SHAREHOLDERS' PERCEPTION OF AUDITOR TYPE AND TIMING OF AUDITOR ENGAGEMENT: EVIDENCE FROM AUDITOR RATIFICATION

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ABSTRACT

Many companies present their selected auditor to shareholders for ratification. In this study, we use auditor ratification voting results to examine whether shareholders view the type of auditor and the timing of the engagement as indicative of audit quality. The auditor ratification literature has yet to examine explicitly these research questions. Our study is unique in that we focus on the auditor switch setting and test how shareholders view a new auditor. We find that shareholders are more likely to approve a Big N auditor than a non-Big N auditor. We also document that shareholders view late auditor engagements (i.e., during or after the fourth quarter) more negatively, consistent with the argument that late appointment of new auditors should be viewed with caution. The timing effect is particularly acute for non-Big N firms; however, shareholders do not seem to mind late engagements of Big N auditors.

INTRODUCTION

The U.S. Treasury's Advisory Committee on the Auditing Profession (ACAP) (2008) recommends that all publicly-traded companies seek shareholder ratification of the auditor selected for the upcoming fiscal year.[1] However, ACAP (2008) notes that shareholders may not have enough information about audit quality to make the ratification decision. Proxy advisors must also rely on publicly available indicators to assess audit quality before making a recommendation (Cunningham 2017). Consequently, ACAP recommends that the Public Company Accounting Oversight Board (PCAOB) (2015) develop potential audit quality indicators (AQIs) that can be used to monitor and encourage high quality audits (ACAP 2008, VIII:15):

> "The Committee believes that requiring firms to disclose indicators of audit quality may enhance not only the quality of audits provided by such firms, but also. . . auditor choice, *shareholder decision-making related to ratification of auditor selection* [emphasis added], and PCAOB oversight."

In this study, we use auditor ratification voting results to examine whether shareholders view the type of auditor and the timing of the engagement as indicative of audit quality.[2]

Our study is unique in that we focus on the auditor switch setting and test how shareholders view a *new* auditor rather than a *continuing* auditor. To our knowledge, our study is the first in the auditor ratification research to test shareholders' perception on auditor type and timing of auditor engagement. The research design using a sample of non-auditor switching firms in prior studies is unable to detect whether shareholders perceive the difference in audit quality between Big N versus non-Big N auditors because the auditors who are voted on the ratification are invariant from last year. If there were no changes in the status of the continuing auditor (and absent other factors such as restatements, internal control weaknesses, etc.), shareholders' votes would have been unchanged. In these cases, the ratification votes likely reflect other factors such as general satisfaction (e.g., firm performance) rather than type of auditors. Not surprisingly, no study examines this research question. As discussed later, many prior studies that investigate the effect of specific events (e.g., restatement) on auditor ratification votes, albeit not all, include type of auditor as a control variable, but the results are mixed. By contrast, the ratification votes held for firms with auditor switches are more likely to reflect their perception on the type of the new auditors. In addition, by restricting our sample to auditor switches, we are able to evaluate the *timing* of engagements as an indicator of audit quality.

Theory predicts that Big N auditors have greater incentive to perform audits of higher quality than smaller audit firms (DeAngelo 1981). Using several proxies for audit quality, prior studies (e.g., Eshleman and Guo 2014; DeFond, Erkens, and Zhang 2016), provide empirical findings that Big N auditors, compared to non-Big N auditors, provide a better audit quality. However, these studies may suffer from endogeniety given that clients' choice of their auditors is not random. For example, Lawrence, Minutti-Meza, and Zhang (2011) find that differences in audit quality between Big 4 and

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[1] Under SOX, the audit committee is responsible for selecting the auditor. Shareholders can only cast a vote to approve or disapprove of the selected auditor. There is no mechanism for shareholders to recommend a different auditor.

[2] Audit firms are first and foremost characterized as either Big N or non-Big N, which we refer to as auditor type.

non-Big 4 auditors are largely due to client characteristics (i.e., client size).[3] Unlike these studies, we test shareholders' perception that are reflected in the ratification votes. DeAngelo (1981) argues that outsiders use auditor type as one way to evaluate unobservable audit quality. With respect to timing, an auditor switch should normally occur soon after the prior year's audit has concluded. In general, a switch is considered "late" if it occurs during or after the fourth quarter. Late engagements are problematic because it leaves less time to perform the audit. In addition, late switches, especially auditor terminations during the annual audit is underway, themselves may be indicative of auditor-client disagreements. Extant evidence consistently indicates that switching auditors late in the year results in lower quality audits (e.g., Cassell, Hansen, Myers, and Seidel 2017).[4]

Using a sample of auditor switches over the period 2009–2017, we examine the relation between the proportion of negative votes and our proposed indicators of audit quality. We find that the voting outcome is more favorable when a Big N auditor has been selected as the successor. This result is consistent with the hypothesis that shareholders believe Big N auditors are more likely to provide high quality audits. We also find that timely auditor engagements (i.e., early auditor engagements) are more likely to elicit favorable votes from shareholders. Moreover, these results are economically significant; the proportion of negative votes increases by more than 30 percent when the selected auditor is either non-Big N or engaged late in the year.

Last, we test whether shareholders' perception of auditor type varies with the timing of the engagement. We find that, when the selected successor is a Big N auditor, shareholder approval does not differ for early and late engagements. In contrast, our results indicate that timing does matter to shareholders when a non-Big N auditor has been selected as the successor. That is, the proportion of negative votes against ratification of non-Big N auditors is 43 percent greater when engaged sometime during or after the client's fourth fiscal quarter (i.e., late) than when engaged before the beginning of the fourth quarter (i.e., early). Shareholder disapproval of the incoming non-Big N auditor is 45 percent greater compared to Big N auditor when both are engaged in a timely manner. When compared to early Big N engagements, the disapproval rate for late non-Big N engagements is doubled. Thus, it appears that shareholders are more confident about Big N auditors' ability to cope with learning about a new client in a short amount of time. Overall, our empirical results are consistent with our predictions that both auditor type and timing of auditor appointment influence shareholders' (ex ante) perception of audit quality.

Our control variables also reveal some noteworthy results given that the auditors in our sample, by definition, are newly engaged. In particular, we find that shareholders are more likely to vote against ratifying the incoming auditor as the tenure of the old auditor is longer and when firms have poor performance in stock returns or returns on assets (ROA), both of which are unrelated to the audit quality of the incoming auditor. These results are consistent with shareholders expressing general dissatisfaction with the firm by voting against ratifying the irreproachable successor auditor (Cassell, Kleppe, and

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[3] For proxies of audit quality, they use the following measures—discretionary accruals, the ex ante cost-of-equity capital, and analyst forecast accuracy.
[4] We use the terms "late switch" and "late engagement" interchangeably.

Shipman 2019).[5] In additional analyses, we also consider mid-tier auditors, auditor industry specialization, and corporate governance. These tests provide added support for our main findings.

Our study contributes to the literature and discussions on audit regulations in several ways. First, by documenting the relation between shareholder votes and auditor type and timing of engagement, we contribute to the auditor ratification literature that investigates factors that influence shareholder ratification voting, such as non-audit fees, auditor tenure, restatements, internal control weaknesses, and PCAOB inspection outcomes (Sainty, Taylor, and Williams 2002; Raghunandan 2003; Raghunandan and Rama 2003; Mishra, Raghunandan, and Rama 2005; Krishnan and Ye 2005; Dao, Mishra, and Raghunandan 2008; Liu, Raghunandan, and Rama 2009; Hermanson, Krishnan, and Zhongxia 2009; Dao, Raghunandan, and Rama 2012; Cunningham 2017; Barua, Rama, and Raghunandan 2017; Son, Song, and Park 2017).

