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The Impact of the Auditor Selection Process and Audit Committee Appointment Power on Investment Recommendations

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SUMMARY: After the global 2007–2008 financial crisis, regulatory bodies proposed alternative auditor selection processes to enhance auditor independence such as mandatory audit firm *rotation* or mandatory *tendering* (i.e., rotation that allows for the current auditor to be reappointed). However, these alternative selection processes may not be effective if management has substantial influence over auditor appointment decisions. We posit that disclosures of high appointment power of the audit committee will enhance the perceived effectiveness of *rotation* and *tendering*, and thus increase investment recommendations. In an experimental study involving 118 experienced investment professionals, we examine the impact of the auditor selection process (mandatory *rotation*, mandatory *tendering*, and *voluntary* selection) and the appointment power of the audit committee (high, low) on investment recommendations. We find that audit committee appointment power affects investment recommendations only when a possible auditor change is anticipated (i.e., in the case of *rotation* and *tendering*), but not when the auditor selection is *voluntary*. Further, *rotation* and *tendering* lead to a higher recommended investment likelihood than *voluntary* selection, but only when an audit committee has high appointment power. In all, the findings underscore that investors do not view auditor selection processes in isolation of a company's internal corporate governance mechanisms.

Keywords: audit firm rotation; audit firm tendering; audit firm voluntary selection; audit committee appointment power; investment recommendations, corporate governance.

JEL Classifications: M42; M48; G11.

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Supplemental material can be accessed by clicking the link in Appendix A.

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INTRODUCTION

The global 2007–2008 financial crisis sparked extensive debate on measures to improve audit quality, particularly ways to strengthen auditor independence in fact and in appearance. In response, proposals designed to mitigate threats to independence were considered by the [European Commission \(2013\)](#) as well as by the Public Company Accounting Oversight Board (PCAOB 2011, 2012), with the Commission adopting regulations requiring public interest entities (PIEs) to periodically put the audit engagement up for competitive proposals by different audit firms ([European Commission 2014](#)) as part of either a mandatory *rotation* or a mandatory *tender* process. With *tendering*, the current auditing firm may continue in subsequent years if reappointed. In contrast, *rotation* takes place when another audit firm replaces the incumbent audit firm.¹ Both approaches differ from a *voluntary* auditor selection process, the prevailing approach in most jurisdictions, where it is up to the client company and the audit firm to decide whether to continue their relationship. The changes in the auditor selection process are aimed at preventing the auditor from becoming overly familiar and aligned with the client, the so-called *familiarity threat* (e.g., International Ethics Standards Board for Accountants [IESBA] 2013; [Bazerman, Loewenstein, and Moore 2002](#)).

In 2011 the PCAOB similarly issued a concept release considering audit firm *rotation* as a means to enhance auditor independence. However, the concept release was met with strong resistance from corporate board members, audit firms, and companies, and, after considerable deliberation, the PCAOB abandoned the idea of mandatory firm rotation. Among the arguments against mandatory firm *rotation* was that corporate governance and, in particular, a strong audit committee is sufficient to ensure auditor independence and audit quality (PCAOB 2012, 2013). More specifically, the Sarbanes-Oxley Act of 2002 reforms (Section 301) were believed to render mandatory *rotation* redundant, since a party independent of management (i.e., the audit committee) selects the auditor.² However, research has shown that despite regulatory reforms, auditor appointment power in practice is often deferred to management (e.g., [Cohen, Krishnamoorthy, and Wright 2010](#); [Fiolleau, Hoang, Jamal, and Sunder 2013](#); [Dhaliwal, Lamoreaux, Lennox, and Mauler 2015](#)). Consequently, auditor independence may be compromised, since the auditor may feel ultimately accountable to management, the *de facto* appointing party (e.g., [Tetlock 1999](#); [Fiolleau et al. 2013](#)).

Of note, the manner in which companies select and appoint their auditor is not currently publicly disclosed, even though this information appears to be relevant to financial statement users, as evidenced by a recent Securities and Exchange Commission (SEC 2015) concept release seeking comments regarding increased disclosure in this area. We utilize the power of the experimental setting to examine the potential impact of such information, if it were disclosed, on professional investor recommendations.

In the current study, we examine the interactive effect of the auditor selection process (*rotation*, *tendering*, *voluntary*) and audit committee appointment power (high, low) on the investment recommendations of investment professionals. Drawing on Source Credibility Theory ([Birnbbaum and Stegner 1979](#)) and Power Theory ([French and Raven 1959](#)), we argue that these two effects are interdependent. First, we predict a positive main effect for audit committee appointment power and expect that this effect will be exacerbated by the presence of mandatory *rotation* or *tendering*. When auditor selection is *voluntary*, auditor changes are relatively rare in practice ([Fiolleau et al. 2013](#); [Huang and Scholz 2012](#)). Thus, in this setting it is unlikely that the audit committee—even when charged with high appointment power—will initiate an auditor change. However, in settings where auditor changes are enforced (i.e., mandatory *rotation*), investors are faced with uncertainties about the quality and independence of the successor auditor, which an audit committee with high appointment power can help alleviate.

Second, we predict that mandatory *tendering* and *rotation* have a positive effect on investment recommendations when audit committee appointment power is high, but not when it is low. When the appointment power of the audit committee is low, investors are likely concerned about the *current* auditor's self-interest threat under both *voluntary* selection and *tendering*. When it comes to *rotation* and *tendering*, the potentially deficient quality of the *future* auditor may also be a concern. However, we expect both these concerns will be alleviated for *tendering/rotation* with an audit committee that exercises high appointment power.

To test our hypotheses, we conduct a between-subjects experiment with a sample of 118 experienced investment professionals in The Netherlands. The experimental case describes an opportunity to invest in the shares of a hypothetical listed company. We manipulate the auditor selection process (mandatory *rotation* at the end of the current year, mandatory *tendering* at the end of the current year, and *voluntary*) and the appointment power of the audit committee (high, low). We ask participants to assume the familiar role of an investment specialist and to offer advice to a client about the investment opportunity. As expected, we find a positive main effect for audit committee appointment power on the likelihood of

¹ Of note, the proposed audit firm *rotation* differs significantly from the requirement of audit partner *rotation*, which most jurisdictions have adopted, as rotation at the firm level will lead to an entirely new audit team, instead of just replacing the audit partner involved.

