

Auditor Changes in the SOX Era

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Auditor changes are ongoing; however, significant client realignments occurred in the immediate aftermath of SOX. Using data from 2003 to 2012, this paper explores auditor changes from a longitudinal perspective, and observes, though to a lesser degree, a continuation of the immediate SOX effects. Also observed are the effects of major historic events. The observations suggest SOX established a new normal with respect to auditor change, but historic events alter this SOX trend.

INTRODUCTION

Auditor change is not uncommon and it is an ongoing interest of regulators. Publicly listed firms are required to report auditor changes and reasons for the changes in the Form 8-K. Regulators continuing focus on auditor changes emphasize its importance as valued information to stakeholders (Turner et. al., 2005). The Security and Exchange Commission's auditor change disclosure requirements parallel the purpose of Sarbanes-Oxley Act (SOX), which is investor protection via improved disclosures, information accuracy and reliability (U.S. Congress, 107 H.R. 3763). SOX altered the auditing profession, and significantly motivated changes in auditor-client realignment. However, whether this trend persisted, and to what extent is unknown. Hence, this study explores auditor changes in the SOX era for trends, differences between Big 4 and non-Big 4 audit firms, and the effect of the recent recession on auditor changes.

The purpose of this paper is to provide descriptive evidence about the frequency and nature of auditor changes in the SOX era, and how these differ between Big 4 and non-Big 4 audit firms. Data is obtained from Audit Analytics for the years 2003–2012. The examination of auditor changes in the SOX era is relevant for several reasons. First, auditor change discussions are current and heightened with the debate on mandatory auditor rotation. Second, the dialogues about auditor independence *vis-a-vis* auditor tenure; and third, the discussions about audit quality and how demand for certain audit quality levels affect auditor changes.

This paper contributes to literatures on auditor changes and SOX by exploring the trends in auditor changes in the SOX era from a longitudinal perspective. The study includes a ten-year timeline while most studies on auditor changes in the SOX era focus on the first few years after SOX enactment (e.g. Rama and Read, 2006; Read et. al., 2004). An observed initial impact of SOX was an increased resignation of smaller audit firms from public company audits (Read et. al., 2004). However, beyond these documented initial effects of SOX on auditor changes, research is sparse on whether these effects continued in later years, and to what extent.

The next section provides reviews of the relevant regulations and literature on auditor changes. Thereafter, data, results, discussions and conclusions are presented.

REVIEW OF REGULATIONS, LITERATURE AND RESEARCH QUESTIONS

Overview of Sarbanes-Oxley Act of 2002

Sarbanes-Oxley Act (SOX) was enacted in July 2002 primarily for investor protection (US Congress, 107 H.R. 3763). SOX substantially changed the regulation of audit practice by creating the Public Company Accounting Oversight Board (PCAOB). Auditors of publicly listed firms (hereafter, issuers) were required to register with the PCAOB and were subject to PCAOB inspections (SOX Sections 102 and 104; Read et. al., 2004). SOX changed corporate practices by stating management's responsibility to: (i) establish and to maintain adequate internal control over financial reporting, and (ii) report on the effectiveness of internal control over financial reporting (SOX Section 404a). SOX also changed audit practice by requiring an integrated audit of publicly listed firms (Griffin and Lont, 2007).

Though the effective date of some SOX sections (e.g. Section 404) were deferred, issuers and auditors were aware of the key requirements of these sections, and the possible increase in resources and risks to meet SOX requirements. The resources include skilled labor, funding, time, and the risks include audit risk, litigation risk, insurance risk, and client risk (Griffin and Lont, 2007; Read et. al., 2004). Therefore, issuers and auditors alike had some information to determine whether to remain SEC issuers and auditors of SEC issuers, respectively.

