the impact of the variables identified in this paper on client/auditor loyalty and switching behavior, that is, a company staying with or dismissing their existing auditor after receiving an adverse ICOFR opinion. An area of further research, aside from developing a regression model, is to further explore the evidence relevant to the additional analysis on type of auditor employed (Big Four, non-Big Four), and the significance of changing from or within broad auditor category. Results in related literature are mixed in this area, but warrant further investigation. Overall, one can surmise that larger companies are more likely to engage Big Four auditors, but the incidence of staying with them versus switching to another Big Four or a smaller firm is beyond the objectives of this study, as it focuses more on switching than on loyalty.

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