² In the EU, the audit committee is gradually being granted greater power in selecting the auditor. The audit committee is responsible for the procedure and recommendation for the selection of statutory auditors. The recommendation should consist of at least two audit firm choices and the justified preference for one of them ([European Commission 2014](#), Article 16.2).

recommending an investment; however, this is significant only in the presence of *rotation* and *tendering*. Further, given high audit committee appointment power, *rotation* and *tendering* both result in a higher investment level than *voluntary* auditor selection. However, when there is low audit committee appointment power, all auditor selection conditions result in an equally low investment recommendation.

This study makes five important contributions. First, neither the United States nor the EU currently requires explicit disclosure of the respective power of management *vis-à-vis* the audit committee in the auditor selection decision, despite the recent call by the SEC (2015) regarding the relevance to investors of increased disclosures on the auditor appointment process. Our experimental design provides a unique forward-looking opportunity to examine the impact on investors' decisions of providing such disclosures. Our findings suggest that mandatory *rotation* or *tendering* may not be effective unless investors are confident that an auditor change is accompanied by a strong and independent audit committee making the auditor selection decision. Hence, we draw attention to the importance of properly enforcing implementation and disclosure of audit committee appointment power, supporting the recent call by the SEC (2015).

Second, our results suggest that strengthening the role of the audit committee may not be effective in the absence of mandatory *rotation* or *tendering*. Third, while extant studies use nonprofessional investors (e.g., Gates, Lowe, and Reckers 2006; Kaplan and Mauldin 2008) or other professionals such as judges (e.g., Jennings, Pany, and Reckers 2006) to examine financial statement user responses to auditor selection processes, our study employs a unique pool of experienced investment professionals. Given their sizeable investments and recommendations to others, investment professionals drive the market (e.g., Nofsinger and Sias 1999). Fourth, the efficacy of mandatory *tendering* has not been examined in prior research despite its current implementation in Europe. Finally, and most importantly, this is the first study to our knowledge to consider and highlight the *joint* effect of the auditor selection process and audit committee appointment power on investment recommendations.

The remainder of this paper is divided into four sections. The next section contains a discussion of the prior literature and the development of the research hypotheses. Subsequent sections provide a description of the method, followed by presentation of the results. The final section is devoted to a summary of the major findings and their implications for practice and future research.

BACKGROUND, PRIOR LITERATURE, AND HYPOTHESES DEVELOPMENT

Auditor Credibility

According to Source Credibility Theory (e.g., Birnbaum and Mellers 1983), the credibility of a source is affected by its competence and bias, the latter of which can be interpreted as source independence. In this study, we argue that the current auditor's perceived *independence* affects investors' investment recommendations. If the auditor is perceived as more (less) independent, then the audit opinion will likely be viewed as having a higher (lower) level of credibility (Kelley 1973), which in turn affects information risk and, ultimately, investment recommendations. Furthermore, we argue that investment recommendations are also influenced by the perceived credibility of the *future* auditor in the case of an anticipated auditor change.

One of the measures proposed to enhance (perceived) auditor independence and, ultimately, audit quality is to impose auditor selection processes that restrict auditor tenure. The following section discusses alternative auditor selection processes.

The Auditor Selection Process

Under a *voluntary* auditor selection process—prevailing, for example, in the United States and before 2016 in the EU—it is up to the discretion of the company being audited and the audit firm to decide whether to end or continue the ongoing relationship. The main concern voiced by regulators and standard setters (e.g., European Commission, PCAOB) is that the frequently lengthy tenure of the auditor may potentially decrease auditor independence, and hence audit quality, due to excessive familiarity between the auditor and the client. Familiarity may result in a decrease in the auditor's attention to detail and (unconscious) incentives to please client management to retain the engagement (e.g., Ewelt-Knauer, Gold, and Pott 2013; Ruiz-Barbadillo, Gomez-Aguilar, and Carrera 2009; Bazerman et al. 2002). A large body of research examines the impact of audit firm tenure on audit quality,³ including a few studies focusing on financial statement user responses.⁴

³ The majority of these studies suggest an overall *positive* relationship between tenure and audit quality (e.g., Carcello and Neal 2000; Geiger and Raghunandan 2002). Interestingly, however, a number of studies observe a decrease in audit quality after some time period (e.g., Davis, Soo, and Trompeter 2009; Jenkins and Velury 2008; Raghunathan, Lewis, and Evans 1994), resulting in an inverted U-relationship between tenure and audit quality. This relationship is posited to be the result of increasing client-specific knowledge in the earlier years, leading to greater audit effectiveness, which is then offset by threats to independence over a longer time period.

⁴ Dao, Mishra, and Raghunandan (2008) report that shareholders believe that longer auditor tenure has a negative effect on audit quality. On the other hand, Ghosh and Moon (2005) find that investors perceive longer auditor tenure improves audit quality. Of note, however, it is unclear whether the results on firm tenure are generalizable to a setting of mandatory firm *rotation* (*tendering*), where it is certain (more likely) that the audit firm will not be reappointed, compared to a *voluntary* auditor selection process where reappointment is uncertain (e.g., Dopuch, King, and Schwartz 2001).

Mandatory audit firm *rotation* has been suggested as a means to alleviate the familiarity threat as rotation limits tenure to a predefined number of years. Following the 2014 regulatory changes, auditing firms in the EU are now required to rotate after a maximum engagement period of ten years, subject to extension of another ten years if a tender process is undertaken and 14 additional years in the case of joint audits with more than one principal audit firm (European Commission 2014).⁵

Mandatory audit firm *tendering* has also, albeit less frequently, been discussed as a means to enhance auditor independence as well as market competition. Alongside the EU legislation described in the previous paragraph, the U.K. has introduced mandatory *tendering* where the 350 largest companies are required to put their statutory audit out for tender at least every ten years (U.K. Competition Commission 2013). Conceptually, the main difference between *rotation* and *tendering* is the possibility of the reappointment of the current auditor that is permissible with *tendering* but not allowed with *rotation*.

A few studies have examined the effects of audit firm *rotation* on financial statement users' judgments.⁶ In 2003, the U.S. General Accounting Office (GAO 2003) surveyed and interviewed a variety of stakeholders on mandatory audit firm *rotation*. In its final recommendation, the GAO emphasized the perceptions of most surveyed stakeholders that the costs of introducing *rotation* would likely outweigh the benefits. However, the majority of Fortune 1000 companies consulted believed that investors' perceptions of auditors' independence would likely increase under mandatory audit firm *rotation*. In an experimental study, Daniels and Booker (2011) report that the presence of an audit firm *rotation* policy results in bank loan officers viewing auditors as more independent. However, perceptions of audit quality are not affected.

Some research findings further suggest that mandatory audit partner *rotation* may be sufficient to achieve a high level of perceived auditor independence (e.g., Kaplan and Mauldin 2008). However, Jennings et al. (2006) and Gates et al. (2006) present evidence from experiments with judges and nonprofessional investors indicating auditor independence perceptions are more strongly positively affected by audit firm *rotation* than by audit partner *rotation*.