Auditor Changes – Requirements

The SEC requires auditor changes to be disclosed in Form 8-K (Current Report). The disclosure identifies the auditor change type: resignation or dismissal (SEC, 2005), and the reason(s) for the auditor change. The reasons include nonstandard audit opinion, auditor-client disagreements, and reportable events such as internal control issues, and unwillingness to rely on management's representations (Rama and Read, 2006; Griffin and Lont, 2005; SEC 2005).

In response to Section 409 of SOX ("Real time issuer disclosures"), the SEC shortened the filing deadline for most items in Form 8-K (SEC, 2004). Effective August 23, 2004, the SEC required auditor change disclosures to be made within four business days of the triggering event (SEC 2004; Griffin and Lont, 2005). The auditor change disclosure requirements including the disclosure time frame further emphasizes the interest of the regulators on auditor changes.

Auditor Changes – Reasons

Auditor changes occur primarily due to client dismissals or auditor resignations (SEC 2005; Krishnan and Krishnan, 1997). However, Stefaniak et. al. (2009) suggest audit changes classification based on historical context e.g. the Great Depression, and mandatory firm rotation. A major historical event since SOX 2002 is the late 2007 to mid-2009 recession. The debate over mandatory firm rotation relates to SOX Section 207 and a conclusion is still pending. But, in the recent past, the demise of Arthur Andersen is the closest event to mandatory auditor switch; though the mandatory switch was one-directional, from Arthur Andersen to other audit firms.

Zhang (2014) documents from a frequency analysis of auditor changes that clients and auditors are hesitant to part ways. Nonetheless, auditor changes still occur, and key reasons for auditor changes from clients' perspectives are audit fees, additional billings, client's business knowledge and auditor-client relationship (Fontaine et. al., 2013; Brazel and Bradford, 2011; Magri and Baldacchino, 2004; Eichenseher and Shields, 1983). Though clients are three times more likely to initiate auditor change than auditors (Whisenant, 2003), auditor-initiated change (auditor resignation) does occur, and it is mostly due to clients' financial distress (Rama and Read, 2006; Krishnan and Krishnan, 1997; DeFond and Jiambalvo, 1993), and increased litigation risk (Griffin and Lont, 2005; Shu, 2000; Krishnan and Krishnan, 1997).

Auditor Changes - Client Characteristics

Several studies examined the characteristics of firms that changed auditors, and found such firms tend to be smaller in size, have weak internal controls, are less likely to comply with regulations, and are more

likely to receive nonstandard audit reports (Ettredge et. al. 2007; Davidson et. al., 2006; Hudaib and Cooke, 2005; Roberts et. al., 1990). Likewise, firms facing unfavorable financial conditions and firms that have disagreements with their auditors are more likely to change auditors (Hudaib and Cooke, 2005; Raghunandan and Rama, 1999; Dhaliwal et. al., 1993; DeFond and Jiambalvo, 1993). Firms with these characteristics tend to switch from Big N audit firms to smaller-tier audit firms for reasons such as audit fees reduction (Ettredge et. al., 2007), and a preference for different audit quality level (Davidson et. al., 2006; DeAngelo, 1981).

Auditor Changes - Pre-SOX

In the Pre-SOX era, firms with Big N auditors tended to switch to other Big N auditors, despite the Big N fee premium (Ettredge et. al., 2007; Landsman et. al., 2009). However, a switch to a non-Big N was more likely when a firm received a modified opinion from a predecessor auditor of any type (Davidson et. al., 2006) or the firm had higher litigation risk (Shu, 2000). Similarly, Davidson et. al. (2006) found firms that received other than an unqualified opinion and changed from a Big N audit firm to a non-Big N audit firm, were more likely to engage in earnings management following the auditor change. Raghunandan and Rama (1999) found Big N audit firms were less likely to accept clients whose auditors resigned; and auditor resignations are more sensitive to client risk than auditor dismissals (Landsman et. al., 2009; Shu, 2000).

