AUDITOR RESIGNATIONS VERSUS DISMISSALS: AN EXAMINATION OF THE DIFFERENTIAL EFFECTS ON MARKET LIQUIDITY AND TRADING ACTIVITY

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ABSTRACT

This study addresses whether an auditor change (a resignation or a dismissal) mitigates information asymmetry as measured by market liquidity or trading activity. For auditor dismissals our results show no effect on our sample firms' market liquidity or trading activity. By contrast, for auditor resignation firms, the market liquidity tests indicate that the 12 month period preceding the 8K filing is characterized by rising information asymmetry. Also, our trading activity analysis suggests that the 8K auditor resignation filing is informative for individual investors but fails to support such informativeness for institutional investors. Our findings lend support for the SEC's decision to differentiate between auditor resignations and dismissals in the 8K. However, the resignation announcement does not appear to decrease information asymmetry subsequent to the 8K filing, which is inconsistent with the presumed SEC objective of maintaining public confidence in the securities markets as a level playing field by mitigating information asymmetry.

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INTRODUCTION

This paper is motivated by the question, does the additional disclosure about whether an auditor change is a resignation or a dismissal mitigate information asymmetry? Over the years, the Securities and Exchange Commission (SEC) has sought to discourage "opinion shopping" by requiring firms to publicly disclose an auditor change in their Form 8K filings. However, it was only in 1988 that disclosure of whether the auditor resigned or was dismissed was made mandatory.

Although prior research indicates a differential stock price response to auditor resignation versus dismissal announcements, thus suggesting the usefulness of distinguishing between the two in the 8K filings, usefulness is a necessary but not a sufficient condition for mandatory disclosure (Lev, 1988). Rather, SEC disclosure regulation is motivated primarily by its mandate to protect the investing public and maintain public confidence in the securities markets as a level playing field by mitigating information asymmetry (Lev, 1988; Levitt, 1998; Shefrin & Statman, 1992).

Information asymmetry implies an information gap between some (informed) investors and others based on private information search, i.e. the ability of informed investors to obtain information that is not publicly available or to extract private information from publicly available data. Differential access to information allows informed investors to increase their wealth at the expense of uninformed investors and is perceived by the U.S. Congress and the SEC to be unfair (Beaver, 1998). As a practical matter, unequal access to information can have adverse social consequences in the form of reduced liquidity (higher transaction costs and thinner markets) as market makers respond defensively to a perceived increase in information asymmetry (Lev, 1988).

An auditor resignation, unlike a dismissal, is likely to be auditor (rather than client) initiated. Business Week (1993) and MacDonald (1997) indicate that resignations are related to unfavorable events within the client firm and may be triggered by one or more of the following: the auditor suspects management fraud (or otherwise distrusts client management), the client has weak internal controls, or the client's financial health is deteriorating. Potentially, a resignation is indicative of future investor losses that might be realized as and when the full extent of the client's problems (such as fraudulent financial statements or financial distress) are eventually revealed.

Consistent with the notion that lawsuits against auditors are almost always triggered by investor losses (Lys & Watts, 1994), DeFond et al. (1997) and Krishnan and Krishnan (1997) suggest that auditor resignations are motivated by the desire to avoid costly litigation and may be triggered by negative private information

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