Reid and Carcello (2017) examine the market reaction to six events in the United States that suggest either increased or reduced likelihood of the adoption of mandatory audit firm *rotation*. The results reveal negative investor reaction to the proposed change, especially for companies that currently have a high-quality auditor or have a longer relationship with their audit firm. While this study suggests investors view mandatory audit firm *rotation* negatively, the results may also mirror the common initial negative reaction to change (Dent and Goldberg 1999), especially when one is relatively happy with the current situation. It is, thus, difficult to extrapolate from these results to how investors would react if such changes were actually put in place.

Finally, opponents of both mandatory firm *rotation* and *tendering* raise concerns that a change in auditors results in lack of client-specific knowledge and an effective working relationship with client management. These factors have been identified as having an important impact on audit quality (e.g., Bell, Marrs, Solomon, and Thomas 1997; Solomon, Shields, and Whittington 1999; Bell, Peecher, and Solomon 2005). Thus, these offsetting effects of *rotation* and *tendering* may have a negative impact on investors' perceptions of audit quality.

In conclusion, with few exceptions (i.e., Reid and Carcello 2017), prior research suggests that financial statement user responses to mandatory audit firm *rotation* are either positive or neutral, but seldom negative, which suggests that investor perceptions of enhanced independence outweigh concerns about client-specific knowledge. However, as discussed in a following section, we posit an interaction where the ultimate effect of the auditor selection process will vary depending on the extent to which the audit committee holds auditor appointment power, and *vice versa*. Therefore, we first discuss the importance of audit committee appointment power before presenting our hypotheses.

Audit Committee Appointment Power

In most jurisdictions, legislative guidance (e.g., European Commission 2014) or best practices stipulate the audit committee should be highly involved in selecting the audit firm. In the United States, the Sarbanes-Oxley Act (U.S. House of Representatives 2002) mandates that the audit committee has the authority to select the audit firm and to oversee the financial reporting and audit processes to protect shareholder interests. In The Netherlands, where the current study was conducted, the auditor is formally appointed by a vote of the shareholders at the general meeting of shareholders. However, according to the

⁵ In The Netherlands, where the current study was conducted, an even shorter eight-year maximum engagement period had been announced to become effective in 2016 at the time of the study (Section 24 of Wta; The Dutch Audit Firms Supervision Act 2006, amended 01/01/2013). In order to align with EU regulations, the maximum engagement period in The Netherlands was later extended to ten years (NBA 2016). Interestingly, by 2013 almost 50 percent of the firms listed on the Amsterdam Stock Exchange had already started or completed the selection procedure to meet the original eight-year rotation requirement (Piersma 2014).

⁶ While our focus is on financial statement users' assessments, other studies have examined the impact of audit firm *rotation* on auditors' responses, i.e., independence in fact. The results of these studies are mixed: support for the efficacy of *rotation* includes Dopuch et al. (2001), Imhoff (2003), Wang and Tuttle (2009), Hatfield, Jackson, and Vandervelde (2011), and Chung (2004); studies reporting negative, mixed, or no effects include Cameran, Francis, Marra, and Pettinicchio (2015), Kwon, Lim, and Simnett (2010), Ruiz-Barbadillo et al. (2009), and Jackson, Moldrich, and Roebuck (2008).

Dutch Corporate Governance Code ([Corporate Governance Code Monitoring Committee 2008](#)), the audit committee advises the supervisory board, which in turn nominates the auditor to be selected. Hence, the audit committee plays an important governance role in the Dutch setting for the auditor appointment decision. Nonetheless, previous research reports that the power of the audit committee *vis-à-vis* management in the auditor selection decision varies widely, even in the United States, from situations in which the audit committee exercises the power of appointment and compensation both formally and informally to situations where, *de facto*, management makes these decisions (e.g., [Cohen, Krishnamoorthy, and Wright 2002](#); [Cohen et al. 2010](#); [Fiolleau et al. 2013](#); [Dhaliwal et al. 2015](#); [Beck and Mauldin 2014](#)).

The construct of power has been extensively examined in the social psychology and corporate governance literatures (e.g., [French and Raven 1959](#); [Elias 2008](#); [van Essen, Otten, and Carberry 2015](#)). Most relevant to our focus on auditor appointment is reward power, a construct from the seminal [French and Raven \(1959\)](#) power taxonomy. Reward power occurs when one party promises some form of compensation to a target in exchange for compliance ([Elias 2008](#)). Given their role as a corporate governance party, audit committees should reward auditors through reappointment and greater compensation for making judgments consistent with accounting standards and shareholders' interests.

If, however, management, rather than the audit committee, has the *de facto* reward power to appoint the auditor, auditors are more likely to consciously or unconsciously pursue strategies that reflect compliance with management's preferences. Indeed, consistent with research in psychology (e.g., [Lerner and Tetlock 1999](#)), prior auditing research has shown the tendency of auditors to make decisions in line with the party to whom they are accountable when that party's preference is known (e.g., [Gibbins and Newton 1994](#); [Salterio 1996](#); [Salterio and Koonce 1997](#); [Cohen and Trompeter 1998](#); [Turner 2001](#)). Importantly, research has found that if one party is clearly more powerful than the other (e.g., management is more powerful than the audit committee), then individuals often align their decisions with the more powerful party ([Tetlock 1999](#)).

There is widespread recognition and concern in the investment community about management's influence over corporate governance parties that may inhibit these parties from properly exercising their responsibilities to protect shareholders' interests (e.g., [Westphal 1999](#)). Research also shows that investors recognize and act on potential impairments in corporate governance. For instance, [Cohen, Milici Gaynor, Krishnamoorthy, and Wright \(2016\)](#) demonstrate in an experimental study that investors' assessments of the effectiveness of the audit committee and resulting investment decisions are influenced by the presence of social and professional ties between the audit committee and the CEO that may impair the independence of the audit committee from management.

We are aware of a handful of studies examining the effect of appointment power on audit quality ([Moore, Tanlu, and Bazerman 2010](#); [Koch, Weber, and Wüstemann 2012](#); [Dhaliwal et al. 2015](#)), but they all focus on auditor judgments and outcomes rather than financial statement user assessments. This makes our study the first to our knowledge to examine financial statement user responses to variations in audit committee appointment power. Importantly, in a forward-looking manner, our experimental approach allows us to examine the effect of audit committee appointment power on investors' judgments even though, as noted previously, such information is not currently required to be disclosed.

