EMPIRICAL STUDY ON THE DISCLOSURE OF REASONS FOR AUDITOR SWITCHING: EVIDENCE FROM JAPAN

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1. Introduction

Auditor switching has been frequently discussed in recent years. In April 2014, the European Parliament enacted new rules requiring public companies to switch auditors after a maximum of 10 years. Meanwhile, in the United States, the Public Company Accounting Oversight Board (PCAOB) reportedly halted a 3-year effort to establish mandatory auditor rotation. While companies are not allowed to switch auditors without certain justifiable reasons in the European Union (EU),[1] auditor switching itself is not limited by specific reasons in the United States.

Given this background, the present study focuses on the reasons that are reported for auditor switching. Similar to the case in the United States, auditor switching is not limited by specific reasons in Japan. Moreover, from April 2008, any company in Japan that switches auditors is required to disclose the relevant information pertaining to the reasons for and the background to auditor switching in an extraordinary report.[2] Thus, the objective of this study is to investigate the relationship between the context of auditor switching and the reasons provided in the extraordinary reports, which are one of the most distinctive characteristics of the auditor switching institution in Japan. In the extraordinary report, many companies that switched auditors (henceforward,

[1] For example, "a disagreement or a difference of opinion between the auditor and the manager" is not regarded as a justifiable reason.

[2] In Japan, companies that switch auditors ("switchers") have to submit an extraordinary report that includes the switching date, audit opinions for the last three years, reasons for and background to switching, and the opinion of the predecessor auditor about the entries in the audit report (The Cabinet Office Ordinance for Partial Revision of the Cabinet Office Ordinance on Disclosure of Corporate Affairs, etc. on March 28, 2008).

"switchers") have claimed the "expiration of auditors' term of office" as the reason for the switch; only a few switchers have provided specific reasons. However, the phrase "expiration of auditors' term of office" does not clearly represent the reality. Ordinarily, the current auditor could continue auditing a firm, and firms do not switch auditors frequently: "unless otherwise resolved at the annual shareholders meeting under the preceding paragraph, accounting auditors shall be deemed to have been re-elected at such annual shareholders meeting" (Companies Act Article 338 (2)) in Japan. Hence, the phrase "expiration of auditors' term of office" does not explain the reasons for and the background to the switching of auditors in the true sense.

Therefore, this study specifically examines whether switchers of a certain kind with a probable motive for not publicly disclosing the true reasons for auditor switching simply tend to provide "expiration of auditors' term of office" as the reason for the switch in the extraordinary reports. Using audit firm size and going-concern opinions (GCO) to examine problematic cases of auditor switching, this study demonstrates that both the switch from Big N auditors[3] to non-Big N auditors ("downgrading") as well as GCO is associated with the use of the reason "expiration of auditors' term of office."

The rest of this paper is organized as follows. Section 2 reviews the extant literature and develops the study's hypotheses. Section 3 outlines the sample and data and describes the research models. Section 4 reports the empirical results. Section 5 summarizes the results of the robustness check. Section 6 presents the conclusions and directions for future research.

2. Prior Research and Hypotheses

(1) Literature Review

A preliminary survey did not reveal any prior empirical studies related to the reasons for auditor switching in the context of Japan. Therefore, this section mainly reviews prior studies conducted in the context of the United States, whose audit institution is similar to that in Japan. Unlike in Japan,

[3] The Big N auditors in Japan include the largest audit firms: Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, KPMG AZSA LLC, and PricewaterhouseCoopers Aarata. The non-Big N auditors include the other audit firms.

however, in the United States, the details related to auditor switching—including the reasons for and the background to switching auditors—are disclosed only when there is (i) a disagreement or a difference of opinion between the predecessor auditor and the manager or (ii) a reportable event in Form 8-K of the institutions.[4] Therefore, most of the studies on the reasons for auditor switching in the United States focus on identifying the true reason for the switch through interviews and/or questionnaires or by using financial data.[5] Additionally, several empirical studies examine why switchers voluntarily disclosed their reasons for switching. The Securities and Exchange Commission (SEC) encourages firms to voluntarily include information about the reasons for auditor switching in the Form 8-K filings in cases other than those involving a disagreement or difference of opinion between the predecessor auditor and the manager. Prior studies reported that 26 percent of the switchers voluntarily disclosed the reasons for auditor switching in their Form 8-K filings (Sankaraguruswamy and Whisenant, 2004). Thus, in the context of the United States, "the majority of the documented causes of why clients switch auditors comes from indirect evidence" (Fontaine and Letaifa (2012) p.6); moreover, the results reported in these prior studies appear to be contradictory. Therefore, this study mainly surveys the prior empirical studies that used voluntarily disclosed reasons for auditor switching in their analyses. The relevant prior studies are summarized in Table 1.