Second, our study based on the ratification vote results as a proxy of *perceived* audit quality complements other studies using other proxies of *realized* audit quality reflected in financial reporting quality (e.g., Francis, Maydew, and Sparks 1999; Eshleman and Guo 2014; DeFond et al. 2016). In order to capture shareholders' perception, prior studies most commonly use stock market reaction. However, results based on market reactions are less clear in that researchers cannot completely rule out other potential confounding factors/effects. Another group of studies employs client-specific ex ante cost of equity to measure *indirectly* investor perceptions on financial reporting credibility and thus audit quality (e.g., Khurana and Raman 2006). In contrast, shareholders' votes *directly* capture their perceptions on potential audit quality of the selected auditor.[6] Broadly speaking, our results are in line with studies that document a perceived Big N effect using market-based proxies (e.g., abnormal returns) for investor perception (e.g., Knechel, Naiker, and Pacheco 2007). However, contrary to Boone, Khurana, and Raman (2010), which uses cost of capital to proxy for investor perception, we do not find that shareholders perceive a difference in audit quality between Big N and mid-tier auditors.

Third, we expand research on the timing of auditor switches that has been largely unexplored (Cassell et al. 2017), by showing that late audit changes negatively affect shareholders' perception that manifests in votes on auditor ratification. Further, the finding that shareholders have a negative outlook on late auditor switches could possibly answer calls from the PCAOB for evidence on the potential effects of audit firm rotation on audit quality. The PCAOB specifically seeks the commenters' views on the learning curve before new auditors can become effective (PCAOB 2011). Our findings suggest that shareholders believe there exists a steep learning curve especially for late auditor hiring.

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[5] Using a sample of non-auditor switching firms, Cassell et al. (2019) document that adverse auditor ratification votes are strongly associated with stock returns, not with restatements (e.g., audit failure). However, this result is inconsistent with Liu, Raghunandan, and Rama's (2009) finding that shareholders are more likely to vote against auditor ratification after a restatement when compared with votes at (1) firms without restatements or (2) restating firms in the preceding period.

[6] Note that actual audit quality may differ from perceived audit quality. For example, restatements are indicative of actual audit quality. Defond and Zhang (2014, 284) argue that restatements are "very direct and egregious measures of audit quality because they indicate that the auditor erroneously issued an unqualified opinion on materially misstated financial statements."

Finally, our study contributes to the debate over mandating auditor ratification. Despite calls to mandate shareholder ratification of the auditor for all publicly traded companies from investors and regulators (e.g., ACAP 2008; CalSTRS 2008), no such requirement in the U.S. Shareholder ratification currently serves as a monitoring mechanism and is considered a best practice in corporate governance (e.g., CalPERS 2011; ISS 2011). The opposition claims that shareholder ratification of the auditor is unnecessary and inconsequential after SOX because the vote is merely advisory. Recently, even the SEC has changed course, acquiescing to companies' lobbying efforts to thwart auditor ratification (Brown 2011).[7] We provide evidence in support of mandatory auditor ratification by showing that shareholders clearly express their opinions about the potential audit quality of newly appointed auditors. Despite the advisory and non-binding nature of the ratification votes, our results suggest that voting is nonetheless an important mechanism by which shareholders can participate in the corporate governance of their firms.

The remainder of the paper is organized as follows. We discuss prior literature and research questions. Next, we describe the sample, the empirical model and present our empirical results. The final section provides conclusion.

BACKGROUND

Shareholder Voting on Auditor Ratification

The majority of publicly-traded companies voluntarily seek shareholder ratification of auditors annually (ACAP 2008).[8] The ratification vote is the primary channel through which shareholders express their opinion on the selected auditor.[9] Shareholders may vote "for" or "against" the selected auditor, or simply abstain from voting.[10] The voting outcome, however, is merely advisory and non-binding. Furthermore, negative votes are few; the auditor is, on average, ratified by 98 percent of the votes (Audit Analytics 2013). Nonetheless, evidence from prior research suggests that the disapproval margin, albeit small, is still meaningful. Anecdotally, even a small deviation, such as 95 percent approval (thus 5 percent disapproval), exposes the auditor to greater scrutiny (Dao et al. 2012, 154). Empirical evidence has also shown that auditor ratification results have capital market consequences (Tanyi and Roland 2017) and increase the likelihood of a subsequent dismissal of the auditor (Barua et al. 2017). In addition, more than 90 percent of Russell 3000 companies adopted the auditor ratification votes, suggesting that the ratification is perceived as a matter of good corporate governance (Cunningham 2017).

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[7] Specifically, the SEC staff has issued No Action letters for a number of companies allowing them to exclude shareholder proposals, such as proposals to initiate annual auditor ratification. Brown (2011) argues that the SEC's shift away from encouraging shareholder ratification was politically driven.

[8] Krishnan and Ye (2005) identify financial and governance factors that are associated with the likelihood that a company submits a shareholder vote on auditor ratification.

[9] The Sarbanes-Oxley Act of 2002 (SOX) shifts the responsibility of auditor hiring, firing, and compensation from management to the audit committee. Thus, during our sample period, the auditor selection decision is made by the audit committee.

[10] Effective February 28, 2010, the SEC required corporations to disclose the results of a shareholder vote in its Form 8-K filing within four business days after the meeting at which the vote was held (SEC 2009).

Auditor ratification voting gives shareholders a monitoring role and indicates their perspective of the auditor and audit quality. In an experimental study, Mayhew and Pike (2004) find that giving shareholders more control over auditor selection enhances auditor independence, and the value of that independence is reflected in higher audit fees. Empirical evidence also supports the notion that auditor ratification is associated with better audit quality and higher audit fees (Dao et al. 2012).

Our study is more closely related to the literature concerning factors that influence shareholders' rejection of the auditor. The proportion of votes against the auditor increases with auditor tenure (Dao et al. 2008) and nonaudit service fees (Raghunandan 2003), particularly tax-related and other fees (Mishra et al. 2005). However, high levels of nonaudit fees appears to be less concerning when all audit committee members are independent (Raghunandan and Rama 2003). Other research focuses on auditing outputs and finds that the proportion of negative votes is greater following financial restatements (Liu et al. 2009), internal control weaknesses (Hermanson et al. 2009), and erroneous going-concern opinions (Sainty et al. 2002). While these indicators of lower quality audits reduce the ratification rate, shareholders seem less concerned with unfavorable PCAOB reports citing audit deficiencies (Son et al. 2017). Overall, shareholders disapprove the auditor when audit quality is questionable.

HYPOTHESIS DEVELOPMENT

Type of Auditor

There are several reasons to believe that audit quality varies with the type of auditor (i.e., auditor size). A larger audit firm likely has more resources, such as technology, training, and facilities, to offer better audit quality. A smaller audit firm might be willing to compromise their independence to avoid losing an important client whereas large audit firms are less susceptible to the threat of losing any individual client. In addition, larger auditors have more valuable reputations and thus face greater reputation costs should an audit failure occur (DeAngelo 1981; Craswell, Francis, and Taylor 1995). Furthermore, because Big N audit firms have "deep pockets," they are more likely to be sued for issuing an inaccurate audit report (Simunic and Stein 1996; Lennox 1999). Empirical evidence also supports the notion that larger, Big N auditors provide higher quality audits than smaller, non-Big N auditors (e.g., Francis et al. 1999; Eshleman and Guo 2014; DeFond et al. 2016).[11] Using a sample of involuntary auditor switches to circumvent the endogeneity problem, Jiang, Wang, and Wang (2019) find that audit quality improves for clients of non-Big N audit firms that are acquired by a Big N audit firm, evidence that Big N auditors provide high quality audits. Lawrence, Minutti-Meza, and Zhang (2011), however, document that the differences in audit quality are actually due to differences in clientele, not auditor type.