Following Power Theory and the reviewed accountability research evidence, we predict a positive effect of audit committee appointment power on investment recommendations for two reasons; the first related to perceptions about the current auditor and the second related to the upcoming successor auditor. First, when audit committee appointment power is high, investors have greater assurances that the current auditor lacks incentives to please management in its reporting preferences in order to be reappointed, because the auditor is accountable to the audit committee. In contrast, when audit committee appointment power is low, investors likely perceive that management may influence the current auditor to accept aggressive accounting practices. Prior literature has provided widespread evidence of management's propensity to act strategically and opportunistically in pursuing their self-interests. For instance, research in Agency Theory supports management's aggressive financial reporting and actions (e.g., [Shleifer and Vishny 1997](#); [Fama and Jensen 1983](#)).

Second, given high-perceived audit committee appointment power, investors are likely to conclude that, in case of an anticipated auditor change, the future auditor will be of overall high quality in terms of both competence and independence, because the audit committee is in the position to choose a high-quality auditor. In contrast, in the case of low-perceived audit committee appointment power, investors are likely to conclude that management has a strong influence in appointing a future auditor to their liking, ultimately leading to potential future auditor independence and/or competence concerns. Overall, following Source Credibility Theory, Power Theory, and Agency Theory, we suggest that resulting perceptions of auditor independence and competence will be reflected in investment professionals' investment recommendations, as stated in our first hypothesis.

H1: Investment professionals' recommendation to invest will be higher when audit committee appointment power is high than when audit committee power is low.

In the following section, we discuss why we expect that the audit committee appointment power effect will be moderated by the auditor selection process in place, and *vice versa*.

FIGURE 1
AC POWER by PROCESS on Recommendation Likelihood
Predicted Interaction Effect

Interaction of Auditor Selection Process and Audit Committee Appointment Power

We first consider the effect of the audit committee appointment power on investment recommendations for each of the three auditor selection processes. We posit that audit committee appointment power is least salient to investors' investment recommendations in a *voluntary* auditor selection process, since prior research shows that *voluntary* audit firm changes are extremely rare, and investors, especially professional investors—the participants in our study—are likely aware of this. For instance, Huang and Scholz (2012) report that only 7 percent of their sample of nonrestatement public companies changed auditing firms. Nonetheless, high appointment power of the audit committee may be of some relevance with a *voluntary* auditor selection process as a signal to investors of the committee's level of independence, which may affect other monitoring activities such as confronting management on contentious financial reporting and internal control matters.

Greater likelihood of an auditor change leads to investor uncertainties about the quality of the successor auditor. In the case of both *rotation* and *tendering*, an audit committee with high appointment power increases the probability that the future auditor will be of high quality and hence alleviates such uncertainties. In addition, in the case of *tendering*, where reappointment of the current auditor is permissible, high audit committee appointment power diminishes the direct incentive for the current auditor to please management in order to be reappointed during the tendering process. Hence, the appointment power of the audit committee is likely to be of greater relevance in making investment recommendations in the case of *rotation* and *tendering* than in a *voluntary* selection process (see Figure 1).

While we recognize, as discussed previously, that the anticipation of a new auditor due to *rotation* or *tendering* may lead investors to be concerned about a lower level of auditor client-specific knowledge than when there is *voluntary* selection and the incumbent auditor is likely to be retained, we posit that an upcoming *rotation* or *tender* is likely to trigger an anticipated enhanced level of independence of the auditor. In the spirit of the proposals in favor of mandatory *rotation* and *tendering*, we expect that independence is viewed by investors as an essential first-order auditor characteristic. That is, what is the value of client-specific knowledge if the auditor does not use such knowledge to ensure financial reporting is in the interests of shareholders? Further, client-specific knowledge biases against finding support for our hypothesis below. In all, the findings will provide an opportunity to test the validity of the contrary view that client-specific knowledge is weighed by investors as more important than, or of equal importance to, potential gains in auditor independence.

H2a: The difference in investment professionals' recommendations to invest between high and low audit committee appointment power is greater in the presence of mandatory *rotation* or *tendering* compared to a *voluntary* auditor selection process.

Next, we discuss how audit committee appointment power moderates the effect of different auditor selection processes on investment recommendations (see Figure 1). First, we consider a situation where the appointment power of the audit committee

is low with the consequence that investors are faced with perceived threats due to management's dominant power in appointing the auditor. As suggested by regulators, mandatory *tendering* has the potential of alleviating a perceived familiarity threat. However, when audit committee appointment power is low, investors are likely to assess that the current auditor has motivations (both conscious and unconscious) to please management for reappointment and higher compensation, i.e., a self-interest threat (IESBA 2013).

Mandatory *rotation* likely eliminates the perceived self-interest threat faced by the current auditor, since the auditor cannot be reappointed. However, absent strong governance mechanisms to safeguard *future* audit quality, management has the discretion to appoint an audit firm of their choice, potentially lacking appropriate independence and/or competence. We argue that the benefits of *rotation* cannot unfold given the remaining concerns about future auditor quality. As a result, we hypothesize that regardless of the auditor selection process, investors will view a low level of audit committee appointment power as reflective of higher information risk and *ceteris paribus* will recommend a low level of investment.

At the other extreme, in a scenario where the audit committee holds high appointment power, the proposed advantages of both *tendering* and *rotation* can manifest because high audit committee appointment power reduces the aforementioned threats of self-interest (*tendering*) as well as future auditor quality uncertainty (*tendering* and *rotation*).⁷ Meanwhile, we expect that despite high audit committee appointment power, the perceived familiarity threat will persist with the *voluntary* auditor selection process and, hence, investment likelihood will be considerably lower in this condition than for *rotation* and *tendering*, as reflected in our final hypothesis.

H2b: When audit committee appointment power is low, investment recommendations will be equivalent across auditor selection process conditions, but when audit committee appointment power is high, *rotation* and *tendering* will lead to a higher investment recommendation than a *voluntary* selection process.