(Insert Table 1 here)

Prior studies have reported a greater variety of reasons for auditor switching in the United States compared to those reported in Japan[6]; moreover, the Form 8-K disclosures are found to have

[4] According to the Securities and Exchange Commission (SEC (1989)), a switcher should state whether the former accountant resigned, declined to stand for re-election, or was dismissed, and the date thereof; whether the principal accountant's report on the financial statements for either of the past two years contained an adverse opinion or a disclaimer of opinion, or was qualified/modified as to uncertainty, audit scope, or accounting principles; whether the decision to change accountants was recommended or approved by (A) any audit committee or similar committee of the board of directors, if the issuer has such a committee, or (B) the board of directors, if the issuer has no such committee; etc. The details (including the reasons for and/or the background to auditor switching) are disclosed only when there is a disagreement or a reportable event.

[5] Burton and Roberts (1967); Eichenseher and Shields (1983); Williams (1988); Kluger and Shields (1989); Haskins and Williams (1990); Beattie and Fearnley (1995), (1998); Tate (2007); Brazel and Bradford (2011); Fontaine and Letaifa (2012); Fontaine, Letaifa, and Herda (2013).

[6] Refer to Turner, Williams, and Weirich (2005) for more details.

information content. However, because of data limitations, some of the prior studies used samples that included mandatorily disclosed reasons (disagreements) and other voluntarily disclosed reasons. In addition, the preliminary survey did not reveal any prior empirical study that investigated whether switchers report the specific reasons for switching in certain contexts.[7] This is because there are different institutions for the disclosure of auditor switching in Japan and in the United States.

(2) Hypotheses Development

It is expected that substantial descriptions of the reasons for and the background to switching auditors would be mentioned in the extraordinary reports when the disclosure of reasons is mandatory. However, it is found that many switchers simply claim "expiration of auditors' term of office" as the reason for switching auditors.

Under the Japanese Companies Act, "an accounting auditor's term of office shall continue until the conclusion of the annual shareholders meeting for the last business year which ends within one year from the time of their election" (Companies Act Article 338 (1)). Further, "unless otherwise resolved at the annual shareholders meeting under the preceding paragraph, accounting auditors shall be deemed to have been re-elected at such annual shareholders meeting (Companies Act Article 338 (2))." Therefore, under ordinary circumstances, auditors cannot be switched simply because of their term of office expired. Thus, the reason "expiration of auditors' term of office" is a cosmetic explanation that is far from the actual situation, and it is a material misstatement. In this context, it is suspected that the instances of auditor switching for which the reason provided in the extraordinary report is the "expiration of auditors' term of office" are different from those for which a specific reason is provided.[8] That is, certain kinds of switchers seem to have motives to not

[7] However, Sankaraguruswamy and Whisenant (2004) report different reasons for auditor switching according to auditor firm size in the case of auditor dismissal.

[8] The extraordinary report submitted when auditor switching has occurred has to include the opinion of the auditor who is subject to the switch in relation to the matters specified in the items of Article 4(1) of the Ordinance on Audit Certification or to the matters listed in the items of Article 6(1) of the Ordinance on Internal Control with regard to the decision for the switch or the grounds and the particulars that led to the switch (Cabinet Office Ordinance on the Disclosure of Corporate Affairs, etc. Article 19 (ix)-2 (c) 5). Therefore, the auditor who is subject to the switch must check the reasons for and the background to switching auditors in the extraordinary report. Hence, clients cannot provide whatever they want to as the specific reasons for auditor switching.

publicly disclose their true reasons for auditor switching, and they tend to provide "expiration of auditors' term of office" as the reason for the switch in the extraordinary reports.[9] Therefore, this study analyzes two issues: *downgrading of audit firm size* and *going-concern opinions*.

Downgrading of Audit Firm Size

According to DeAngelo (1981), a large audit firm has better resources for providing high-quality audits compared to smaller audit firms (theoretically). Thus, "when a client switches to a smaller auditor, the quality of the client's financial reporting could be expected to decline" (Carver et al. (2011) pp. 37-38). Therefore, investors often consider the downgrading of audit firm size as a "red flag" (Eichenseher et al. (1989); Knechel et al. (2007)). However, several prior studies report that there are hardly any differences in the audit quality of large audit firms and that of smaller audit firms (Choi et al. (2008)); further, they report that switchers tend to not have success in opinion shopping[10] (Chow and Rice (1982); Krishnan (1994); Krishnan and Stephens (1995); Geiger et al. (1998)). Moreover, in Japan, there is no empirical evidence to suggest the existence of successful opinion shopping. However, it seems to be conventional practice that smaller audit firms agree to work with the former clients of large audit firms (Machida (2010)). For instance, Riso Kyoiku Co., Ltd., whose accounting fraud was revealed in 2014, was found to have switched its auditor from one of the Big 4 auditors to a small audit firm when the manager had committed the accounting fraud.[11]

According to signaling theory,[12] switchers may disclose their reasons for auditor switching if the reasons are beneficial, i.e., if the reasons could assist in the search for better services and/or a lower audit fee (Chang et al. (2010) p.84), from the perspective of the asymmetry of information. In contrast, switchers may not provide any specific reasons for the switch when they have certain

[9] In fact, in the case of the fraud committed by Olympus, which is one of the biggest accounting scandals in Japan, auditor switching occurred in the defective fiscal year because of the disagreement between the auditor and the manager. However, the publicly disclosed reason for auditor switching was "expiration of auditors' term of office," initially.