Auditor Changes – Immediate aftermath of SOX

In the years following SOX enactment, the number of auditor changes and the number of audit firms that ceased performing SEC audits increased in comparison to the Pre-SOX era (Griffin and Lont, 2007; Rama and Read, 2006; Read et. al., 2004). Most issuers, who changed audit firms, and were previously audited by Big 4 auditors, changed to a non-Big 4 auditors (Ettredge et. al., 2007). These changes were motivated by the possibility of eliminating Big 4 fee premiums, since these issuers that changed audit firms experienced lower audit fee increases in comparison to issuers that did not change auditors or issuers that changed from a Big 4 to another Big 4 (Ettredge et. al., 2007).

Prior studies document the shedding of very high-risk clients by the Big 4 audit firms (Landsman et. al., 2009; Rama and Read, 2006), and rising audit fees across all firms (Griffin and Lont, 2007; Rama and Read, 2006; Griffin and Lont, 2005). Though audit fees increased in the Post-SOX era, issuers with higher audit fees were more likely to change auditors in search of reduced audit cost (Ettredge et. al., 2007), and issuers with greater litigation risks, financial stress, and those requiring more audit efforts received higher audit fees (Griffin and Lont, 2007). The sensitivity of auditor resignation and dismissal to client risk persisted, but did not surge, and auditor resignation remained more sensitive to client risk (Landsman et. al., 2009).

Research Questions

Prior studies relating to SOX effect on auditor changes mostly focused on the first few years after the enactment of SOX (e.g. Landsman et. al., 2009; Ettredge et. al., 2007; Griffin and Lont, 2007; Rama and Read, 2006; Read et. al., 2004). While the contributions and findings of these studies laid some foundation about auditor changes in the SOX era, this study builds on this foundation by focusing on an extended time frame (ten years), and highlighting audit change patterns resulting from the enactment of SOX. Hence, this paper addresses the question of what trends are observable about auditor changes in the SOX era.

Additionally, since audit quality is often differentiated based on auditor type, Big N versus non-Big N (Kim et. al., 2003; DeFond 1992; DeAngelo 1981), the impact of SOX on auditor type is explored. If SOX motivated a “new normal” with respect to auditor change, is the effect different for Big 4 and non-Big 4 firms? Hence, this paper addresses the question of whether any observed trends in the SOX era are different for Big 4 and non-Big 4 audit firms.

Stefaniak et. al. (2009) document based on their review of auditor change literature that there appears to be a deviation from typical patterns of auditor change during periods of economic crisis. In response to

their call for further research on similar events, this study explores whether any observed SOX era trend alters during the recent economic downturns of late 2007 to mid-2009. Hence, this paper also addresses the question of whether there are changes to any observed SOX era trends during the recent economic recessions.

DATA

Data on auditor changes was obtained from Audit Analytics for the years 2003 –2012. Sarbanes-Oxley Act was enacted on July 30, 2002, and the Post-SOX era includes all fiscal and calendar year-ends from July 31, 2002. However, data was collected from 2003 since it is the first full year after SOX and also to minimize traces of other significant events (e.g. Arthur Andersen demise) that occurred around SOX enactment. 15,939 initial observations of auditor changes were noted from 2003 – 2012. Observations without auditor change type (n = 5) and observations relating to company mergers and benefit plan subsidiaries (n = 1045) are eliminated. Table 1 presents a breakdown of the observations by year and auditor change type.

TABLE 1
AUDITOR CHANGE TYPE, BY YEAR

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Observation of auditor changes	1,652	2,092	2,054	1,883	1,668	1,412	1,634	1,419	1,138	987
Less: Auditor change due to client mergers benefit plans	93	141	164	178	124	93	84	63	53	52
Less: Observations without auditor change type	0	0	3	0	0	1	0	0	1	0
	1,559	1,951	1,887	1,705	1,544	1,318	1,550	1,356	1,084	935
Auditor dismissals	1,047	1,270	1,201	1,119	1,001	947	1,152	901	810	682
Auditor resignations	512	681	686	586	543	371	398	455	274	253
Total	1,559	1,951	1,887	1,705	1,544	1,318	1,550	1,356	1,084	935

Table 1 shows more observations of auditor dismissal in comparison to auditor resignations across the years and the ratio of auditor dismissals to auditor resignations is approximately 2.3:1. Auditor dismissals and auditor resignations peaked in 2004 and 2005, respectively, while the lowest observation of either type of auditor change occurred in 2012. These provide some insight on realignments in the audit services market during the earlier and later years of SOX.