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[11] One exception is Lawrence, Minutti-Meza, and Zhang (2011), which implies that the differences in audit quality are actually due to differences in clientele, not auditor type.

Whether shareholders' ratification votes differ depending on auditor type, however, is less apparent in the auditor ratification literature. No one explicitly examines how shareholders differently perceive the type of auditors. Of the studies that examine the determinants of shareholders' ratification, many do not include a variable of auditor type (i.e., Big N versus non-Big N) as a control variable in their regressions (Raghunandan 2003; Mishra et al. 2005; Liu et al. 2009). Among the studies that do include auditor type in their models, results are mixed. When the auditor to be ratified is a Big N auditor, the proportion of votes against ratification has been found to be lower (Sainty et al. 2002; Cassell et al. 2019), higher (Dao et al. 2008), or not statistically related (Raghunandan and Rama 2003; Cunningham 2017). We believe that these mixed results are attributable to the inclusion of non-auditor switching firms in the sample. We attempt to shed light on this issue by using a sample of auditor switches (excluding non-switching firms) to directly investigate whether shareholders react positively to engagements of Big N auditors through shareholder voting on auditor ratification.

As discussed in the previous section, prior research has shown that the selected auditor's approval rate tends to decline when audit quality suffers. We note, however, that shareholders' ratification of the auditor reflects their perception of audit quality rather than actual audit quality because the ratification votes in our sample are held for *incoming* auditors. Using cost of capital to proxy for investor perception, Boone et al. (2010) compare Big N and mid-tier auditors and find that investors believe Big N audits are of better quality than mid-tier audits, even though there is little difference in actual audit quality. If shareholders' *ex ante* belief is that Big N auditors perform higher quality audits, then we expect fewer votes against ratification when the selected auditor is a Big N than when the selected auditor is non-Big N. However, it is possible that shareholders hold judgment until observing the quality of the audit report. In other words, engagement-specific signals may matter more than auditor-specific characteristics. Alternatively, shareholders simply do not care the auditor ratification votes because of non-binding nature. Our first hypothesis, therefore, is stated in null form.

H1: *Shareholders do not perceive a difference in audit quality between Big N and non-Big N auditors.*

Timing of Auditor Engagement

Companies are free to switch auditors at any point in time, but it is ideal to separate with the incumbent auditor and engage the successor auditor soon after the previous audit is complete. Indeed, most companies settle on the new auditor within one or two months (Khalil, Cohen, and Schwartz 2011). Although the auditor switching literature is well-established and extensive (see Stefaniak, Robertson, and Houston 2009 for a review), only a handful of studies have examined the timing of an auditor switch. These studies find that a late auditor switch is associated with longer reporting lags (Schwartz and Soo 1996), lower audit quality (Cassell et al. 2017; Burks and Stevens 2019), and client firm risk (Her, Howard, and Son 2019). Another approach in the literature is to examine the time between dismissal/resignation of an incumbent auditor and the appointment of the new auditor (i.e., auditor search period). A lengthy search period is associated with lower audit quality and suggests greater client risk (Pacheco-Paredes, Rama, and Wheatley 2017; Mande, Son, and Song 2017). We extend this line of research by examining how shareholders view the timing of an auditor engagement.

The overall conclusion in the literature is that late auditor switching is problematic for two main reasons. A newly engaged auditor faces the steepest learning curve in the first year of engagement. Not only must the auditor gain sufficient knowledge to thoroughly understand the client's business, but also plan the audit, assess risks, perform tests, etc. A late engagement also leaves little time to review quarterly earnings, which facilitates audit planning and risk assessment (Pacheco-Paredes et al. 2017) as well as enhances the credibility of reported earnings (Manry, Tiras, and Wheatley 2003). Thus, audit quality suffers because the successor auditor does not have enough time. Auditors face this time constraint because all public firms must file audited financial statements with the SEC by the filing deadline.[12]

In addition to the time constraint, a late engagement itself may be indicative of client riskiness that can compromise audit quality (Her et al. 2019). As the annual audits progress, auditors are more likely to collect increasingly more information about the audit risk of their clients. In particular, the predecessor auditor may have discovered significant accounting issues during the audit that could not be resolved with the client. Dhaliwal, Schatzberg, and Trombley (1993) find that firms that switch auditors after an auditor-client disagreement exhibit poor or deteriorating financial conditions, consistent with these firms facing stronger incentives to inflate earnings. Disagreements that lead to an auditor switch are more likely to occur late in the audit process when enough work has been done to identify any issues (Schwartz and Soo 1996). These disagreements are usually about issues that are complex, significant, and important to both parties (Gibbins, Salterio, and Webb 2001). Auditor-client negotiation can be time-consuming because the process requires research (e.g., accounting standards and regulations) and analysis from all parties involved and much discussion to ensure that the auditor understands the issues and transaction, which can take weeks or even months to resolve (Gibbins, McCracken, and Salterio 2007). Auditor-client negotiations over accounting issues lead to audit delays (Salterio 2012, 273), whereas failure to reach an agreement results in an auditor switch. Assuming concession is not an option, the client firm must find another auditor with different risk tolerance or one that is more lenient (i.e. engage in opinion shopping). These type of auditor switches tends to occur later in the fiscal year (Burks and Stevens 2019)

In summary, audit quality may be compromised when a client firm switches its auditor late in the audit process because successor auditor must rush to meet the filing deadline. Alternatively, a late switch could occur due to failed negotiations over serious accounting issue(s), which could also result in lower audit quality if the next auditor, whether intentionally or unintentionally, allows the client to maintain their (incorrect) position on the accounting issue. If shareholders believe that the auditor switch occurred late because the client firm refused to accept an audit adjustment, we expect more shareholders will be compelled to vote against ratifying the selected auditor. However, unlike auditor type, existing evidence in this area (i.e., switch timing) is relatively sparse in the literature, and as in H1, shareholders may pay little attention to the auditor ratification votes because of non-binding nature of the votes. As a result, whether timing of engagement influences shareholders' perception of audit quality is not as clear ex ante, and thus we state our second hypothesis in null form:

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[12] The 10-K filing deadline is 60 days for the large accelerated filers (with market cap of $700 million or more), 75 days for the accelerated filers (with market cap of $75 million or more but less than $700 million) and 90 days for the non-accelerated filers (with market cap less than $75 million) for fiscal year-ends on or after December 15, 2006 (SEC 2002).

H2: *Shareholders do not perceive a difference in audit quality between late auditor engagements and early auditor engagements.*

Interactions between Auditor Type and Timing of Engagements

Our final hypothesis examines whether auditor type and timing of engagement have any interactive effects on shareholders' view of the selected auditor. Blokdijk, Drieenhuizen, Stein, and Simunic (2006) find that differences in audit quality between Big N and non-Big N auditors are primarily related to audit technology rather than the amount of effort. In terms of audit phases, the study finds that Big N auditors spend more time on planning and assessing (e.g., risk, internal controls) than substantive testing and completion whereas non-Big N auditors spend more time on substantive testing and completion.[13] In addition, audit effort allocation varies when auditors decide to rely more on the client's internal controls. Big N auditors reallocate audit effort from substantive testing to planning and assessment. Non-Big N auditors also put more effort into planning and assessment, but do it without reducing substantive testing, resulting in an increase in total audit hours. Thus, Big N auditors may be better able to adapt their audit programs to maintain their standard of audit quality even when facing a time constraint or greater risk.