RESEARCH METHOD

Design, Participants, Task, and Procedure

To test our hypotheses, we conducted an experiment using a between-subjects, three-by-two, full-factorial design, in which we manipulated the auditor selection process (*PROCESS*: mandatory *rotation*, mandatory *tendering*, or *voluntary*) and audit committee appointment power (*AC POWER*: high or low). The experiment was administered in 2013 in The Netherlands, about three years before mandatory audit firm *rotation* was formally implemented. We assigned each participant to one of the six treatment conditions.⁸

We sought individuals to participate in the experiment who had sufficient task-specific experience as a professional investment advisor to evaluate and make an investment recommendation on a common stock investment opportunity. We obtained the desired number of individuals via two participant pools of professional investors. First, we solicited participation of experienced investment professionals holding a professional qualification by posting invitations in newsletters distributed to members of the Dutch Association of Investment Professionals (Vereniging van Beleggingsanalisten [VBA]) and the Dutch Securities Institute (DSI). A URL in the newsletter directed participants to a web-based version of the experiment. Second, novice investment professionals enrolled in the final stages of certification courses to acquire professional qualification (CFA and VBA programs at a large university in The Netherlands)⁹ also participated in the experiment by completing a paper-based version of the instrument. All individuals voluntarily participated in the study in exchange for a donation by the researchers of €2.00 to a cancer charity and the possibility of winning a dinner voucher of €100.¹⁰

⁷ When an audit committee has high appointment power there is the possibility that investors may perceive the current auditor must be of high quality, and mandatory firm *rotation* can lead to the potential for a lower-quality successor auditor, especially given the oligopolistic audit market where there are few audit firm choices. However, this possibility is viewed as unlikely, since investors focus on both independence and competence. As discussed, the threat of familiarity can lead to conscious or unconscious bias, which *rotation* is designed to mitigate. Further, there is more than one audit firm in all industries with the competence to perform a high-quality audit. Such effects, if present, serve to bias against supporting our hypotheses.

⁸ At the time of data collection, the approval by an institutional review board for the use of human subjects was not required at Dutch universities.

⁹ The CFA (Chartered Financial Analyst) program prepares individuals for the international CFA I, II, and III exams. The VBA (Vereniging van Beleggingsanalisten [Dutch Association of Investment Professionals]) program is an investment management program, educating people to become a "Registered Beleggingsanalyst" (RBA).

¹⁰ Distribution of the two participant pools to treatment groups was not entirely random due to the later discovery of the need to revise the instrument for the *rotation* condition to further clarify the selection process for the replacement auditor. At this stage, we had exhausted our access to the participant pool of experienced investment professionals with a professional qualification; hence, rotation cells contain only investment professionals enrolled in certification courses. Table 1 provides demographic data on the treatment groups and the two participant pools. While both participant pools have sufficient task-specific experience for our experiment, in the "Results" section we report the findings of robustness analyses to rule out the possibility that our results are driven by the participant pool.

Participants read the experimental case materials and then responded to the dependent measure (likelihood of recommending that a client invest) and a secondary measure (recommended investment amount). Participants in the paper-based setting placed the first part of the materials in an envelope, sealed the envelope, and opened a second envelope, which contained a post-experimental questionnaire, manipulation checks, covariate measures, and demographic questions. At the end of the session the experimenter collected both envelopes.

In the web-based version of the experiment, participants read the case materials and responded to measures on eight consecutive computer screens. Participants were able to browse back and forth to review case facts before responding to the dependent variable, investment likelihood. However, before proceeding to the post-experimental questionnaire, they were explicitly asked not to go back to the previous screen while answering consecutive questions.

Experimental Case

Consistent with their customary responsibilities, participants assumed the role of an investment professional who had been asked to give advice to a client about an opportunity to invest in the shares of a listed company, XYZ Industries. The company would be part of a European equity portfolio held by an institutional investor where the amount currently available for new opportunities is €10 million. The total size of the investment portfolio is about €200 million, and the investment opportunity is described as consistent with the portfolio's investment policy. Next we provided background information on the investment, including a description of the organization's background, strategy, commercial outlook, and some key audited figures. On the fourth screen/page, immediately preceding measurement of the dependent variable, we described key facts related to the corporate governance of XYZ and its financial statement auditor. We held audit committee expertise constant across all conditions, indicating the committee is compliant with regulatory and stock exchange requirements with respect to financial expertise. The audit committee members were also described as having "no financial or business ties with the company"; hence, economic independence was held constant. The audit firm was described as a Big 4 auditor that had been engaged for the past eight years and had issued unqualified opinions in all preceding years. Thus, the competence (Big 4) and tenure (eight years) of the current audit firm were held constant.

Audit Committee Appointment Power

We manipulated audit committee appointment power by varying the extent to which the audit committee and the CFO of the company, respectively, have influence over the selection and appointment of the auditor. In the high audit committee appointment power condition, the CFO was described as having "very limited say in the selection and appointment of the auditor" and that "the audit committee makes its own decision on which auditor to select." In contrast, participants in the low appointment power audit committee condition read about a CFO with "very important say in the selection and appointment of the auditor" and learned that "the audit committee selects an auditor that is satisfactory to the CFO's preferences." We use a relatively strong manipulation of audit committee appointment power in our experiment, with the goal of providing a powerful test of our hypotheses (Kerlinger 1973).

Audit Firm Selection Process

First, participants in the mandatory *rotation* condition were informed, "after an audit firm serves for eight years, regulations require a change (rotation) to another audit firm, such that a tender process be instituted where various firms, excluding the current auditor, compete for the appointment as financial auditor. Consequently, 2012 was the current audit firm's last audit of XYZ and another audit firm will perform the forthcoming 2013 audit." We selected an eight-year horizon given that the study was conducted in The Netherlands where this period was proposed and enacted into law prior to the EU initiatives, and participants might anticipate an upcoming mandatory audit requirement of this time period. We deliberately referred to the notion of a tender process since we wanted to hold that part of the auditor change constant across *rotation* and *tendering* conditions.

Second, in the mandatory *tendering* condition, we informed participants "after an audit firm serves for eight years, regulations require a tender process be instituted where various audit firms, including the current auditor, compete for the appointment as financial auditor. Consequently, the current audit firm may or may not be the audit firm that will perform the forthcoming 2013 audit."

Finally, participants in the *voluntary* selection process treatment learned that "there are no legal limitations as to how long the audit firm can serve. Consequently, the auditor may continue for as long as the company and audit firm decide to work together."

Dependent Variable

Our dependent variable is the likelihood that participants would recommend an investment in XYZ Industries on a scale from 0 percent (“Would definitely not recommend an investment”) to 100 percent (“Would definitely recommend an investment”), i.e., we refer to this variable as the “recommendation likelihood” for brevity. We deliberately did not elicit participants’ personal investment likelihood since we wanted him or her to perform a task that is consistent with his or her professional responsibilities as an advisor. In this capacity, the advisor is anticipated to focus on the investment worthiness of the securities.

RESULTS

Sample Demographics

A total of 136 investment professionals participated in the experiment. Eighteen individuals were eliminated because they did not respond to all the essential items in the questionnaire. Hence, we omit these observations and are left with a sample of 118 participants.¹¹ Table 1 summarizes the overall demographics of our sample, including demographics across treatment conditions (Panel A) and the two participant pools (Panel B). The majority of participants are currently employed as investment professionals (69.5 percent) and they have an average of 10.74 years of experience in this field, confirming that participants are highly experienced and have the requisite task experience for the study.