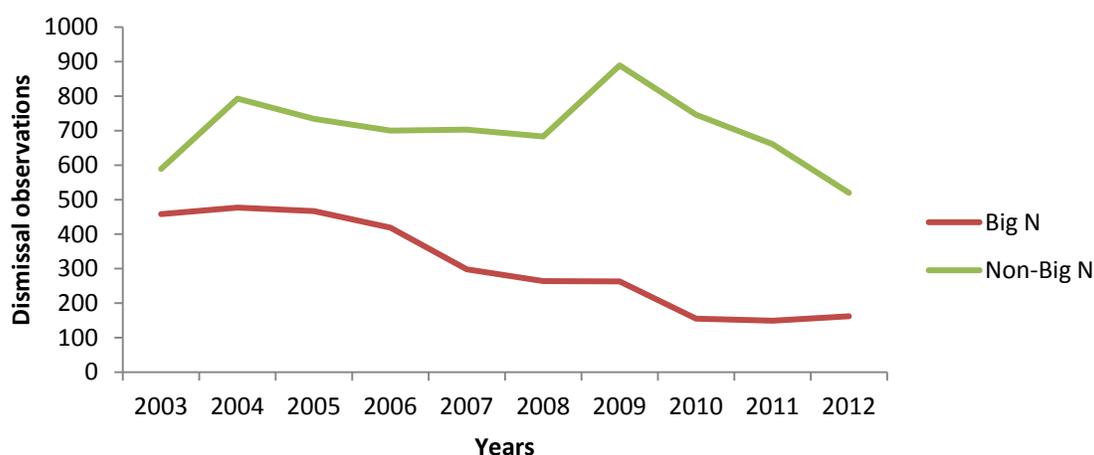
RESULTS AND DISCUSSIONS

Table 2 provides descriptive data about the frequency and pattern of Big 4 and non-Big 4 dismissals and resignations. With respect to auditor dismissals, the average for Big 4 audit firms across the years is 311 observations and the average for non-Big 4 firms is 702 observations. This indicates on average that non-Big 4 audit firms are more than twice likely to be dismissed than Big 4 audit firms. The data shows a relatively steady decline in the frequency of Big 4 audit firm dismissal (see figure 1). Further, Big 4 audit firms' dismissals peaked in 2004 while non-Big 4 audit firms' dismissals peaked in 2009. The gap in years and the patterns suggest a difference in the motivation for the dismissals. For the Big 4 audit firms, the dismissal frequency between 2003 and 2006 suggests some reaction to SOX (e.g. difference in desired audit quality level). For the non-Big 4 audit firms, the elevated frequency in 2009 may be attributed to the economic recession, and the resultant need of issuers to lower audit fees, a controllable cost.

TABLE 2
AUDITOR CHANGE TYPE BY AUDITOR TYPE: 2003 TO 2012

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Auditor dismissals:										
Big 4	458	477	467	419	298	264	263	155	149	162
Non-Big 4	589	793	734	700	703	683	889	746	661	520
Total	1,047	1,270	1,201	1,119	1,001	947	1,152	901	810	682
Auditor resignations:										
Big 4	164	261	226	137	101	34	22	106	30	24
Non-Big 4	348	420	460	449	442	337	376	349	244	229
Total	512	681	686	586	543	371	398	455	274	253

FIGURE 1
SOX ERA AUDITOR DISMISSALS FOR BIG 4 VERSUS NON-BIG 4



For auditor resignations, the average for Big 4 audit firms across the years is 111 observations and the average for non-Big 4 audit firms is 365 observations. This shows on average that non-Big 4 audit firms

are more than thrice likely to resign than Big 4 audit firms. A prior study (Landsman et. al., 2009) suggest a positive association between client risk and auditor resignation, and document a movement from Big 4 audit firms to non-Big 4 firms by riskier clients, following a Big 4 resignation. These findings suggest that the immediate aftermath reaction to SOX of the Big 4 audit firms to resign from riskier clients and their market realignment resulted in an increase in the pool of riskier clients for non-Big 4 audit firms (Ettredge et. al., 2007).