[10] Opinion shopping is defined as "shopping for an improved audit opinion from a new auditor" (Krishnan and Stephens (1995) p. 179).

[11] Similar to the case of Olympus (Note 9 in this paper), the publicly disclosed reason for auditor switching in the case of Riso Kyoiku was "expiration of auditors' term of office."

[12] Refer to Ijima (2011) for more details on the signaling function of auditing in Japan.

problems and are motivated to hide the problem. Therefore, it is assumed that the downgrading of audit firm size involves auditor switching where the switchers do not want to disclose the true reason for the switch because of a certain problem; in such situations, the switchers would tend to provide "expiration of auditors' term of office" as the reason for auditor switching in their extraordinary reports. This leads to the following hypothesis.

HYPOTHESIS 1-1: The switchers involved in instances of *Downgrading of audit firm size* will provide "expiration of auditors' term of office" as the reason for auditor switching in the extraordinary reports more frequently compared to the switchers involved in instances of *Upgrading of audit firm size* and *Lateral switching*.[13]

Going-Concern Opinion

The second focus of this study is related to the instances of auditor switching after the client receives going-concern opinions (GCO) from the auditor. "Explanatory notes regarding the going concern assumption" are provided by the clients; however, "if events or conditions are identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall determine whether or not a material uncertainty regarding the going concern assumption exists, with regard to the management's assessment and plans for future actions for a reasonable period of time."[14] Thus, in the difficult economic environment, receiving GCO is a matter of life and death for clients (Machida (2010) p.136). That is, clients have a strong incentive to avoid GCOs as much as possible.

However, receiving a GCO is in itself neither considered a rational reason for auditor switching nor approved by stakeholders. Accordingly, receiving a GCO may correlate with the use of the reason "expiration of auditors' term of office" in extraordinary reports. This leads to the following hypothesis.

[13] In this study, *Upgrading* refers to a switch from a non-Big N auditor to a Big N auditor; *Lateral switching* refers to a switch from a Big N auditor to another Big N auditor or from a non-Big N auditor to another non-Big N auditor; and *Downgrading* means a switch from a Big N auditor to a non-Big N auditor.

[14] Auditing Standards Board Report No.22.

HYPOTHESIS 1-2: Switchers who received a GCO in the fiscal year just before switching will provide "expiration of auditors' term of office" as the reason for switching auditors in their extraordinary reports more frequently compared to other switchers.

Moreover, it is assumed that the market reactions vary according to the reason for auditor switching if the disclosed reason in the extraordinary report has information content and is useful for investors. Specifically, investors may suspect the possibility of a negative true reason for auditor switching when "expiration of auditors' term of office" is disclosed as the reason for the switch in the extraordinary reports. Thus, it is likely that the reason "expiration of auditors' term of office" in the extraordinary reports is one of the aspects of "bad news" related to auditor switching from the investors' perspective; therefore, the cumulative abnormal returns (CAR) in such cases would tend to be lower than in other cases of switching. Therefore, this study additionally investigates the following hypothesis.

HYPOTHESIS 2: Firms that provide "expiration of auditors' term of office" as the reason for auditor switching in their extraordinary reports will experience more negative abnormal returns around the announcement of auditor switching compared to firms that provide specific reasons for the switch.

In Japan, switchers do not have to disclose whether a particular instance of auditor switching involves the dismissal of the auditor or the auditor's resignation. Thus, it is difficult to clearly categorize instances of auditor switching into cases of dismissal and resignation. Therefore, this study investigates both these cases together to avoid subjectivity problems.

3. Research Design

(1) Sample and Data

The sample for this study was selected from cases of auditor switching involving all the listed companies in Japan from April 2008 to March 2012. The initial sample included 623 instances of

auditor switching. Subsequently, banks, securities companies, and insurance companies (38 observations), [15] accounting term alterations (19 observations), delisted companies (77 observations), cases that did not involve actual switching (e.g., mergers and acquisitions of audit firms; changes in the name of audit firms) (22 observations), auditor switching during the term[16] (64 observations), and cases that lacked data (including companies that did not submit an extraordinary report) (39 observations) were excluded from the sample. The final sample contained 364 observations. The sample selection process is presented in Table 2.

(Insert Table 2 here)

The data pertaining to auditor switching used in this study were extracted from the auditors' reports contained in financial reports, extraordinary reports, and investor relations (IR) reports using an *eol database* because Japan has no exhaustive database on auditor switching. Simultaneously, the dates when the companies disclosed the extraordinary report and/or IR report for auditor switching were collected. The data source for the accounting variables was the NIKKEI NEEDS-Financial Quest from Nikkei Media Marketing; the stock price data were extracted from the Stock Price CD-ROM released by *TOYOKEIZAI DATA Service*.