Moreover, Big N auditors exercise client screening on client acceptance decisions to control audit firms' exposure to litigation risks, which is called ex-ante conservatism (Krishnan, Raghunandan, and Yang 2007). For example, Big N firms are less likely to accept a client when their auditor search period is long (Mande et al. 2017), consistent with Big N firms shying away from riskier clients. We also believe that Big N auditors are likely to accept a client in the later time of the year only when they are able to get the audit done within the time restriction using their superior assets such as high specialized industry expertise. In contrast, non-Big N firms may be more willing to accept a potentially risky, late engagement because litigation and reputation is less of a concern to them. These arguments lead us to a prediction that non-Big auditors may experience relatively steeper learnings curve (thus providing lower audit quality) than Big N auditors due to time restriction inducted by a late appointment. Nonetheless, whether shareholders' perception of Big N and non-Big N auditors varies with the timing of the engagement remains an empirical question. As such, our third hypothesis is as follows:

H3: *The relation between the proportion of shareholder votes against ratification and auditor type does not vary with the timing of the engagement.*

RESEARCH DESIGN

Timing Measures

To test our timing-related hypotheses, we classify auditor switches as either "late" or "early." The late switch period spans the fourth quarter up to the audit report date.[14] The early switch period starts at the

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[13] The four audit phases are planning, risk assessment, substantive testing, and completion.
[14] The audit report date is when the auditor has obtained sufficient evidence to support an opinion, and events occurring thereafter need not be reviewed (American Institute of Certified Public Accountants (AICPA) 1972).

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audit report date and ends at the completion of the third quarter. See Appendix 1 for an illustration of these two definitions. For empirical tests, we define *LateSwitch* as an indicator variable that is set to one if the auditor switch occurs during the fourth quarter or after the fiscal year-end but before the audit report date, and zero otherwise. Conversely, *EarlySwitch* is equal to one for auditor switching between the audit report date and the end of the third quarter, and zero otherwise. These definitions are generally consistent with prior research that considers an auditor switch to be late if it occurs during or after the fourth quarter (e.g., Schwartz and Soo 1996; Cassell et al. 2017).

Empirical Models

We follow the auditor ratification literature and use the proportion of shareholder votes against ratification of the auditor as our measure of the voting outcome. *VoteAgainst* is calculated as the votes against and abstentions over total votes.[15] Because abstentions are not left out of the count, they are similar to votes against in that they reduce the proportion of affirmative votes, which determines the auditor ratification outcome (Raghunandan 2003).

To test our first and second hypotheses, we model adverse ratification votes as function of auditor type, timing of auditor engagement, and other determinants that have been suggested by prior studies.

$$
\begin{aligned}
LnVoteAgainst = {} & \beta_0 + \beta_1 BigN + \beta_2 LateSwitch + \beta_3 Resignation + \beta_4 LnAudTenure + \beta_5 DumIssues + \\
& \beta_6 GoingConcern + \beta_7 LateFiler + \beta_8 Restatement + \beta_9 ICWeakness + \\
& \beta_{10} MarketReturns + \beta_{11} ROA + \beta_{12} Leverage + \beta_{13} LnAssets + \text{Year FE} + \text{Industry} \\
& \text{FE} + \varepsilon
\end{aligned}
\tag{1}
$$

We use the log-transformation, *LnVoteAgainst*, as the dependent variable in our OLS regressions because *VoteAgainst* is positively skewed, which is consistent with prior studies (Dao et al. 2008; Liu et al. 2009). The skewness of *VoteAgainst* is not surprising given that an overwhelming majority of shareholders usually vote for, not against, ratifying the auditor. If more shareholder votes will reflect approval when the selected auditor is a Big N auditor, then we will find a negative coefficient on *BigN* ($\beta_1 < 0$). In addition, if shareholders cast more dissenting votes for late auditor engagements, then we will find a positive coefficient on *LateSwitch* ($\beta_2 > 0$).

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\begin{aligned}
LnVoteAgainst = {} & \gamma_0 + \gamma_1 BigN \times LateSwitch + \gamma_2 Non\text{-}BigN \times LateSwitch + \\
& \gamma_3 Non\text{-}BigN \times EarlySwitch + \gamma_4 Resignation + \gamma_5 LnAudTenure \\
& + \gamma_6 DumIssues + \gamma_7 GoingConcern + \gamma_8 LateFiler + \gamma_9 Restatement + \\
& \gamma_{10} ICWeakness + \gamma_{11} MarketReturns + \gamma_{12} ROA + \gamma_{13} Leverage + \\
& \gamma_{14} LnAssets + \text{Year FE} + \text{Industry FE} + \varepsilon
\end{aligned}
\tag{2}
$$

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[15] Abstentions are counted as negative votes. Our measure of voting outcomes is consistent with the auditor ratification literature.

For our third hypothesis, we test for any potential interactive effects of auditor type and switch timing on shareholders' voting decision. Model (2) follows the same general form as Model (1), except we replace *BigN* and *LateSwitch* with interaction terms. In particular, we include interaction terms reflecting the combinations of the binary measures of auditor type and timing of engagement: *BigN×LateSwitch*, *Non-BigN×LateSwitch*, *Non-BigN×EarlySwitch*, with *BigN×EarlySwitch* serving as the base. As such, the three interaction terms are interpreted as relative effects compared to *BigN×EarlySwitch*, which presumably provides the highest level of audit quality.

Our regression models also include several control variables. We control for characteristics related to the outgoing auditor such as the type of departure (*Resignation*), auditor tenure (*LnAudTenure*), and disclosure of disagreements or reliability issues related to audit circumstances (*DumIssues*). We expect that *Resignation* and *DumIssues* increase the proportion of adverse shareholders' votes. *LnAudTenure* is expected to attract favorable votes. Dao et al. (2008) document that shareholders tend to vote against *continuing* auditors with lengthy tenure. If this result holds in our study, the termination of auditors with lengthy tenure should be favorably viewed. We also include control variables that proxy for adverse circumstances such as going concern opinions (*GoingConcern*), late 10-K filings (*LateFiler*), restatements (*Restatement*), and material weaknesses in internal control (*ICWeakness*). These factors are associated with negative votes (Hermanson et al. 2009; Liu et al. 2009). Note that some of the control variables in the above discussion (e.g., *Resignation*, *LnAudTenure*, and *DumIssues*) relate to the departing auditor, not the incoming auditor that is up for ratification. However, these variables may reflect underlying problems with the company. Therefore, we include these variables to control for the possibility of general dissatisfaction toward the company (Cassell et al. 2019).[16]

We also include client firm characteristics such as annual market returns (*MarketReturns*), return on assets (*ROA*), leverage (*Leverage*), and size (*LnAssets*). [17] The two performance measures (*MarketReturns* and *ROA*) should be negatively associated with the proportion of against votes because shareholders are more likely to support management proposals in good times (Dao et al. 2008; Liu et al. 2009). *Leverage*, a proxy for client firm riskiness, is expected to have a positive sign. Since shareholder activists tend to pay closer attention to large firms, which thus often become targets for shareholder activism (Dao et al. 2008; Hermanson et al. 2009), we predict *LnAssets* to positively associate with *LnVoteAgainst*. Finally, we control for industry (one-digit SIC codes) and year fixed effects. The definitions of variables and their sources are found in the Appendix 2.

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[16] Cassell et al. (2019) find greater shareholder disapproval of auditor ratification votes in the presence of poor firm performance.

[17] Glass Lewis & Co. and Institutional Shareholder Services (ISS), two proxy advisors, illustrate the criteria leading to an ''against'' recommendation on auditor ratification including breaches of auditor independence such as excessive nonaudit services and indicators of poor financial reporting quality such as restatements, material weaknesses in internal controls, late filings, and aggressive accounting policies (Glass Lewis & Co. 2012; ISS 2012). However, many of these criteria are irreverent to our study because voting results in our study capture shareholder's view on incoming auditors rather than on continuing auditors.

