



# Understanding Auditor Switching: Unraveling Corporate Governance Effects With Board Oversight And Investor Responses

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## Abstract

The rotation of auditors influences managerial misconduct by affecting the financial performance and corporate governance of the company. The research explores the oversight of management and the board of directors in regulating auditor rotations, aiming to identify factors that lead to these rotations and assess their resulting effects. The size of the board of directors and management has a varying impact on the size of auditing firms, which are crucial for instilling confidence in shareholders and investors regarding corporate financial reporting. Additionally, doctrinal research underscores how investors and shareholders respond to frequent auditor switches, proposing different internal and external control mechanisms for ensuring independent checks and balances. Despite auditors not directly influencing a company's performance as part of its management team, there is an important recognition here regarding their significant role in understanding the link between financial performance and corporate governance. In conclusion, examining auditor switching uncovers insights into various stakeholders' involvement within a company while demonstrating its impact on both financial performance as well as corporate governance.

**Keywords:** Auditor Switch, Board of Directors, Corporate Governance, Financial Performance, Investment Decisions, Transparency.

## INTRODUCTION

[1.] According to **Lord Justice Lopes**, "*an auditor is the watchdog of a company*".<sup>1</sup> A company's auditor is an essential component of the auditing process. He has an obligation to logically, methodically, and with an inquiring mind satisfy the company's accounting. However, the alarming rate at which corporations transfer auditors has an influence not just on the corporation's financial performance, but also on corporate governance as a result of resource misuse.<sup>2</sup> Corporate governance, on the other hand, is a serious subject that has received more attention in recent years. The study's goal is to provide insight on auditors' roles and the influence that switching auditors has on a corporation.

<sup>1</sup> In Re, *Kingston Cotton Mills Co.*, [1896] 2 Ch. 279.

<sup>2</sup> Samuel Babatunji Adedeji, *Auditors Switching In the Relationship Corporate Governance and Financial Performances*, 10(1) INTERNATIONAL JOURNAL OF ECONOMICS AND MANAGEMENT 53, 53 – 68 (2016).

## RESEARCH HYPOTHESIS

[2.] *H<sub>1</sub>: Auditor switching is positively correlated with the corporate governance and financial collapses.*

*H<sub>2</sub>: Auditor switching shows a negative correlation with corporate governance and financial collapses*

*H<sub>3</sub>: Auditor switching have an impact on board size determination and managerial arrangement.*

*H<sub>4</sub>: The intersection of auditor switch and investor responses influences the reputation and standing of a company.*

## LITERATURE REVIEW

[3.] *Belkhir (2008)* highlights the dynamic correlation between board size and composition, and its impact on a company's financial performance in influencing auditor switches. Additionally, changes in a company's disclosure policy can also affect the likelihood of auditor switches and subsequently influence the client-auditor relationship as well as the company's objectives.

Dissatisfaction among auditing firms may lead to alterations in auditing techniques, consequently affecting management within a company, as demonstrated by *Schwartz & Krishnagopal Menon (1985)*.

Moreover, *Chan & Lee (2011)* examine investor reactions following auditor switches which reflect upon both the reputation and shareholder confidence of the company.

*Verma (2019)* illustrates case studies from India to analyze corporate governance development while *Shailer (2014)* juxtaposing this view, identifies Iran's post-privatization determinants of auditor switch with relevance to agency-related conflicts in Iran.

## AUDITOR SWITCHING AND CORPORATE GOVERNANCE

### [4.] PRINCIPLE OF CORPORATE GOVERNANCE:

The **Cadbury committee** had released the "corporate governance report" which became a significant code in India since 1980's. The Satyam case in 2009 was a massive disappointment in terms of financial systems failing because of the same the Indian government had to set up governance standards to prevent instances like these from happening.<sup>3</sup>

### [5.] CONTEMPORARY SCENARIO IN PLACE:

Every company has a set of objectives and a particular set or rules and standardised auditing and proper set of rules and regulations help in smooth functioning and proper compliance. The inspection of books of accounting and financial documents.<sup>4</sup> On several occasions the securities and Exchange commission has articulated its concern over the rambling switches of the auditor asking for disclosure for the practice of getting favourable or bias treatment.<sup>5</sup> There are numerous legislations that define the basic framework with respect to audit committees and requirement the companies act being one. SEBI has also laid down certain guidelines concerning the same. Organisations like ICAI and ICSI have laid down certain set of standardised rules and regulation to formulate auditing.<sup>6</sup>

### [6.] RELATIONSHIP BETWEEN AUDITOR SWITCHING AND CORPORATE GOVERNANCE:

The CFO and chairman of the company have huge impact on switching of the auditor. The size of the board affects the financial performance of the company.<sup>7</sup> It cannot be disputed that a large number of board members can lead to several problems in terms of coordination problems which is not ideal for the corporate

<sup>3</sup> Boon & Ong, *An Empirical Study of Auditors Switching, Corporate Governance and Financial Performances of Malaysian Public Listed Companies (PLCs)*, JURNAL PENGURUSAN, 47 (2016).

<sup>4</sup> LIU Ming, *Corporate Governance, Auditor Choice and Auditor Switch*, HONG KONG BAPTIST UNIVERSITY (2007).