(2) Model

To test hypotheses H1-1 and H1-2, this study estimates Model (1) using logistic regression.

$$REASON = \alpha + \beta_1 DOWN + \beta_2 GCO_{t-1} + \beta_3 SIZE_{t-1} + \beta_4 NI_{t-1} + \beta_5 AFEE + \beta_6 TEAM + \beta_7 NONAUDIT + \beta_8 EMP_{t-1} + \beta_9 MULTI + \beta_{10} MG + YEAR + INDUSTRY + \varepsilon \quad (1)$$

REASON A dummy variable, coded 1 if the switcher provides "expiration of auditors'

[15] Since the accounting items in banks, securities companies, and insurance companies differ widely from those in other operating companies, they were excluded from the final sample in this study.

[16] In the case of auditor switching during the term, a switch is made and a temporary auditor is appointed without the approval of the annual shareholders' meeting. In such cases, it is theoretically impossible to provide "expiration of auditors' term of office" as the reason for the switch in the extraordinary report. Therefore, such cases of auditor switching are excluded from the final sample in this study.

	term of office" as the reason in the extraordinary report, and 0 if the switcher provides any other specific reasons
DOWN	A dummy variable, coded 1 if the predecessor auditor is among the Big N auditors and the successor auditor is among the non-Big N auditors, and 0 otherwise
GCO	A dummy variable, coded 1 if the auditor reported a going-concern opinion for year *t*-1, and 0 otherwise
SIZE	The natural logarithm of the total assets for year *t*-1
NI	The net income divided by the total assets for year *t*-1
AFEE	Difference between the audit fee before and after auditor switching
TEAM	Difference between the number of audit team members before and after auditor switching
NONAUDIT	A dummy variable, coded 1 if the predecessor auditor or the successor auditor provides non-audit and attestation services, and 0 otherwise
EMP	A dummy variable, coded 1 if there are the additional paragraphs in the auditors' reports except for GCO, and 0 otherwise
MULTI	A dummy variable, coded 1 if the company switched auditors more than once, and 0 otherwise
MG	A dummy variable, coded 1 if the company is listed in Japan's new stock markets
YEAR	Year dummy
INDUSTRY	Industry dummy
ε	Error term (subscript *t*: accounting period)

The dependent variable of Model (1) is *REASON*, and the independent variables are *DOWN* and *GCO*.[17] Some variables are used to control for the factors influencing the disclosure of the reason(s) for switching auditors. *AFEE* is a control variable for audit fee as the reason for auditor switching. The expected sign for *AFEE* is positive because the audit fee may not increase after auditor switching if the switch was initiated because of audit fee. If the reason for the switch is service-related, the number of audit team members and/or whether the auditor provides non-audit and attestation services may change after the switch. However, as each client has different demands for

[17] The correlation between *DOWN* and *GCO* is 0.148; thus, they hardly overlapped.

the services provided by audit firms, the expected sign for *TEAM* and *NONAUDIT* is positive/negative. Further, *SIZE* and *NI* are variables controlling for the financial factors, and *EMP* controls for the factors related to the auditors' reports. In addition to controlling the factors associated with reasons for auditor switching, *MULTI*, *MG*, *YEAR* and *INDUSTRY* are used in model (1).

Next, to test hypothesis H2, this study estimates Model (2) using multiple regression.

$$CAR[-1,+1] = \alpha + \beta_1 REASON + \beta_2 REASON * DOWN + \beta_3 REASON * GCO_{t-1} + \beta_4 SIZE_{t-1} + \beta_5 NI_{t-1} + \beta_6 LEV_{t-1} + \beta_7 LIQ_{t-1} + \beta_8 GROWTH + \beta_9 EMP_{t-1} + \beta_{10} FORECAST_t + \beta_{11} SURPRISE_t + \beta_{12} MULTI + \beta_{13} MG + YEAR + INDUSTRY + \varepsilon \quad (2)$$

CAR(-1, +1)	3-day cumulative abnormal returns around the date of an auditor switching announcement
REASON	A dummy variable, coded 1 if the switcher provides "expiration of auditors' term of office" as the reason for the switch in the extraordinary report, and 0 if the switcher provides any other specific reasons
DOWN	A dummy variable, coded 1 if the predecessor auditor is among the Big N auditors, and the successor auditor is among the non-Big N auditors, and 0 otherwise
GCO	A dummy variable, coded 1 if the auditor reported a going-concern opinion for year *t*-1, and 0 otherwise
SIZE	The natural logarithm of the total assets for year *t*-1
NI	The net income divided by the total assets for year *t*-1
LEV	Total debt divided by total assets for year *t*-1
LIQ	Current assets divided by total assets for year *t*-1
GROWTH	Growth rate of total assets
EMP	A dummy variable, coded 1 if there are the additional paragraphs in the auditors' reports except for GCO, and 0 otherwise
FORECAST	The net income forecast by managers divided by the total assets for year *t*-1