TABLE 1: SAMPLE SELECTION PROCEDURES

	Firm-years
Auditor switches from Audit Analytics that appear in Compustat during 2009-2017	4,098
Less: Foreign firms (Compustat item ADRR)	(183)
Less: Funds, trusts, shell companies, subsidiaries, or inactive firms	(808)
Less: Missing ratification data	(1,629)
Less: Missing values for control variables	(342)
Final sample	1,136

Sample Description

We obtain audit-related data from Accounting and Oversight module of Audit Analytics, companies' financial statement data from Compustat, and market returns from CRSP. Table 1 presents our sample selection procedures. Our initial sample of 4,098 firm-year observations comprises auditor switches during 2009 – 2017 with non-missing values for total assets in Compustat. Our sample period begins in 2009, which is the fiscal year when auditor ratification data became available in Audit Analytics.[18] Because we limit our sample to domestic publicly-traded corporations, we exclude 183 foreign firms that trade as American Depository Receipts in the U.S. (Compustat item ADRR) and 808 observations that are classified as a fund, trust, shell company, subsidiary, or inactive in Audit Analytics. We also drop 1,629 observations that do not have ratification data in Audit Analytics and 342 that do not have Compustat and CRSP data for control variables. The final sample consists of 1,136 firm-year observations.

Table 2, Panel A presents the descriptive statistics of our regression variables. All continuous variables are winsorized at the 1st and 99th percentile levels to alleviate the effects of extreme values. The mean of *VoteAgainst* indicates that two percent of votes are against or abstain, which is in line with prior studies.[19] For example, Tanyi and Roland (2017) report a mean of 1.67 percent. We also note that the mean of *LateSwitch* is 24 percent, which implies that the remaining 76 percent are early switches. About 42 percent of our sample engage one of the Big 4 audit firms (mean of *BigN* = 0.419), and about seven percent receive a going concern opinion (*GoingConcern*). Only six percent of auditor switch firms disclose any disagreements or other adverse audit-related circumstances in Form 8-K (mean of *DumIssues* = 0.062). Taken at face value, this implies that the other 94 percent of firms and their auditors did not encounter any disagreements or other audit issues before switching auditors. As prior studies suggest (e.g., Burks and Stevens 2019), these seemingly suspect statistics also cast doubt on the compliance with 8-K mandatory disclosures.

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[18] The shareholders' meeting for the auditor ratification voting typically takes place three to six months *after* the fiscal year ends (Cunningham 2017).

[19] Our results are qualitatively similar when we use only against votes for *VoteAgainst*.

TABLE 2: SAMPLE DESCRIPTION

Panel A: Descriptive Statistics (N = 1,136)

Variable	Mean	Std Dev	25th Pctl	Median	75th Pctl
VoteAgainst	0.020	0.042	0.003	0.007	0.019
LnVoteAgainst	-4.931	1.517	-5.879	-4.912	-3.963
LateSwitch	0.239	0.427	0.000	0.000	0.000
BigN	0.419	0.494	0.000	0.000	1.000
Resignation	0.190	0.393	0.000	0.000	0.000
LnAudTenure	2.078	0.707	1.609	2.079	2.639
DumIssues	0.062	0.241	0.000	0.000	0.000
GoingConcern	0.069	0.253	0.000	0.000	0.000
LateFilers	0.129	0.335	0.000	0.000	0.000
Restatement	0.164	0.370	0.000	0.000	0.000
ICWeakness	0.097	0.296	0.000	0.000	0.000
MarketReturns	0.185	0.787	-0.234	0.064	0.363
ROA	-0.104	0.303	-0.131	0.004	0.041
Leverage	0.147	0.196	0.000	0.055	0.238
LnAssets	5.656	1.895	4.200	5.622	6.893

Panel B: Frequencies of "Significant" Negative Votes

	Votes Against or Abstaining from Auditor Ratification		
	VoteAgainst $\geq$ 5%	*VoteAgainst* < 5%	Total
Full Sample	116 (10.21%)	1,020 (89.79%)	1,136 (100%)
By Auditor Type:			
Big N	29 (6.09%)	447 (93.91%)	476 (100%)
Non-Big N	87 (13.18%)	573 (86.82%)	660 (100%)
Chi-Square statistic	29.00		
p-value	<.0001		
By Timing of Engagement:			
Late switch	38 (13.97%)	234 (86.03%)	272 (100%)
Early switch	78 (9.28%)	786 (90.98%)	864 (100%)
Chi-Square statistic	23.31		
p-value	<.0001		

Panel A presents the summary statistics of *VoteAgainst* and our regression variables. Panel B presents the number of observations in subsamples partitioned on *VoteAgainst* and the test variables, auditor type and timing of engagement. Variables are defined in the Appendix 2.

TABLE 3: COMPARISONS IN MEANS OF ADVERSE VOTE RATIOS

Panel A: Mean *VoteAgainst* by Quarters

Fiscal Quarter	N	Mean of *VoteAgainst*
Q1	339 (29.84%)	0.022
Q2	394 (34.68%)	0.017
Q3	233 (20.51%)	0.018
Q4	170 (14.96%)	0.027
	1,136	

Panel B: Mean *VoteAgainst* for Two Sub-periods of Quarter 1

	N	Mean of *VoteAgainst*	Test of Mean Difference (t-statistic)
Pre-Audit Report Date	102	0.026	
Post-Audit Report Date	237	0.020	1.04
	339		

Panel C: Mean *VoteAgainst* for Late versus Early Switches

	N	Mean of *VoteAgainst*	Test of Mean Difference (t-statistic)
LateSwitch	272	0.027	
EarlySwitch	864	0.018	2.90***
	1,136		

Panel D: Mean *VoteAgainst* by Auditor Type and Timing of Engagement

Timing of Engagement	Auditor Type	Mean of *VoteAgainst*
LateSwitch	(1) Big N (N=81)	0.0135
	(2) Non-Big N (N=191)	0.0323
EarlySwitch	(3) Big N (N=395)	0.0145
	(4) Non-Big N (N=469)	0.0217
Test of Mean Differences	(1) = (2)	2.92***
(t-statistic)	(3) = (4)	2.70***
	(1) = (3)	0.22
	(2) = (4)	2.87***
	(1) = (4)	1.94*

*, **, *** denote significance at the 0.10, 0.05, and 0.01 levels, respectively. This table presents the mean values of *VoteAgainst* by various subsamples. Panel A partitions the sample by fiscal quarter. Panel B presents difference in means tests for Q1 partitioned by the audit report date. Panel C partitions on the timing of engagement. Panel D presents mean values by timing and auditor type. *LateSwitch* includes Q4 and the pre-audit report date portion of Q1. *EarlySwitch* includes post-audit report date portion of Q1, Q2, and Q3. Variables are defined in the Appendix 2.

Following Barua et al. (2017), we consider shareholder disapproval of the selected auditor to be "economically significant" when five percent or more of the votes are cast against ratification or abstentions.[20] In other words, we partition the sample into two subgroups (e.g., high and low disapproval) using the five percent threshold. We report the frequencies by auditor type and by timing of auditor engagement in Panel B of Table 2. We observe a "significant" level of shareholder disapproval of the successor auditor for about 10 percent of our sample, which is well above the two percent in Tanyi and Roland (2017) but similar to 7.3 percent in Barua et al. (2017). These differences are likely attributable to sample composition. Auditor switching firms are generally considered riskier than non-switching firms. In addition, our sample of auditor switches includes both resignations and dismissals, which implies that our sample firms are riskier than to those used in Barua et al. (2017).[21] We further partition on our variables of interest, auditor type and timing of engagement, also shown in Panel B. We find that when firms engage Big N auditors, disapproval rate is 29 observations (6.09 percent). By comparison, the frequency of disapproval more than doubles 87 observations (13.18 percent) when non-Big N auditors are selected for ratification. We also observe a high level of disapproval in 13.97 percent of the late switches but only 9.29 percent of early switch auditors receive a significant number of votes against ratification. In both cases of the "economically significant" category, the Chi-square test indicates that the frequencies of each combination are statistically different at $p<0.01$. As predicted, we find that both auditor type and timing of engagement are associated with "economically significantly" votes.