<sup>5</sup> Schwartz & Krishnagopal Menon, *Auditor Switches by Failing Firms*, 2 THE ACCOUNTING REVIEW, 248–61 (1985), <http://www.jstor.org/stable/246789>

<sup>6</sup> Bhumesh Verma, *Evolution of Corporate Governance in India*, SCC ONLINE (Nov. 13, 2019), <https://www.sconline.com/blog/post/2019/11/13/evolution-of-corporate-governance-in-india/>.

<sup>7</sup> Belkhir, *Board of directors' size and performance in the banking industry*, 5 INTERNATIONAL JOURNAL OF MANAGERIAL FINANCE, 201-222 (2008).

governance standards but a greater board size also aids in improving the financial statements and switching to larger auditors.<sup>8</sup>

### **[7.] INFLUENCE OF INDEPENDENT DIRECTORS & INVESTORS:**

There is a increase in the number of auditor switches when there is a presence of independent directors. In a case where there are a greater number of independent directors the switching of directors is comparatively low as frequent switching of auditor decreases the reliability of the financial statements.

Investors usually prefer the Big 4 in comparison to the smaller auditing firms. Switching to high quality auditors signal good corporate governance to investors that help raise funds and give a good impression to the outsiders whereas frequent change in auditing patterns leads to change in the subjectivity and the reliability of the information that is being provided.

Frequent changes in auditing patterns give sign that the auditors are expressing their disagreement regarding any of the policy which has led to the change in the auditors. The worsening situation of the company, which is driven by management failure, is frequently blamed on auditing companies, resulting in changes in auditing.<sup>9</sup> The auditor becomes increasingly open to claims of carelessness in discovering flaws, generating fears about greater legal action against auditing companies.

### **NATIONAL AND INTERNATIONAL CASE INSTANCES**

[9.] The *Satyam Computer Services* controversy exposed the significance of auditors in corporation governance. Furthermore, the *Ricoh India case*<sup>15</sup> highlighted legislative modifications and governmental intervention to strengthen the framework for corporate governance as a result of the regulatory authority's inability to cover the costs of auditors and their standing committees, among other things.<sup>16</sup>

[10.] According to a study, Iran rewards auditors who change companies to eliminate agency-related organisational problems. The upsides of switching auditors depend on ownership and capital structure, which might impact the trustworthiness of financial statements and debt arrangements. The privatisation of corporations in 2001 fuelled rivalry among auditors, resulting in a significant consumer demand prompting a change in auditors from government-controlled companies. Independent auditors availed benefits from privatisation, strengthening auditor-client congruence while abusing businesses. Another critical difference between Iran and India is that auditors might be imprisoned for filing false reports. Thus, auditors choose prudent accounting practices since they are incentivised. As a result, organisations with an adverse voluntary accumulation tend to replace auditors more frequently than others.<sup>17</sup>

### **CRITICAL ANALYSIS**

[11.] Corporations with inadequate corporate oversight should ideally switch auditors to improve the administration of operations. The response of the market and orders may have a consequence on the business's financial performance and valuation, either positively or negatively. Since the auditor's responsibility is to ensure openness, creditors may believe that data is being withheld and that changes are to blame for slowing the company's economic growth.

[12.] Irrespective of the auditor changeover, several external auditors play an oversight function that ensures the integrity of audits and company governance.<sup>18</sup> There is no clear link between privatisation and auditor switching in India. Shifting to smaller auditing companies could suggest excessive disclosure and market swings, whilst larger businesses can reveal prudent accounting procedures.

<sup>8</sup> Zhang & Ren, *Auditor switching by corporate governance: Empirical analysis from the listed company in China*, 9(2) JOURNAL OF MODERN ACCOUNTING AND AUDITING 230, 230-238 (2013).

<sup>9</sup> Schwartz & Krishnagopal Menon, *Auditor Switches by Failing Firms*, 2 THE ACCOUNTING REVIEW, 248-61 (1985), <http://www.jstor.org/stable/246789>.

## SUGGESTIONS

1. Develop a national business governance regime prioritising responsibility, openness, and accountability for auditors and leadership.
2. Frequent transitions isolate systems, making evaluating the company's financial results inefficient.
3. Defining a code of conduct for audits can lessen the load on the business and directors' obligations.
4. A practical approach to making choices for switching auditors can help prevent financial disasters and business malfeasance by establishing a reliable and consistent framework.
5. Implement effective internal business governance mechanisms to ensure activities align with organisational aims.

## CONCLUSION

[13.] An auditor helps to reduce redundancies regarding accounting documentation since a company's governance is intended to regulate the ethical risk of the business. The idea leans heavily towards two distinct kinds of shifts, namely, a more experienced auditor and a less experienced auditor, with their respective effects on the organisation. The study examines the relationship between good corporate governance and shifting auditors to determine the influence on financial outcomes and corporate oversight. Frequent changes may also raise investor concerns about the credibility of the financial statements. Furthermore, increasing audit rivalry, modifications to the BOD, and executive incentives for auditor-client congruence may occur due to more tremendous auditor shifts.

[14.] Companies with poorer systems for corporate governance are more likely to swap auditors for short-term gains. However, when the company grows, shifting to a stronger auditing company will guarantee a beneficial impact on revenues. All of the assumptions have been proved, and internal and external auditing procedures prevent repeated auditor shifts, which influence not only business ethics but also the interest of shareholders. Indeed, financial anomalies should be controlled to boost the corporate governance of the business significantly.

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