

## **Auditor Resignations and Dismissals Their Effect on the Profession**

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JANUARY 2008 - The auditing profession has seen tremendous change over the last 10 years. The Big Five have become the Big Four, the profession is now externally regulated, specific consulting services can no longer be provided to audit clients, audit committee roles and responsibilities have been expanded, management must assess the effectiveness of internal controls, and auditors must render an opinion on the effectiveness of internal controls. These changes and others mandated by the Sarbanes-Oxley Act of 2002 (SOX) have transformed how audit firms conduct business.

One significant transformation is the skepticism with which audit firms evaluate clients. Given the tremendous change in the auditing profession and litigation cases that refer to the profession's deep pockets, Big Four audit partners claim to be more conservative in their decisions on the initial assessment and retention of clients. The recent trend in auditor resignations and movement of SEC clients from Big Four to other national (the next seven largest firms) and to regional and local firms provides support for these claims. In 2004, the number of auditor resignations and movement of SEC clients to national and regional audit firms hit a 10-year high. Furthermore, an examination of resignations from SEC audit clients by the Big Four and the movement of SEC clients from the Big Four to local and other national firms reveals a significant increase since the passage of SOX.

### **Increase in Resignations and Dismissals**

Given the more stringent client-acceptance/retention policies of the Big Four, the movement of SEC registrants to regional and other national firms is expected. However, the volume and extent of audit firm-client realignment is more aggressive than anticipated. The resignation by a Big Four firm from a public company client may be driven by concerns about reducing client-related business risks in the wake of the increased resources needed in order to be SOX-compliant. A joint SEC-PCAOB roundtable held in May 2007 to obtain feedback on experiences with complying with SOX section 404 internal control requirements revealed that audit staffing and audit firm internal structure are still based on a bottom-up approach, as opposed to the top-down, risk-based approach to the audit and section 404 recommended by the SEC and PCAOB. Accordingly, in the current environment, the audit manager must review not only the audit work, but also the section 404 work, in a timely manner so that the filing of year-end or quarterly reports is not delayed. Furthermore, an economic downturn may negatively impact the profession, because riskier or more poorly performing clients are particularly susceptible to failure.

The failure of a public company is frequently followed by a series of lawsuits. Audit firms are typically included in such lawsuits because in the aftermath of a corporate failure, the audit firm is generally one of the few solvent parties. Many audit firms that have picked up the smaller, riskier, or financially weaker registrants are regional and local firms with comparatively limited resources. The survival of these audit

firms in the aftermath of corporate failure and major lawsuit settlements is a concern to the profession.

Over the last eight years, the number of auditor resignations and client dismissals has grown significantly, and the trend picked up sharply between 2001 and 2004. As shown in Panel A of [Exhibit 1](#), Big Four resignations from public company clients rose from 89 in 2001 to 139 in 2004, a 56% increase. The 89 resignations in 2001 represented 0.7% of the total client base; whereas the 139 resignations in 2004 represented 1.5% of the total client base. Similarly, public company clients' dismissal of Big Four audit firms rose from 152 in 2001 to 298 in 2004, a 96% increase (Exhibit 1, Panel B). The pattern in dismissals of Big Four firms by SEC registrants can be attributed in part to rising Big Four audit fees in the wake of SOX, as indicated in [Exhibit 2](#). Average Big Four audit fees increased by more than 144% between 2001 and 2004. This is to be expected, given the nature of the integrated audits that are now required. Similarly, audit fees increased by 105% between 2003 and 2005, while the number of audit engagements decreased by 22%.

**Trends in Relocation of Big Four and National SEC Registrant Clients**  
The majority of Big Four and national firm public company clients that change auditors are moving to regional and local firms, according to data from AuditAnalytics.com and Auditor+Trak ([www.straffordpub.com/products/atr/](http://www.straffordpub.com/products/atr/)). An analysis of that data shows that 346 U.S. companies left Big Four auditors in 2006, fewer than the 403 firms that left Big Four auditors in 2005. In addition, it appears that 53,2% of the companies moved downstream to non-Big Four firms in 2006.

[Exhibit 3](#) shows the size of audit firms that have picked up clients. Consistently over the last six years, non-Big Four firms have acquired SEC registrant engagements from the Big Four firms. In 2005, a total of 403 SEC audit clients left Big Four firms, with 289 (72%) of those audit engagements going to non-Big Four firms. Over the same period, 96 SEC registrant clients left national firms, with 35 (36%) going to smaller audit firms. In 2004, a total of 437 public company clients left Big Four firms, with 316 (72%) going to non-Big Four firms. In 2003, a total of 332 public company clients moved from Big Four firms, of which 206 (62%) went to smaller firms.

Some of the downstream movement of clients in 2003-2005 can be explained by the secondary realignment of Arthur Andersen clients. [Exhibit 4](#) shows that of the 922 SEC registrants that left Arthur Andersen between 2001 and 2002, 167 moved to a different auditor by 2005. This represents only 12% of the total resignations and dismissals from Big Four and national firms during the same timeframe.

Although 2000 and 2004 have almost exactly the same number of resignations and dismissals among Big Four firms, the trend indicates significantly larger movement to non-Big Four firms in 2004 than 2000. Specifically, 2000 shows 55% of Big Four clients switching to other Big Four firms; while in 2004 the percentage of Big Four clients switching to other Big Four firms is almost cut in half, down to 28%. Notably, 41% of SEC registrant client changes from Big Four firms in 2005 went to local or regional firms. The increase in the movement of SEC registrants from Big Four to national, regional, or local audit firms suggests the need for smaller firms to assess changes in litigation risk.

## **Increase in Litigation Risk**

Audit firms have realized the extent of their potential liability and have tried to protect themselves with malpractice insurance. Nevertheless, the Economist (“Revenge of the Nerds,” May 31, 2003) reports that “insurance firms are either refusing to cover auditors for much, or are charging prohibitively expensive premiums.” The problem has become so great that some insurance companies are closing their doors to accounting firms. Insurers willing to serve smaller accounting firms limit the maximum insurance payments to between \$1,000,000 and \$10,000,000. The annual cost of insurance and settlements is now more than 19% of the large firms’ fee income. Interviews with a spokesperson at AON Insurance Services in September 2007 indicated that this percentage has grown considerably over the last five years for smaller firms.

Lawsuits against CPA firms are estimated to have increased, with many asserting conflicts of interest and poor audit quality. As the national economy slows, more businesses are likely to fail. In the past, the number and size of lawsuit settlements have risen as the economy declined. In times of hardship, investors and creditors will continue to try to recoup their losses from the deep pockets of audit firms. This should be a concern to the profession because, while the Big Four audit firms have in-house legal staff and funds set aside for settlements, regional and local firms will face similar liability claims without the same resources to defend themselves.

The AICPA recommends a three-tiered malpractice insurance program from AON Insurance Services. Insurance providers recognize the litigation risk and are recommending procedures to protect the interests of the regional and local firms. The procedures include recommendations on hiring partners with certain skill sets, and amendments to engagement letters that mandate arbitration of client disputes. SEC independence rules, however, prohibit any limitations on the amount of exposure, and shareholder lawsuits cannot be affected by such “amendments.” The auditing profession will be negatively affected if the survival of Big Four firms is threatened by lawsuit settlements and reduced insurance coverage. Furthermore, the survival of regional and local firms will also be threatened by the additional business risk they assume by accepting higher-risk clients and the increased work mandated by SOX, given that smaller firms possess more-limited resources.

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