MAIN RESULTS

Univariate Analyses

In Table 3, we examine the adverse votes (*VoteAgainst*) for various subsamples. Panel A reports the ratification vote results for each fiscal quarter. The second quarter is when we observe the highest frequency of auditor switches (35 percent), consistent with Burks and Stevens (2019). We also find that opposition to auditor ratification is highest when the switch occurs in the fourth quarter (2.7 percent) and first quarter (2.2 percent). Recall that *LateSwitch* represents the period between the beginning of the fourth quarter and the audit report date, which occurs during the first quarter. In Panel B, we partition further the first quarter switches into pre- and post-audit report date subgroups. A pre-audit report date switch implies that the client-auditor relationship was terminated before the audit is complete.[22] Auditors usually do not walk away or get dismissed while the audit is well underway. Therefore, pre-audit report date switches are more likely than post-audit report switches to be attributable to disagreements on

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[20] On average, 98 to 99 percent of shareholder votes are in favor of auditor ratification. In addition, 95 percent of the time the shareholder approval rate is at or above 95 percent (Audit Analytics 2013). Even though the difference between 98 and 95 percent seems negligible, the auditor may face more scrutiny as a result (Dao et al. 2008, 154)

[21] Barua et al. (2017) excludes resignations from their sample.

[22] We obtain audit report date from Audit Analytics (AA) and use it for classification of the first quarter switches into pre- and post-audit report date. To make sure that our classification using AA is accurate, we manually checked all Form 8-Ks of firms switching their auditors in the first quarter (339 firm-years). We find that about 5 percent of observations contain discrepancy between Audit Analytics and Form 8-Ks about firm information (e.g., when the termination/engagement occurs, who audits the current fiscal year, etc.). For these observations, we use the information directly obtained from Form 8-Ks.

accounting issues or audit opinions. However, we do not find a statistically significant difference in ratification vote results between the two sub-periods of Q1 (t = 1.04).

Table 3, Panel C presents the voting results split on the timing of engagement. As expected, we find that shareholders are less likely to ratify the selected auditor after a late switch (mean *VoteAgainst* = 0.027) than after an early switch (mean *VoteAgainst* = 0.018). This result is consistent with H2. In Panel D, we report the auditor ratification vote results by timing and auditor type. Shareholder disapproval is highest for the combination of *LateSwitch* and non-Big N auditor at 3.23 percent of votes being cast against ratification, which is 62 percent greater than the sample mean (two percent as reported in Table 2). When a non-Big N auditor is appointed, *VoteAgainst* is higher for a late switch (0.0323) than for an early switch (0.0217), and the difference is statistically significant (t-statistic = 2.87). In contrast, when a Big N auditor is selected, there is no difference in *VoteAgainst* between the late switch (0.0135) and the early switch (0.0145), a comparison between (1) and (3). Moreover, non-Big N auditor appointments results in greater shareholder disapproval, regardless of timing. Interestingly, the auditor ratification outcome is more favorable for *LateSwitch* with Big N (mean *VoteAgainst* = 0.0135) than for *EarlySwitch* with non-Big N (mean *VoteAgainst* = 0.0217), a comparison between (1) and (4), suggesting that the type of auditor is more important in ratification votes than the timing of engagement. Put another way, a Big N auditor is viewed more favorably than a non-Big N auditor, even if the Big N auditor is hired late and the non-Big N is hired early.

Regression Results

Table 4 presents the OLS estimation of models (1) and (2). Reported test statistics are based on robust standard errors clustered by firm and reported p-values are two-tailed to report test results conservatively. [23] In Model 1, we find that our test variables, *BigN* and *LateSwitch* , are statistically significant at the one percent level and in the predicted directions. The coefficient on *BigN* (-0.3997) corresponds to a voting outcome that is 33 percent less negative when the auditor is a Big N compared to non-Big N. [24] The coefficient on *LateSwitch* is 0.3246, which suggests that the proportion of negative votes is 38 percent greater for late switches than for early switches. This result is in line with recent studies that find audit quality suffers when the auditor is appointed late in the fiscal year because the incoming auditor faces not only a learning curve but also time constraint (Cassell et al. 2017; Pacheco-Paredes et al. 2017). These results of two variables of interest suggest that shareholders consider both auditor type and timing of engagement as important indicators of audit quality.

In Model 2, where *BigN×EarlySwitch* serves as the base, we find that two of the three test variables, *Non-BigN×LateSwitch* and *Non-BigN×EarlySwitch*, are positive and statistically significant at the one percent level. From an economic perspective, the coefficients on *Non-BigN×LateSwitch* (0.7311) and *Non-BigN×EarlySwitch* (0.3700) suggest that the shareholder disapproval rate is 108 percent (45 percent) greater for late (early) engagements of non-Big N auditors relative to early engagements of Big

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[23] We note that all simple correlations between regression variables are less than 0.60 (untabulated) and variance inflation factors in all regressions are less than 5, suggesting multicollinearity is not a concern in our study.
[24] The calculations are as follows: exp (0.3246) -1 for *LateSwitch* and 1- exp (-0.3997) for *BigN*.

N auditors. Furthermore, the (Wald) Chi-Square test shows that the difference between *Non-BigN×LateSwitch* and *Non-BigN×EarlySwitch* is statistically significant (p = 0.0062), which suggests that a late engagement of a non-Big N auditor is 43 percent worse than an early engagement of non-Big N auditors in terms of shareholder approval. However, when the auditor is a Big N, there is no penalty for a late switch as evidenced by the coefficient of *BigN×LateSwitch* (p-value = 0.3392). Note that *BigN×EarlySwitch* serves as a base in the regression. Last, we examine how shareholders view late switches of Big N versus early switches of non-Big N, a test of which one, type of auditor or timing of auditor switch, is more important. We do not find a statistically significant difference between *Non-BigN×EarlySwitch* (non-Big N but early switch) and *BigN×LateSwitch* (Big N but late switch), even though the coefficient of *Non-BigN×EarlySwitch* (0.3700) is greater in magnitude than that of *BigN×LateSwitch* (0.1676). Therefore, the results are inconclusive as to which type of auditor or timing of engagement is more important.

Turning to the control variables, we find that adverse votes are increasing with the predecessor auditor's tenure (*LnAudTenure*) and announcement of restatements (*Restatement*s) but decreasing with both market (*MarketReturns*) and accounting (*ROA*) performance, and firm size (*LnAssets*).[25] Some results are worth noting. The negative coefficient of firm size (*LnAssets*) is opposite to ratification studies that exclude auditor switches from their sample (e.g., Hermanson et al. 2009; Cassell et al. 2019). A brand new auditor more likely to be approved by shareholders the bigger the client firm. The positive coefficient of *LnAudTenure* suggests that replacing an old auditor with lengthy tenure unfavorably influences shareholder voting on the new auditor. In other words, shareholders are more likely to vote against the new auditor the longer the tenure of the old auditor. This result is in contrast with Dao et al. (2008), which shows that shareholders vote against *continuing* auditor with lengthy tenure. Our result suggests that auditor switching from the auditor with lengthy tenure might be a negative signal to shareholders because shareholders believe that the separation with auditors working with long time might be due to disagreements in accounting choices or audit opinions.[26]

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[25]Although negative votes are extremely rare, we believe that statistically significance on the regression results is meaningful to capture shareholders' views. This argument is supported by our other findings that high performance both in the stock market and in financial reporting reduces shareholders' negative votes and bad news such as announcement of restatements increases shareholders' negative votes. Note that these variables are not agenda that shareholders vote on, but simply represent causes of general dissatisfaction toward the firm. See also Cassell et al. (2019).

[26] However, untabulated pairwise correlation tests show that there is no correlation between LnAudTenure and DumIssues.