SURPRISE	(The actual net income minus the net income forecast) divided by the total assets for year *t*-1
MULTI	A dummy variable, coded 1 if the company switched auditors more than once, and 0 otherwise
MG	A dummy variable, coded 1 if the company is listed in Japan's new stock markets
YEAR	Year dummy
INDUSTRY	Industry dummy
ε	Error term (subscript *t*: accounting period)

The dependent variable of Model (2) is *CAR(-1, +1)*, and the independent variable is *REASON*; the interaction variables involve *REASON* and *DOWN*, and *REASON* and *GCO*. These three variables are tested simultaneously to control their effect on one another. Additionally, *LEV, LIQ,* and *GROWTH* are used to control the financial factors influencing CAR (Eichenseher et al. (1989); Klock (1994); Knechel et al. (2007)). *FORECAST* and *SURPRISE* control some cases in which the earnings information was announced (e.g., the brief financial result) within the event window.[18]

In this study, the event date was taken as the earliest announcement date when the switchers published the extraordinary report, IR report, and press release(s) on their websites (the Tokyo Stock Exchange (TSE), Rules on the Listing of Securities Article 402 (1)). If the announcement date was a non-service day for the TSE, the next day was regarded as the event date. The CAR is calculated using Model (3) and Model (4).

$$AR_{it} = R_{it} - R_{mt} \tag{3}$$

$$CAR\ (S,T) = \sum_{t=S}^{T} (AR_{it}) \tag{4}$$

where $t = 0$ is the announcement date of auditor switching; R_{it} is the return of the sample company i on day t; and R_{mt} is the Tokyo Stock Price Index (TOPIX) on day t. CAR_{it} is calculated by

[18] If there is no earnings surprise because the earnings information is not announced during the event window, *SURPRISE* is coded 0; therefore, the expected sign is positive/negative.

cumulating AR_{it} from -1 ≦ S to T ≧ +1.

4. Results

(1) Descriptive Statistics

The disclosed reasons for auditor switching are classified into four categories according to the size of the predecessor and the successor auditors (i.e., Big N or non-Big N auditors), as shown in Table 3. For the case of switching from a Big N to a non-Big N auditor, the most common reason is "expiration of auditors' term of office"; the second most common reason is audit fee.

(Insert Table 3 here)

Table 4 displays the descriptive statistics for the variables used in the models in this study. Panel D of Table 4 indicates that *DOWN*, *GCO*, *LEV*, and *MG* for the switchers that provided "expiration of auditors' term of office" as the reason for the switch were significantly (at the 5% level) higher than those for the other switchers, using both mean and median. The result for the variable *MG* is significant at the 1% level; this result suggests that the switchers listed in Japan's new stock markets tend to provide "expiration of auditors' term of office" as the reason for the switch more frequently compared to the other switchers.

(Insert Table 4 here)

(2) Empirical Results

The logistic regression results of estimating Model (1) are reported in Table 5. The coefficients of *DOWN* and *GCO* have a significant positive association with *REASON* ($p < 0.05$), which is consistent with hypotheses H1-1 and H1-2. With regard to the other control variables, the coefficient of *MG* has a strongly significant positive association with *REASON* ($p < 0.01$). This implies that the companies that are listed in Japan's new stock markets tend to provide "expiration of auditors' term of office" as the reason for the switch in their extraordinary reports; however, further research is required to validate this finding.

(Insert Table 5 here)

The multiple regression results of Model (2) are reported in Table 6. The coefficients of *REASON*, *REASON*DOWN*, and *REASON*GCO* have no significant association with *CAR*, which is not consistent with hypothesis H2; this finding is similar to what was reported in Aldhizer III et al. (2009).[19]

(Insert Table 6 here)

There are some possible explanations regarding why there is no significant difference in the market reactions to the different disclosed reasons for auditor switching. First, the positive and negative market reaction might be offset as both positive reality as well as negative reality is associated with the phrase "expiration of auditors' term of office." However, if the auditor switch took place because of a positive reason, the switchers would disclose the reason without any hesitation, according to signaling theory. Thus, it is difficult to determine whether the switchers conceal positive reasons for auditor switching, and whether the positive and negative market reactions are offset. Second, investors might find it difficult to comprehend the actual situation about auditor switching even though it is negative for them. In this case, the disclosure content could be useless for the investors, since the investors are not able to grasp the actual situation from the disclosed reasons for auditor switching. Third, it is possible that the disclosure of reasons does not lead to any investment behavior either because the content has no information value for the investors, or because the investors have already obtained the information about the reasons for auditor switching from other sources. In these cases, the disclosure could not be regarded as beneficial for the investors (from the perspective of this institution's main purpose).