The ridged decline in non-Big 4 audit firms' resignation (see figure 2) suggests that not only did the non-Big 4 audit firms resign from riskier clients immediately after SOX, as they acquired new clients from the Big 4 audit firms, but in later years, around the recession, the non-Big 4 audit firms may have assessed their clients alignment, and resigned from some of them. Interestingly, the Big 4 audit firms' resignation heightened in 2010. It is uncertain whether this was a spill-over effect of the recession, a reaction to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), or a combined effect. Further research in this area is warranted.

FIGURE 2
SOX ERA AUDITOR RESIGNATIONS FOR BIG 4 VERSUS NON-BIG 4

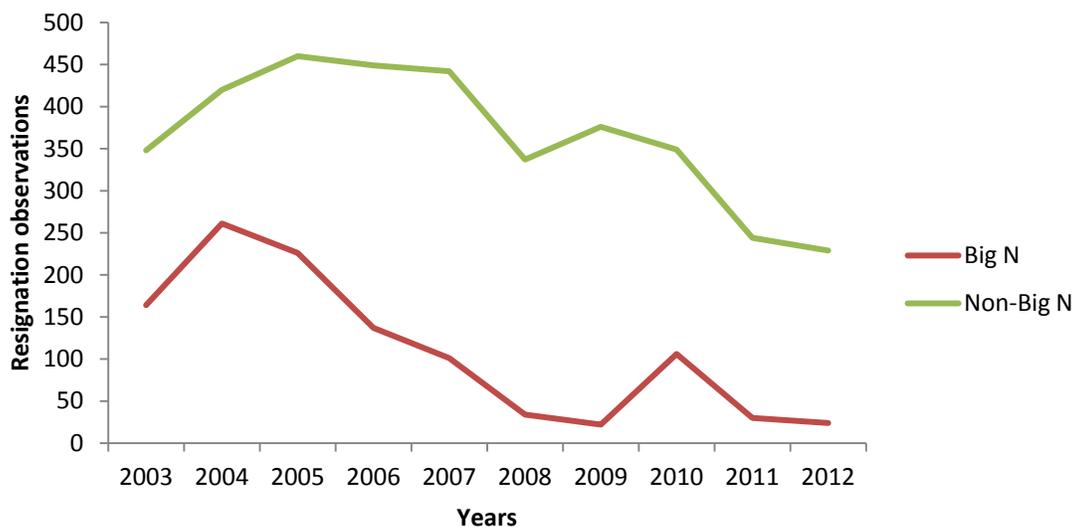


Table 3 presents data on successor auditors following auditor dismissals (see figures 3 and 4). The data shows that following a Big 4 audit firm dismissal, the likelihood of an issuer engaging another Big 4 audit firm averages 56%, while the likelihood of engaging a non-Big 4 audit firm averages 44%. However, in instances of a non-Big 4 audit firm dismissal, the data suggests the likelihood of issuers engaging a Big 4 audit firm only averages 7%, and the likelihood of engaging another non-Big 4 audit firm averages 92%.