TABLE 4: RESULTS OF REGRESSIONS ESTIMATING RATIFICATION VOTES AGAINST AND ABSTAIN

Dependent Variable: *LnVoteAgainst*	Model 1			Model 2		
	Estimate	t-stat	p-value	Estimate	t-stat	p-value
LateSwitch	**0.3246**	**2.91**	**0.0037**			
BigN	**-0.3997**	**-3.77**	**0.0002**			
BigN×LateSwitch				**0.1676**	**0.96**	**0.3392**
Non-BigN×LateSwitch				**0.7311**	**4.82**	**<.0001**
Non-BigN×EarlySwitch				**0.3700**	**3.30**	**0.0010**
Resignation	0.1077	0.88	0.3798	0.1026	0.84	0.4003
LnAudTenure	0.1641	2.60	0.0093	0.1640	2.61	0.0092
DumIssues	0.1021	0.57	0.5689	0.0996	0.55	0.5821
GoingConcern	-0.1884	-0.89	0.3714	-0.1844	-0.87	0.3819
LateFiler	0.2210	1.53	0.1268	0.2142	1.47	0.1418
Restatement	0.3982	3.31	0.0010	0.4038	3.36	0.0008
ICWeakness	0.2319	1.43	0.1526	0.2298	1.41	0.1580
MarketReturns	-0.1159	-2.37	0.0181	-0.1144	-2.33	0.0199
ROA	-0.6573	-3.73	0.0002	-0.6618	-3.75	0.0002
Leverage	0.0470	0.19	0.8458	0.0629	0.26	0.7942
LnAssets	-0.1076	-3.49	0.0005	-0.1079	-3.49	0.0005
Intercept	-4.5435	-14.93	<.0001	-4.9388	-14.71	<.0001

Tests between Coefficients:

Non-BigN×LateSwitch = Non-BigN×EarlySwitch				$\chi^2 = 7.50$	p =0.0062	
BigN×LateSwitch = Non-BigN×LateSwitch				$\chi^2 = 1.21$	p =0.2712	

Adj R-Sq	0.122			0.1214		
N	1,136			1,136		

This table presents results of logistic regressions that examine the effects of auditor type and engagement timing on auditor ratification votes. The dependent variable is LnVoteAgainst, proportions of adverse votes. The test variables are in bold type. All regressions are estimated using robust standard errors clustered by firm and p-values are calculated at two-tailed tests. Industry and year dummies are included in analyses but not reported. See Appendix 2 for the variable definitions.

ADDITIONAL ANALYSES

Regression Results Including Auditor Tiers

The Big N and non-Big N dichotomy is arguably an oversimplification, particularly given that there are only four Big N auditors and the Big N auditors' market shares measured by the number of client firms are just 60-65 percent during our sample period.[27] Prior research examining audit quality of mid-tier (or second-tier) auditors relative to other tiers is mixed. Using accounting restatements as a measure of audit quality, Eshleman and Guo (2014) find that Big N auditors provide higher quality audits than mid-tier auditors but no difference between mid-tier and smaller auditors. Boone et al. (2010) find little difference in financial reporting quality between Big N and mid-tier auditors; however, mid-tier auditors are perceived to provide lower audit quality than Big N auditors.[28]

We also consider whether mid-tier auditors differ from Big N and smaller auditors with respect to shareholders' ratification by distinguishing between mid-tier (*Mid-tier*) and small (*Small*) auditors. Following Hogan and Martin (2009), the second tier auditor category includes four national audit firms—Grant Thornton LLP, BDO Seidman, McGladrey & Pullen, and Crowe, Chizek and Company. Table 5, Panel A shows that the second tier auditors comprise about nine percent of the whole sample. As predicted, the mean of *VoteAgainst* increases monotonically as from Big N auditors to Small auditors, which is also consistent with the hierarchy suggested in Eshleman and Guo (2014). However, mid-tier auditors are least likely to be hired late (mean *LateSwitch* = 0.095).

In Panel B, we find that both coefficients of *BigN* and *Mid-tier* are negative and statistically significant, suggesting that shareholders relatively content with appointments of second tier and Big N auditors, compared to the last tier auditors. In addition, we test the equality of the coefficients on *BigN* and *Mid-tier* and do not find that they are statistically different. Model 2 interacts the three auditor tiers (*BigN*, *Mid-tier*, and *Small*) with the two timing measures (*EarlySwitch* and *LateSwitch*) and *BigN×EarlySwitch* serving as the base. Only two interaction terms, *Small×LateSwitch* and *Small×EarlySwitch*, are positive and statistically significant, consistent with our main results. This result also suggests that, contrary to Boone et al. (2010), shareholders do not perceive a difference between Big N and Mid-tier. Furthermore, the (untabulated) test between *Small×LateSwitch* and *Small×EarlySwitch* indicates that they are statistically different, again, consistent with our main results.

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[27] We calculate these market shares using the whole population on Compustat. If we restrict it to our own sample, the market shares of the Big N auditor is less than 50 percent.

[28] Boone et al. (2010) proxy for investor perception using ex-ante equity risk premium.

TABLE 5: RESULTS OF REGRESSIONS INCLUDING SECOND TIER AUDITORS

Panel A: Descriptive Statistics by Auditor Tier

Auditor Type	N	Mean of *VoteAgainst*	Mean of *LateSwitch*
Big N auditors	476 (41.90%)	0.014	0.170
Mid-tier auditors	105 (9.24%)	0.021	0.095
Small auditors	555 (48.86%)	0.025	0.326
Total	1,136 (100%)		

Panel B: Regressions with Auditor Tiers

	Model 1 Estimate	t-stat	p-value	Model 2 Estimate	t-stat	p-value
LateSwitch	0.2432	2.33	0.0203			
BigN	-0.5528	-5.08	<.0001			
Mid-Tier	-0.6418	-3.87	0.0001			
BigN×LateSwitch				0.1654	0.95	0.3438
Mid-tier×LateSwitch				0.5188	1.06	0.2895
Mid-tier×EarlySwitch				-0.1407	-0.79	0.4303
Small×LateSwitch				0.7963	5.16	<.0001
Small×EarlySwitch				0.5386	4.67	<.0001
Intercept	-4.4564	-14.92	<.0001	-5.005	-15.06	<.0001
Controls	Included			Included		
Adj R-Sq	0.1338			0.1330		
N	1,136			1,136		

The second tier auditors include the following four auditing firms: Grant Thornton LLP, BDO Seidman, McGladrey & Pullen, and Crowe, Chizek and Company. Others are defined as non-Big auditors other than the second tier auditors. Test statistics are calculated using robust standard errors clustered by firm, and two-sided p-values are reported. Variables are defined in the Appendix 2.

Untabulated Additional Tests

We conduct two additional tests, which are not tabulated for brevity. First, we include proxies for specialist auditors (national- and city-level industry specialists as in (Reichelt and Wang 2010)) in the model and test whether they have any incremental effect above and beyond *BigN*. Our original test variables (i.e., *BigN* and *LateSwitch*) remain significant in the expected directions; however, we do not find that industry specialization has any bearing on shareholder voting. Similarly, we do not find significant coefficients on the industry specialist variables when they replace *BigN* in the regression. We also note that the Pearson correlations between *BigN* and industry specialization are surprisingly low—just 22 percent for city-level and 16 percent for national-level.[29] Thus, auditor type (e.g., Big N) and industry specialization seem to capture different aspects of audit quality. However, it is not clear whether shareholders indeed put more weight on a simple measure (Big N) than a more sophisticated

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[29] These correlations are in line with Reichelt and Wang (2010).

measure (industry specialists) or the results are attributable to measurement error.[30] Consistent with Jiang et al. (2019), our results suggest that shareholders value Big N auditors for their general competence as opposed to industry-specific expertise.