Thus, the current disclosure system associated with auditor switching has several issues related to the explanation of the reasons for and the background to switching auditors. Hence, it can be

[19] Aldhizer III et al. (2009) investigate whether required and voluntary Form 8-K auditor switching disclosures in 2004 and 2005 convey information content to investors in a post-Sarbanes‐Oxley act (SOX) era. They find that voluntary disclosures such as fee disputes do not convey information content. The present study investigates the difference between the market reactions to the reason "expiration of auditors' term of office" and specific reasons for auditor switching.

concluded that a reconfiguration of the disclosure system that reflects the realities of auditor switching is necessary.[20]

5. Additional Tests

Further analyses were conducted to verify the robustness of the results reported in the previous section. These analyses included additional and/or different variables, involved sample cutting, and paid attention to endogeneity issues.

First, *TAFEE* (difference between the total fee for auditors before and after switching auditors), *TEAM_CPA* (difference in the number of certified public accountants in the audit team before and after auditor switching), and *LOSS* (a dummy variable, coded 1 if the net income for year *t*-1 is negative, and 0 otherwise) are used in the models instead of *AFEE, TEAM,* and *NI*, respectively. Second, *REASON*, *REASON*DOWN*, and *REASON*GCO* are separately set in Model (2). Third, the companies that announced the earnings information in the event window (108 observations) were removed from the sample to exclude the impact of the earnings information announcement. Fourth, both Model (1) and Model (2) are tested after the variables *YEAR* and *INDUSTRY* are removed to take sample size into consideration. These regression results are consistent with the original results.

Further, Model (2) is estimated using the treatment effect model to solve the endogeneity issues. The results are reported in Table 7.

(Insert Table 7 here)

The results of the treatment effect model are consistent with the results of the original model (presented in Section 4). Thus, the results are robust when different attributes are considered.

6. Summary and Conclusion

[20] Theoretically, the possibility of abolishing the extraordinary report can be debated because it is quite useless. However, to abolish it would be against the current movement of Japanese institutions, which have been trying to expand the scope of disclosure related to auditor switching recently.

This study investigated the relationship between the context of auditor switching and the reasons for the switch provided in the extraordinary reports. Dealing with downgrading and GCO just before auditor switching revealed that switchers tend to use "expiration of auditors' term of office" as the reason for the switch in their extraordinary reports when the auditor switch is problematic. In addition, this study examined whether the reasons for the switch provided in the extraordinary reports affect investment behavior. Using CAR, this study demonstrated that there are no significant market reactions associated with the disclosure of the reasons for auditor switching. Therefore, it is possible to conclude that the disclosure system related to auditor switching may not be useful for investors.

This study contributes to the literature on auditor switching in several ways. First, although auditor switching has been frequently discussed in recent years, there is not enough empirical research on auditor switching in the specific context of Japan. This study addresses this gap. Second, most of the prior studies do not deal with auditor switching from the perspective of the specific reasons provided in the extraordinary reports. This study considered extraordinary reports, which represent one of the most important characteristics of auditor switching in Japan. Third, as an institutional implication, it is possible to say that the disclosure of reasons in the extraordinary report may not prove useful for investors.

This study has a number of limitations. Although the model proposed in this study used some control variables, it is extremely hard to control everything that influences the disclosure of the reasons for switching auditors and CAR. Further, the results of Model (2) (which implied no significance) could be interpreted in various ways other than what was discussed in this study. Finally, this study does not analyze every auditor switch individually in great detail. The case study method may prove helpful in this context. Future research should examine these issues in further detail.

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Table 1: Summary of Prior Research

Literature	Period	Sample	Results
Fried and Schiff (1981)	1972-1975	48 switchers	There is some evidence of negative market reaction around the time of announcement of the switch. It is not clear what motivates this reaction. The dimension of size and conflict examined in the study did not yield a conclusive explanation.
Smith and Nichols (1982)	1973-1979	27 companies that switched auditors because of disagreements	The study investigates the information content of the disclosures of the auditor-company disagreements. The analysis indicates a significant negative market reaction in the week when the Form 8-K is filed with the SEC. This finding is consistent with the reported finding that disclosure provides information useful to investors.
McConnell (1984)	1974-1978	748 observations	The results of this study indicate that Big 8 firms were more frequently both predecessors and successors in the case of auditor switches involving disagreements. Further, significant differences were found to exist among Big 8 firms in terms of disagreement involvement rates as both predecessor and successor auditors.
Hackenbrack and Hogan (2002)	1991-1997	802 auditor switching	The study investigates the relative informativeness of earnings announcements of the Form 8-K disclosures of the reason for auditor switching. The average price response per unit of earnings surprise is found to be lower following an auditor switch for disagreement-related or fee-related reasons and higher for a switch made for service-related reasons.
Sankaragurus wamy and Whisenant (2004)	1992-1996	2,076 observations	They found evidence that the clients' non-verifiable voluntary disclosures of reasons are interpreted as "good news" by investors, and that voluntary disclosures of reasons credibly describe the common underlying factors affecting change and choice decisions, with fee-related reasons being associated with choice decisions and service-related reasons being associated with change decisions.
Aldhizer III et al. (2009)	2004-2005	713 switchers	The study investigates whether required and voluntary Form 8-K auditor switching disclosures in 2004 and 2005 convey information content to investors in a post-SOX era. The results indicate that disclosures related to internal control material weakness and non-reliance on management representation convey negative information content, while disclosures related to audit scope limitation, earnings restatement, and client–auditor disagreement do not convey any information content.