With respect to Big 4 audit firms' dismissals, the increased changes, in 2004 – 2005, to non-Big 4 audit firms is attributable to higher audit fees and premiums charged by the Big 4 audit firms (Ettredge et. al., 2007). In 2008 - 2009, the decline in the change to a non-Big 4 audit firm, and the rise in the change to a Big 4 audit firm, following a Big 4 audit firm dismissal may be due to the demand for a higher audit quality level or the desire to maintain an audit quality level (Davidson et. al., 2006). In regards to non-Big 4 audit firms' dismissals, the majority of issuers changed to another non-Big 4 audit firm, thus suggesting higher audit quality or higher audit fees may not necessarily be the reasons for the changes, except to the extent that issuers benefitted from fee discounts in the first year of the successor auditors. The data also shows issuers are more likely to cease being SEC registrants following a non-Big 4 audit firm dismissal, and the peak in 2009 of no successor auditors may be attributable to the recession.

TABLE 3
SUCCESSOR AUDITOR AFTER AUDITOR DISMISSAL: 2003 TO 2012

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Big 4 Dismissals:										
Big 4 successors	227	201	202	203	143	173	170	115	100	95
Non-Big 4 successors	228	273	264	216	154	91	93	40	48	67
No successor	3	3	1	0	1	0	0	0	1	0
Total	458	477	467	419	298	264	263	155	149	162
Non-Big 4 Dismissals:										
Big 4 successors	33	44	52	43	56	51	54	59	54	43
Non-Big 4 successors	553	742	676	650	644	627	820	680	602	474
No successor	3	7	6	7	3	5	15	7	5	3
Total	589	793	734	700	703	683	889	746	661	520

FIGURE 3
SUCCESSOR AUDITOR FOLLOWING BIG 4 DISMISSALS

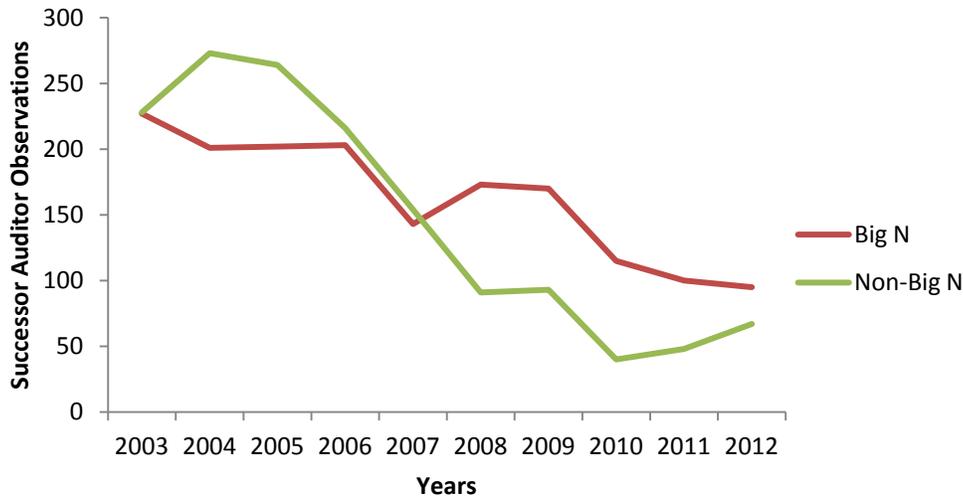


Table 4 presents data on successor auditors following auditor resignations (see figures 5 and 6). The data indicates that following a Big 4 audit firm resignation, the likelihood of an issuer engaging another Big 4 audit firm averages 49%. The likelihood of a non-Big 4 audit firm being engaged following a Big 4 audit firm resignation averages 42%. As shown in recent studies (Landsman et. al., 2009; Rama and Read, 2006), the Big 4 audit firms realigned their portfolio of clients following SOX and resigned from riskier clients. This explains the significantly higher change to non-Big 4 audit firms in 2004 and 2005. However, except for the outlier year of 2010, the data shows a decrease in Big 4 audit firms' resignation. The spike in 2010 may be due to the effects of Dodd-Frank Act, a notion that warrants further investigation.