Second, we test whether our results are robust to controlling for corporate governance. Shareholder voting can be viewed as a monitoring device, albeit limited, and part of corporate governance. Prior research suggests that the voting outcome is less favorable when corporate governance is weak (e.g., Raghunandan and Rama 2003). We consider two proxies for governance prior studies have commonly used: institutional ownership and CEO-Chair dual role. Unfortunately, it is not feasible to include a CEO-Chair indicator variable due to data availability; only 17 percent of our sample have non-missing CEO-chair data in the Institutional Shareholder Services (ISS) database. While not as drastic, the institutional ownership data requirement also reduces our sample size considerably (by 38 percent). To maximize sample size, we set missing values of institutional ownership to zero rather than excluding them.[31] Our main results remain unchanged even after including institutional investor ownership as an additional control variable. We note that the coefficient on the institutional ownership variable is negative and significant at p<0.01, consistent with Raghunandan (2003).

CONCLUSION

This study uses shareholder voting on auditor ratification following an auditor switch to examine whether shareholders' perception of audit quality varies with auditor type and timing of engagement. No one in the auditor ratification literature explicitly examines these research questions. Results support the argument that shareholders take into consideration not only auditor type but also the timing of engagement when casting their auditor ratification votes. In particular, we find more favorable votes when (1) the successor is a Big N auditor or (2) the auditor switch is timely (i.e., before the end of the third quarter). However, newly engaged Big N auditors appear to be relatively immune to the timing of the switch. By contrast, shareholder disapproval of non-Big N auditors is worse for late engagements and still relatively high for early engagements. However, we are unable to definitively conclude that the auditor type is more or less important than the timing of engagement.

The present study incrementally contributes to the auditor switching literature and shareholders' ratification voting literature by documenting shareholders' views on the auditor type and timing of engagement. In addition, our findings are relevant to company management and audit committees who may consider auditor switches. To avoid unfavorable shareholders' ratification votes, they should select a Big N auditor at any time of the fiscal year or a non-Big N auditor at the earlier timing than the beginning of the fourth quarter. This study should be also of interest to corporate governance activists and regulators in that the auditor type and the timing of engagement are important factors to determine shareholders' perceptions on audit quality.

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[30] While using industry specialization enables us to examine quality variation within Big N auditors, a downside of this test is a lack of consensus on its measurement and thus the measure may suffer from large measurement error (Neal and Riley 2004; Defond and Zhang 2014).
[31] We confirm that excluding observations with missing institutional investor data yields qualitatively similar results.

APPENDIX 1: DEFINITIONS OF TIMING OF AUDITOR APPOINTMENT
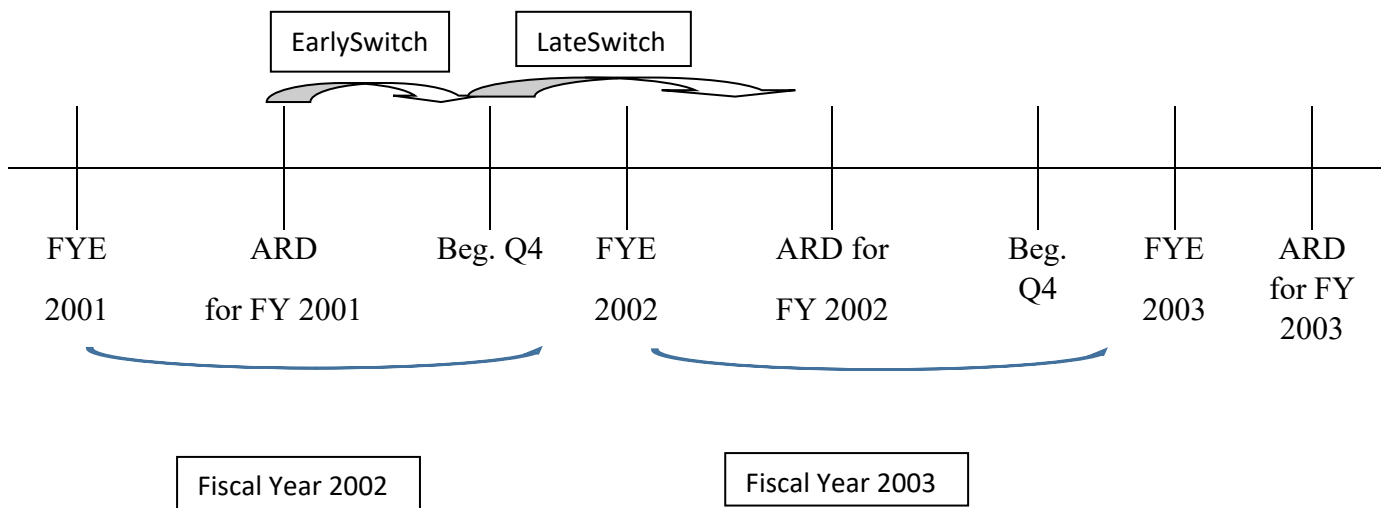
This Appendix presents a timeline to illustrate our timing variables. Audit reporting date (ARD) is the date when auditors complete their audits for the past fiscal year. The shareholders' meeting for the auditor ratification voting typically takes place three to six months after the fiscal year end (FYE). For the fiscal year 2002, *EarlySwitch* refers to auditor switches that occur after the audit report date for fiscal year 2001 (ARD for 2001) but before the fourth quarter of 2002 (Beg. of Q4). For fiscal year 2002, *LateSwitch* represents auditor switches that occur after fourth quarter of 2002 (Beg. of Q4) but before the audit report date for 2002 (ARD for 2002).

APPENDIX 2: VARIABLE DEFINITIONS (COMPUSTAT MNEMONIC IN BRACKETS)

Variable	Definition
VoteAgainst	Percent of shareholder ratification votes against or abstain over total votes (Source: Audit Analytics)
LnVoteAgainst	Logarithm of the percent of shareholder ratification votes against or abstain over total votes (Source: Audit Analytics)
LateSwitch	An indicator variable equal to one for client-years which terminated their relationship during the fourth quarter or the period after the fiscal year end but before the audit report date; zero otherwise (Source: Audit Analytics)
EarlySwitch	An indicator variable equal to one for client-years which terminated their relationship from the audit report date to the end of the third quarter; zero otherwise (Source: Audit Analytics)
BigN	An indicator variable equal to one if the incoming auditor [AU] is one of Big 4, and 0 otherwise
Resignation	An indicator variable set to one if the auditor resigns, and zero if the auditor is dismissed (Source: Audit Analytics)
LnAudTenure	Logarithm of the departing auditor's tenure (Source: Audit Analytics)
DumIssues	An indicator variable set to one if any of the following three events of negative disclosures in the Audit Analytics database are present, and zero otherwise: management representation not reliable assertion (ISS_MNGMT_REP), disagreement about audit opinion (ISS_AUDIT_OPINION), and disagreement about accounting treatments (ISS_ACCOUNTING) (Source: Audit Analytics)
GoingConcern	An indicator variable equal to one for client-years which received a going-concern opinion; zero otherwise (Source: Audit Analytics)
LateFiler	An indicator variable equal to one for client-years which filed a Form NT-10 K; zero otherwise (Source: Audit Analytics Non-Timely (NT) Filer Information)
Restatement	An indicator variable equal to one for client-years which announced restatements; zero otherwise (Source: Audit Analytics Non-Reliance database)
ICWeakness	An indicator variable equal to one for client-years which disclosed internal control material weakness; zero otherwise (Source: Audit Analytics)
MarketReturns	Annual market returns (Source: CRSP)
ROA	Net earnings [NI] divided by total assets [AT]
Leverage	Total client firm debt [DLTT] scaled by total assets [AT]
LnAssets	A client-year's logged total assets [AT]

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