Table 2: Sample Selection Process

Initial sample of switchers listed on Japanese stock market		623		
Banks, securities companies and insurance companies	38			
Accounting term alterations	19			
Delisted firms	77			
Cases that did not involve substantial switching	22			
Switching during the term	64			
Lack of data (including failure to file the extraordinary report)	39	259		
			Final Sample	364

Table 3: Disclosed Reasons for Auditor Switching and Size of Audit Firm

	Total	Switch Direction			
		BigN to BigN	BigN to Non-BigN	Non-BigN to BigN	Non-BigN to Non-BigN
"Expiration of auditors' term of office"	299	50	148	33	68
Engagement with the same auditor in company group	25	20	2	3	0
Audit fee	16	2	11	0	3
Service-related	15	6	5	3	1
Periodic rotation (voluntarily)	8	2	4	0	2
Having an interest	1	1	0	0	0
	364	81	170	39	74

Table 4: Variables Description of Switchers

Panel A: Total																
Variables	*DOWN*	*GCO*	*CAR*	*SIZE*	*NI*	*LEV*	*LIQ*	*GROWTH*	*FORECAST*	*SURPRISE*	*AFEE*	*TEAM*	*NONAUDIT*	*EMP*	*MULTI*	*MG*
N	364	364	364	364	364	364	364	364	364	364	364	364	364	364	364	364
Mean	0.467	0.129	0.009	9.486	-0.053	0.549	0.581	-0.043	-0.015	0.000	-0.046	-0.110	0.354	0.261	0.074	0.569
Std. Dev.	0.500	0.336	0.080	1.517	0.249	0.243	0.202	0.244	0.169	0.006	0.425	0.515	0.479	0.440	0.262	0.496
10%	0	0	-0.064	7.646	-0.188	0.223	0.316	-0.263	-0.102	0.000	-0.543	-0.742	0	0	0	0
25%	0	0	-0.027	8.583	-0.060	0.350	0.453	-0.119	-0.021	0.000	-0.298	-0.415	0	0	0	0
50%(Median)	0	0	0.004	9.330	0.008	0.550	0.574	-0.038	0.009	0.000	-0.092	-0.105	0	0	0	1
75%	1	0	0.038	10.399	0.032	0.726	0.730	0.029	0.031	0.000	0.196	0.202	1	1	0	1
90%	1	1	0.074	11.325	0.058	0.855	0.847	0.109	0.061	0.000	0.492	0.584	1	1	0	1
Panel B: Switchers that claimed "expiration of auditors' term of office"																
N	299	299	299	299	299	299	299	299	299	299	299	299	299	299	299	299
Mean	0.495	0.147	0.012	9.425	-0.059	0.560	0.577	-0.058	-0.019	-0.000	-0.056	-0.108	0.348	0.268	0.080	0.605
Std. Dev.	0.501	0.355	0.084	1.472	0.265	0.245	0.203	0.190	0.166	0.003	0.446	0.527	0.477	0.443	0.272	0.490
10%	0	0	-0.063	7.594	-0.208	0.228	0.310	-0.276	-0.114	0.000	-0.589	-0.776	0	0	0	0
25%	0	0	-0.026	8.582	-0.065	0.357	0.449	-0.132	-0.021	0.000	-0.334	-0.424	0	0	0	0
50%(Median)	0	0	0.007	9.328	0.008	0.565	0.576	-0.040	0.009	0.000	-0.118	-0.105	0	0	0	1
75%	1	0	0.041	10.275	0.029	0.748	0.719	0.029	0.030	0.000	0.220	0.215	1	1	0	1
90%	1	1	0.079	11.179	0.058	0.873	0.849	0.109	0.060	0.000	0.504	0.589	1	1	0	1
Panel C: Switchers that provided specific reason(s)																
N	65	65	65	65	65	65	65	65	65	65	65	65	65	65	65	65
Mean	0.338	0.046	-0.004	9.768	-0.026	0.486	0.599	0.026	0.000	0.001	0.001	-0.117	0.385	0.231	0.046	0.400
Std. Dev.	0.477	0.211	0.057	1.692	0.150	0.221	0.198	0.406	0.181	0.012	0.308	0.457	0.490	0.425	0.211	0.494
10%	0	0	-0.065	8.327	-0.155	0.119	0.358	-0.241	-0.082	0.000	-0.374	-0.629	0	0	0	0
25%	0	0	-0.028	8.586	-0.014	0.339	0.462	-0.104	-0.021	0.000	-0.223	-0.405	0	0	0	0
50%(Median)	0	0	-0.004	9.363	0.013	0.517	0.573	-0.030	0.011	0.000	0.000	-0.154	0	0	0	0
75%	1	0	0.020	10.766	0.038	0.677	0.765	0.033	0.036	0.000	0.148	0.087	1	0	0	1
90%	1	0	0.047	11.847	0.055	0.741	0.839	0.072	0.063	0.001	0.422	0.411	1	1	0	1
Panel D: "Expiration of auditors' term of office" vs. the specific reason																
t-statistics	-2.376**	-3.033***	-1.793*	1.513	1.380	-2.389**	0.811	1.665	0.821	1.134	1.219	-0.129	0.550	-0.628	-1.115	-3.043***
z-statistics	2.288**	2.196**	1.917*	1.161	1.679*	2.083**	0.593	0.728	0.698	0.087*	1.961**	0.502	0.560	0.610	0.948	3.024***