Following non-Big 4 audit firms' resignations, on average, the likelihood of issuers engaging a Big 4 audit firm is only about 3%. The majority of the change to another non-Big 4 audit firm, following a non-Big 4 audit firm resignation, suggests issuers audited by non-Big 4 audit firms are fairly consistent with

their desired audit quality level. Data in table 4 also shows higher instances of issuers not engaging successor auditors after a non-Big 4 audit firm resigns in comparison to when a Big 4 audit firm resigns.

FIGURE 4
SUCCESSOR AUDITOR FOLLOWING NON-BIG 4 DISMISSALS

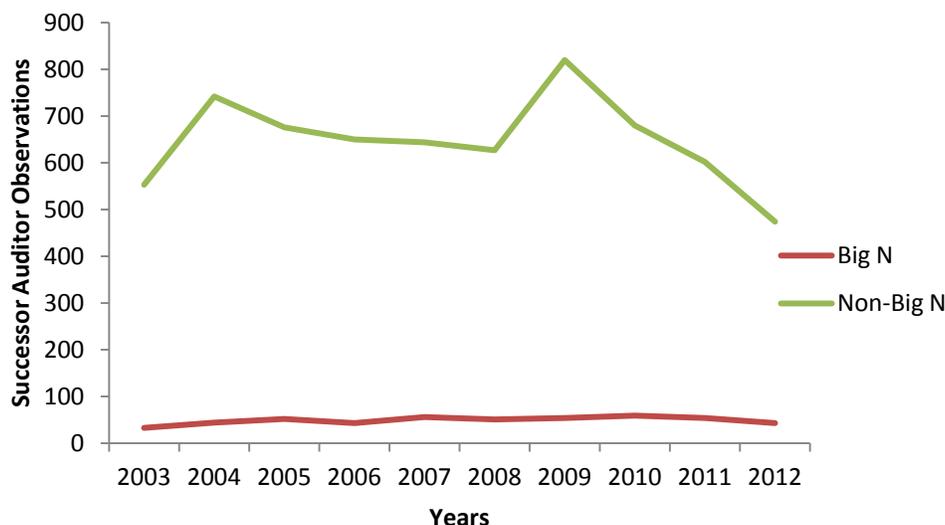


TABLE 4
SUCCESSOR AUDITOR AFTER AUDITOR RESIGNATION: 2003 TO 2012

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Big 4 Resignations:										
Big 4 successors	60	72	67	67	71	15	10	93	10	15
Non-Big 4 successors	82	175	153	65	27	14	8	11	13	8
No successor	22	14	6	5	3	5	4	2	7	1
Total	164	261	226	137	101	34	22	106	30	24
Non-Big 4 Resignations:										
Big 4 successors	7	7	35	9	18	10	11	7	10	8
Non-Big 4 successors	301	391	401	420	406	296	340	318	217	197
No successor	40	22	24	20	18	31	25	24	17	24
Total	348	420	460	449	442	337	376	349	244	229

CONCLUSIONS

This paper presents a trend analysis of auditor changes in the SOX era. Prior literature on auditor changes after SOX enactment focused mostly on the aftermath effect of SOX. While these studies document an initial exodus of Big 4 audit firms from riskier clients, and an overall realignment of client portfolio amongst audit firms, literature is sparse on the state of auditor changes beyond the first few years after SOX. This study shows that auditor resignations and dismissals declined over the years, with notable increases in the period of the recent economic recession, particularly for non-Big 4 audit firms. In

instances of dismissals or resignations of non-Big 4 audit firms, issuers are more likely to engage other non-Big 4 audit firms. Issuers are also more likely to engage non-Big 4 audit firms when Big 4 audit firms are dismissed. But, when a Big 4 audit firm resigns, issuers are more likely to engage another Big 4 audit firm.

These observations suggest the trends noted in the initial aftermath of SOX persisted, though to a lesser extent, over the years. Interestingly, the declining SOX trends were altered during the economic recession, mostly for non-Big 4 audit firms. Also, increased auditor resignations were observed in 2010, particularly for Big 4 audit firms. While this paper suggests the significant increase may be attributable to a reaction to the Dodd-Frank Act., hence a change due to a major historical event following Stefaniak et. al. (2009), further research is required.