The investment opportunity described in the case was intended to raise some level of willingness to recommend the investment. At the same time, we did not intend to cause a ceiling effect where all participants would select a 100 percent recommendation likelihood. Participants considered the market (recycling and renewable energy) reasonably attractive (mean = 4.71 on a scale from 1 = not at all attractive to 7 = highly attractive) and the risk return profile of a potential equity investment in XYZ Industries as moderate (mean = 3.95 on a scale from 1 = very negative to 7 = very positive), which is in line with our intentions. Further, the auditor was considered reasonably independent (mean = 4.64 on a scale from 1 = not at all independent to 7 = highly independent) and relatively competent (mean = 4.87 on a scale from 1 = not at all competent to 7 = highly competent).¹²

As described previously, we solicited responses from two distinct channels: 58 (49.2 percent) experienced professional investors via a web-based instrument, and 60 (50.8 percent) novice professional investors via a paper-based instrument. To assess the two groups’ homogeneity, we compared them on a number of demographic dimensions and case-based measures, using two-tailed tests (see Table 1, Panel B for descriptives and respective statistical tests). As expected, compared to novice professionals, experienced professionals have more working experience as investment professionals (mean = 17.41 years versus 4.19 years), have analyzed financial statements more frequently (mean = 2.36 versus 1.80), and have more frequently been employed as investment professionals (94.8 percent versus 66.7 percent) than the novice investment professionals.

Despite these differences, both the experienced and novice professionals have on average substantial domain and task-specific knowledge and are, thus, appropriate participants for the current experiment. Thus, as expected, the two groups do not differ significantly with respect to their risk appetite nor their case-based judgments regarding recommendation likelihood (our dependent variable), investment amount, perceived auditor competence, perceived auditor independence, perceived importance of the auditor’s report, perceived attractiveness of the described market, or the assessed risk-return profile of the investment target (all p ’s > 0.14). Further, we also conducted our hypothesis tests controlling for participant pool and all demographic variables. The results are equivalent to our primary findings, confirming that our results are not driven by participant pool. Hence, we do not control for participant pool in our primary analyses.

During hypothesis testing we control for the recommended investment amount (*AMOUNT*) and the assessed risk-return profile of the investment target (*RISK-RETURN*), because both assessments are theoretically expected to affect the likelihood of investing and are strongly correlated with the dependent variable (*AMOUNT*: $r(116) = 0.56$, $p < 0.001$, two-tailed; *RISK-RETURN*: $r(116) = 0.54$, $p < 0.001$, two-tailed). The investment amount is an indication of the strength or intensity of the

¹¹ Of the 18 omitted participants, nine did not complete the manipulation checks, the demographic questions, and the case-based measures (auditor competence, etc.); and another nine did not answer the demographic questions and the case-based measures. When including eliminated participants, the overall results are robust, with one exception, which we discuss in footnote 14. Further, as shown in Table 1, Panel A, 31 participants indicate they have no work experience as an investment professional and/or report no prior experience with financial statement analysis, which may present concerns about whether they have the requisite task experience. Despite the drastic sample and cell size reduction when omitting all of these participants (remaining sample of $n = 87$), the results are qualitatively equivalent to our primary results, although with lower levels of significance likely due to lower power of the tests.

¹² Some case-based measures are positively correlated with recommendation likelihood, as would be expected (not tabulated): auditor competence ($r(116) = 0.24$; $p < 0.01$), audit report importance ($r(116) = 0.18$; $p < 0.10$), auditor independence ($r(116) = 0.38$; $p < 0.001$), and market attractiveness ($r(116) = 0.30$; $p < 0.01$). Controlling for these measures leads to overall results that are robust, with one exception, which we discuss in footnote 14.

TABLE 1
Descriptive Statistics
Panel A: Demographics—Overall Sample and by Treatment Group, Followed by Statistical Comparisons between Treatment Groups

	Overall Sample		(1) High AC POWER/ Rotation		(2) High AC POWER/ Tendering		(3) High AC POWER/ Voluntary		(4) Low AC POWER/ Rotation		(5) Low AC POWER/ Tendering		(6) Low AC POWER/ Voluntary		Statistical Tests ^a
	n	Mean (SD)/%	n	Mean (SD)/%	n	Mean (SD)/%	n	Mean (SD)/%	n	Mean (SD)/%	n	Mean (SD)/%	n	Mean (SD)/%	
Years of Experience as Investment Professional	117	10.74 (11.00)	19	4.00 (5.75)	18	13.17 (10.11)	20	12.60 (11.00)	20	4.35 (5.71)	21	12.90 (11.69)	19	17.58 (13.37)	(1) < (6), $p < 0.01$; (4) < (6), $p < 0.01$
F/S Analysis Experience ^b	118	2.08 (1.39)	19	2.11 (1.20)	18	2.33 (1.50)	20	2.35 (1.42)	20	1.65 (1.23)	21	1.67 (1.43)	20	2.40 (1.50)	Remaining p-values > 0.05 All p-values > 0.70
Risk Appetite ^c	117	6.62 (2.25)	18	7.17 (2.04)	18	7.06 (2.24)	20	5.75 (2.10)	20	6.95 (2.40)	21	6.10 (2.64)	20	6.85 (1.84)	All p-values > 0.50
Gender															
Male	99	83.9%	14	73.7%	15	83.3%	18	90%	16	80%	18	85.7%	18	90%	$p = 0.752$
Female	19	16.1%	5	26.3%	3	16.7%	2	10%	4	20%	3	14.3%	2	10%	FET, two-tailed
Participant Pool															
Experienced	58	49.1%	0	0%	14	77.8%	15	75.0%	0	0%	15	71.4%	14	70%	$p < 0.001$
Novice	60	50.9%	19	100%	4	22.2%	5	25.0%	20	100%	6	28.6%	6	30%	FET, two-tailed
Ever Worked as Investment Professional															
Yes	95	80.5%	11	57.9%	14	77.8%	20	100%	13	65%	19	90.5%	18	90%	$p < 0.01$
No	22	18.6%	8	42.1%	4	22.2%	0	0%	7	35%	2	9.5%	1	5%	FET, two-tailed
Currently Employed as Investment Professional															
Yes	82	69.5%	8	42.1%	12	66.7%	18	90%	13	65%	16	76.2%	15	75%	$p < 0.05$
No	36	30.5%	11	57.9%	6	33.3%	2	10%	7	35%	5	23.8%	5	25%	FET, two-tailed
F/S Analysis Experience															[not computed due to insufficient cell sizes in many conditions]
Never	14	11.9%	1	5.3%	2	11.1%	1	5%	4	20%	4	19%	2	10%	
A Few Times (< 10)	39	33.1%	6	31.6%	5	27.8%	7	35%	6	30%	9	42.9%	6	30%	
Regularly (> 10)	17	14.4%	5	26.3%	2	11.1%	3	15%	4	20%	2	9.5%	1	5%	
Often (> 25)	20	16.9%	4	21.1%	3	16.7%	2	10%	5	25%	2	9.5%	4	20%	
Very often (> 100)	28	23.7%	3	15.8%	6	33.3%	7	35%	1	5%	4	19%	7	35%	