Note:

1. *t*-statistics for *t*-test (two-tailed) and *z*-statistics for the Wilcoxon Rank Sum test (two-tailed). ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.
2. The results of *INDUSTRY* and *YEAR* are omitted.

Table 5: Logistic Regression Results for Model (1)

Variables	Expected Sign	Coefficient	*z*-statistics (*p*-value)
(Intercept)		-1.557	-0.853 (0.393)
$DOWN$	+	0.857	2.239** (0.025)
GCO	+	2.087	2.391** (0.016)
$SIZE$	+	0.183	1.231 (0.218)
NI	−	1.319	1.028 (0.304)
$AFEE$	+	0.185	0.399 (0.690)
$TEAM$	±	0.363	0.983 (0.325)
$NONAUDIT$	±	-0.341	-0.980 (0.326)
EMP	+	0.562	1.489 (0.136)
$MULTI$	+	-0.053	-0.067 (0.946)
MG	+	1.244	2.949*** (0.003)
$YEAR$	Yes		
$INDUSTRY$	Yes		
Highest VIF	2.331		
Mean VIF	1.674		
AIC	350.3		

Note: As the highest VIF is below 5, the problem of multicollinearity does not seem to occur in this model (the table of the correlation coefficient is omitted because of space constraints).

Table 6: Multiple Regression Results for Model (2)

Variables	Expected Sign	Coefficient	*t*-statistics (*p*-value)
(Intercept)		-0.055	-1.560 (0.119)
$REASON$	−	0.010	1.326 (0.185)
$REASON * DOWN$	−	0.005	0.691 (0.489)
$REASON * GCO_{t-1}$	−	0.005	0.384 (0.701)
$SIZE$	+	0.003	1.208 (0.227)
NI	+	-0.040	-1.599 (0.110)
LEV	−	-0.003	-0.250 (0.802)
LIQ	+	0.008	0.487 (0.626)
$GROWTH$	+	-0.009	-0.683 (0.495)
EMP	−	0.006	0.841 (0.400)
$FORECAST$	+	0.080	2.623*** (0.009)
$SURPRISE$	±	-1.188	-3.385*** (0.000)
$MULTI$	−	0.005	0.435 (0.663)
MG	−	-0.004	-0.557 (0.577)
$YEAR$	Yes		
$INDUSTRY$	Yes		
Highest VIF	1.864		
Mean VIF	1.403		
Multiple R^2	0.183		
Adjusted R^2	0.082		

Note: As the highest VIF is below 5, the problem of multicollinearity does not seem to occur in this model (the table of the correlation coefficient is omitted because of space constraints).

Table 7: Treatment Effect Model for Model (2)

Variables	Expected Sign	Coefficient	Std. Error	*p*-value	95% Confidence Interval Lower Confidence Limit	95% Confidence Interval Upper Confidence Limit
(Intercept)		0.059	0.044	0.184	-0.028	0.147
LEV	−	0.010	0.018	0.584	-0.026	0.047
LIQ	+	-0.024	0.023	0.306	-0.070	0.022
$GROWTH$	+	-0.008	0.019	0.678	-0.029	0.045
$FORECAST$	+	0.046	0.026	0.074*	-0.004	0.097
$SURPRISE$	±	-1.293	0.696	0.063*	-2.658	0.071
$REASON$	−	-0.034	0.044	0.437	-0.121	0.052
(treatment)						
(Intercept)		-0.154	0.727	0.832	-1.580	1.271
$DOWN$	+	0.379	0.185	0.041**	0.015	0.744
GCO	+	0.673	0.330	0.041**	0.025	1.320
$SIZE$	+	0.061	0.068	0.373	-0.073	0.195
NI	−	-0.117	0.477	0.806	-1.053	0.818
$AFEE$	+	-0.206	0.204	0.311	-0.607	0.193
$TEAM$	±	0.306	0.179	0.088*	-0.045	0.658
$NONAUDIT$	±	-0.102	0.172	0.552	-0.441	0.236
EMP	+	0.235	0.185	0.205	-0.128	0.599
$MULTI$	+	0.227	0.345	0.511	-0.449	0.903
MG	+	0.488	0.200	0.015**	0.094	0.882
$YEAR$	Yes					
$INDUSTRY$	Yes					
Wald chi2	49.01					
Prob > chi2	0.036					

Note: The results of *INDUSTRY* and *YEAR* are omitted.