FIGURE 5
SUCCESSOR AUDITOR FOLLOWING BIG 4 RESIGNATIONS

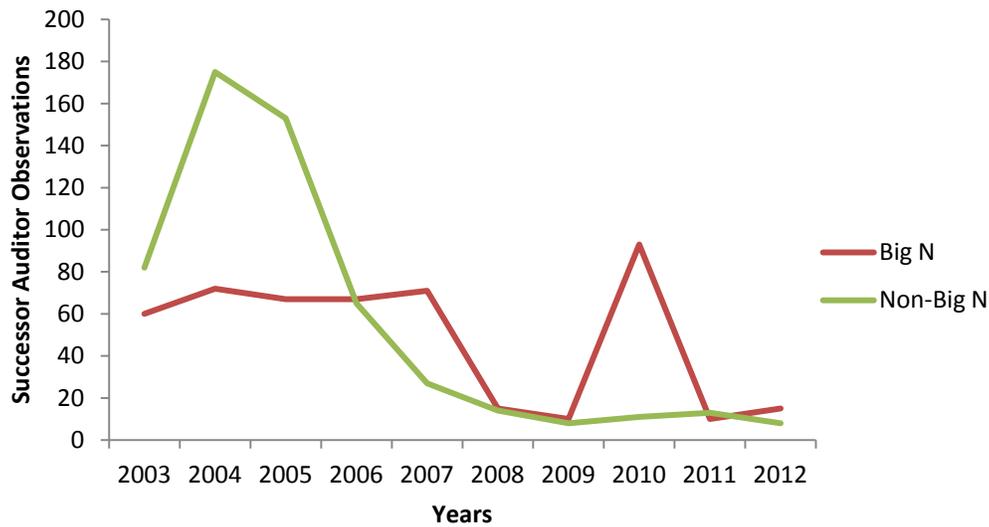
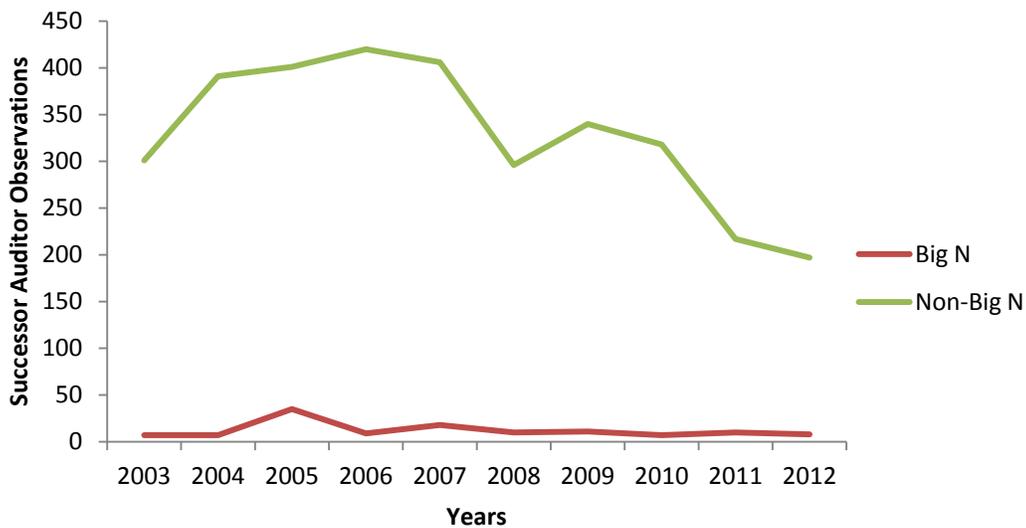


FIGURE 6
SUCCESSOR AUDITOR FOLLOWING NON-BIG 4 RESIGNATIONS



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