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TABLE 1 (continued)

Panel B: Demographics and Case-Based Measures by Participant Pool

	Experienced Investment Professionals		Novice Investment Professionals		Statistical Tests ^a
	n = 58	Mean (SD)/%	n = 60	Mean (SD)/%	
Demographics					
Years of Working Experience as Investment Professional	58	17.41 (11.30)	59	4.19 (5.33)	t(115) = 8.119 p < 0.001, two-tailed
F/S Analysis Experience ^b	58	2.36 (1.45)	60	1.80 (1.29)	t(116) = 2.232 p < 0.05, two-tailed
Risk Appetite ^c	58	6.40 (2.33)	59	6.85 (2.16)	t(115) = -1.086 p = 0.280, two-tailed
Gender	58		60		
Male	53	91.4%	46	76.7%	p < 0.05 FET, two-tailed
Female	5	8.6%	14	23.3%	
Ever Worked as Investment Professional	58		59		
Yes	55	94.8%	40	66.7%	p < 0.001 FET, two-tailed
No	3	5.2%	19	31.7%	
Currently Employed as Investment Professional	58		60		
Yes	47	81.0%	35	58.3%	p < 0.01 FET, two-tailed
No	11	19.0%	25	41.7%	
F/S Analysis Experience	58		60		
Never	4	6.9%	10	16.7%	
A Few Times (< 10)	20	34.5%	19	31.7%	
Regularly (> 10)	6	10.3%	11	18.3%	
Often (> 25)	7	12.1%	13	21.7%	
Very often (> 100)	21	36.2%	7	11.7%	p < 0.05 FET, two-tailed
Case-Based Measures					
Recommendation Likelihood ^d	58	47.41 (25.52)	60	53.67 (20.08)	t(116) = -1.482 p = 0.141, two-tailed
Investment Amount ^e	58	2,483 (2,294)	60	2,933 (2,130)	t(116) = -1.106 p = 0.271, two-tailed
Perceived Auditor Competence ^f	58	4.90 (1.05)	60	4.85 (1.34)	t(116) = 0.209 p = 0.834, two-tailed
Perceived Auditor Independence ^g	58	4.52 (1.60)	60	4.77 (1.58)	t(116) = -0.852 p = 0.396, two-tailed

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TABLE 1 (continued)

	Experienced Investment Professionals		Novice Investment Professionals		Statistical Tests ^a
	n = 58	Mean (SD)/%	n = 60	Mean (SD)/%	
Perceived Importance of the Auditor's Report ^b	58	4.57 (1.39)	60	4.77 (1.58)	t(116) = 0.373 p = 0.710, two-tailed
Perceived Attractiveness of Described Market ^c	58	4.59 (1.63)	60	4.83 (1.39)	t(116) = -0.886 p = 0.378, two-tailed
Perceived Risk-Return Profile of the Investment Target ^d	58	3.79 (1.28)	60	4.10 (1.16)	t(116) = -1.365 p = 0.175, two-tailed

Table 1 is available as a downloadable Word document, see Appendix A for the link.

^a For continuous variables, we test for statistical differences using ANOVAs (not reported) followed by Sidak multiple comparison tests, the p-values of which are reported in the table (Panel A) and t-tests (Panel B). For categorical variables, we test for cell size differences using two-tailed Fisher's exact tests (FET), given the relatively small cell sizes.

^b We measured experience with financial statement analysis on a five-point scale: 0 = Never; 1 = A few times (< 10 times); 2 = Regularly (> 10 times); 3 = Often (> 25 times); 4 = Very often (> 100 times).

^c When do you prefer a lottery over a sure thing? The following ten items represent a series of choices between two alternatives: a sure thing versus a lottery. You can either receive €500 for sure or you can decide to take part in a lottery. Please indicate at which point you *first prefer the lottery option* over a sure thing:

- 1 = €500 for sure versus lottery: 10 percent chance for €1,000; 90 percent chance for €0.00
- 2 = €500 for sure versus lottery: 20 percent chance for €1,000; 80 percent chance for €0.00
- 3 = €500 for sure versus lottery: 30 percent chance for €1,000; 70 percent chance for €0.00
- 4 = €500 for sure versus lottery: 40 percent chance for €1,000; 60 percent chance for €0.00
- 5 = €500 for sure versus lottery: 50 percent chance for €1,000; 50 percent chance for €0.00
- 6 = €500 for sure versus lottery: 60 percent chance for €1,000; 40 percent chance for €0.00
- 7 = €500 for sure versus lottery: 70 percent chance for €1,000; 30 percent chance for €0.00
- 8 = €500 for sure versus lottery: 80 percent chance for €1,000; 20 percent chance for €0.00
- 9 = €500 for sure versus lottery: 90 percent chance for €1,000; 10 percent chance for €0.00
- 10 = €500 for sure versus lottery: 100 percent chance for €1,000; 0 percent chance for €0.00

^d Based on the case described above, please indicate the likelihood that you would recommend an investment in XYZ Industries: 0 percent (Would definitely not recommend an investment) to 100 percent (Would definitely recommend an investment).

^e Within the investment policy of the portfolio, the minimum initial investment amount is set at €1 million. Consequently, the investment amount can range between €1 million and €10 million. If you advise that an investment in XYZ Industries be made, how much money would you recommend be invested, taking into account a total portfolio size of €200 million?

^f In your opinion, how *competent* is the *auditor* in determining whether the 2012 financial statements give a true and fair view of the financial status and performance of XYZ Industries? 1 (Not at all competent) to 7 (Highly competent).

^g In your opinion, how *independent* is the auditor in determining whether the 2012 financial statements give a true and fair view of the financial status and performance of XYZ Industries? 1 (Not at all independent) to 7 (Highly independent).

^h How important was the 2012 auditors' report in your assessment of the investment opportunity in XYZ Industries? 1 (Not at all important) to 7 (Very important).

ⁱ As you know, XYZ operates in the recycling and renewable energy market. Do you consider this an attractive market to invest in? 1 (Not at all attractive) to 7 (Highly attractive).

^j What do you consider to be the risk-return profile of an equity investment in XYZ Industries? Note: "Very positive" in this question means the returns greatly exceed the risks taken. 1 (Very negative) to 7 (Very positive).

participant's recommendation to invest, i.e., larger amounts reflect a stronger recommendation, while the risk-return profile reflects the perceived attractiveness of the investment. Since none of the demographic variables (gender, working experience, financial statement analysis experience, current employment as investment professional, and risk appetite) are significantly correlated with recommendation likelihood, we do not include them in the main analysis.

Manipulation Checks

To assess whether our manipulation of audit committee appointment power (*AC POWER*) was successful, we asked participants to indicate the primary party that determines the selection and appointment of the auditor. Participants responded on a seven-point scale with 1 = The CFO; 4 = CFO/audit committee equally; 7 = the audit committee. The mean in the high *AC POWER* condition (5.96) is significantly higher (and in the expected direction) than in the low *AC POWER* condition (3.18; $t(116) = 9.41$, $p < 0.001$, one-tailed). We also asked participants to indicate the extent to which the members of XYZ's audit committee are independent *vis-à-vis* the company's management, where independence was described as the extent to which the committee makes its own decisions—whether their choices conflict with management's preferences (1 = not at all independent; 7 = highly independent). Again, the difference between the two treatment means is significant and in the expected direction ($t(116) = 3.86$, $p < 0.001$, one-tailed), such that participants in the high *AC POWER* condition rated independence significantly higher (mean = 4.74) than participants in the low *AC POWER* condition (mean = 3.67). Overall, we conclude that our manipulation of audit committee appointment power was successful.

We assess the effectiveness of the auditor selection process (*PROCESS*) manipulation in two ways. First, participants responded to a categorical measure, which asked them to choose among three alternatives to identify the legal requirements as to the appointment of the audit firm. The vast majority of participants (86 out of 118 participants) provided the correct answer, and the distribution of correct answers across experimental conditions is significantly different in the expected direction ($\chi^2(4, 118) = 84.11$; $p < 0.001$). However, 12 participants in the *voluntary* condition, 8 participants in the *rotation* condition, and 12 participants in the *tendering* condition selected a selection process that was inconsistent with the manipulation.

Second, participants responded to a continuous measure from 0 percent (will definitely not be the auditor next year) to 100 percent (will definitely be the auditor next year). As expected, the *rotation* mean (25.38) is significantly lower than the *tendering* mean (58.97; $t(76) = 4.56$, $p < 0.001$, one-tailed) and the *voluntary* process mean (68.0; $t(77) = 6.04$, $p < 0.001$, one-tailed), and the latter two means are marginally different from each other ($t(77) = 1.39$; $p < 0.10$, one-tailed).¹³

Hypothesis Testing

H1 predicts a positive effect of *AC POWER* on recommendation likelihood. The ANCOVA in Table 2, Panel B reveals a significant main effect of *AC POWER* ($F(1, 110) = 12.20$, $p = 0.001$, two-tailed) and a nonsignificant main effect for *PROCESS* ($F(1, 110) = 0.45$, $p = 0.64$, two-tailed). Inspection of the adjusted means (see Table 2, Panel A and Figure 2) demonstrates that recommendation likelihood is higher when *AC POWER* is high (mean = 56.18) compared to low (mean = 45.62), providing support for H1. However, when considering the findings regarding H1 it is important to recognize that in H2a and H2b we predict interactive effects between *AC POWER* and *PROCESS*; thus, this finding cannot be interpreted unambiguously.

To test H2a and H2b, we use a planned contrast test (adjusted for covariates *AMOUNT* and *RISK-RETURN*) since we predict a nonsymmetrical, ordinal interaction (Buckless and Ravenscroft 1990). As illustrated in Table 2, Panel C, we use contrast weights +1.5, +1.5, 0, -1, -1, -1 since H2 predicts the lowest recommendation likelihood when *AC POWER* is low—regardless of *PROCESS* (Cells D, E, and F)—a small increase in recommendation likelihood given *voluntary* auditor selection in combination with high *AC POWER* (Cell C), and the highest recommendation likelihood for *rotation* and *tendering* when *AC POWER* is high (Cells A and B) (see, also, Figure 1). The contrast shown in Table 2, Panel D is statistically significant ($F(1, 110) = 16.13$; $p < 0.001$, one-tailed), providing overall support for our interaction prediction.

Next, we examine planned pairwise mean comparisons (one-tailed and adjusted for covariates *AMOUNT* and *RISK-RETURN*) in Table 2, Panel E. First, H2a predicts that the difference in recommendation likelihood between high and low *AC POWER* is greater when there is mandatory *rotation* or *tendering* compared to a *voluntary* auditor selection process. Results in Table 2, Panel E demonstrate that the positive effect of *AC POWER* is significant only in the presence of *rotation* (High 58.29 versus Low 47.09; $\Delta = 11.20$, $p < 0.05$, one-tailed) and *tendering* (High 60.38 versus Low 41.23; $\Delta = 19.15$, $p < 0.001$, one-tailed), but not when a *voluntary* auditor selection process is in place (High 49.85 versus Low 48.55; $\Delta = 1.30$, $p = 0.401$, one-tailed).¹⁴ The results are

¹³ Excluding participants that failed the categorical manipulation check of the auditor selection process (leaving a remaining sample of $n = 86$) does not affect our primary results. Results are also robust to excluding participants in the rotation condition, indicating a positive reappointment likelihood (leaving a remaining sample of $n = 103$). Finally, including the assessed reappointment likelihood as a covariate does not alter the primary findings, either.

¹⁴ In addition, (non-tabulated) difference-in-differences tests confirm that the difference in recommendation likelihood between high and low *AC POWER* is smaller for the voluntary process compared to rotation ($t(77) = 1.92$; $p < 0.05$, one-tailed) and tendering ($t(77) = 3.43$; $p < 0.001$, one-tailed).

TABLE 2
Hypothesis Testing

Panel A: Adjusted Means (S.E.) for Recommendation Likelihood in Experimental Conditions (n = 118)

<i>PROCESS</i> Condition	<i>AC POWER</i> Condition		
	High	Low	Total
<i>Rotation</i>	58.29 (3.76) n = 19	47.09 (3.66) n = 20	52.69 (2.63) n = 39
<i>Tendering</i>	60.38 (3.86) n = 18	41.23 (3.57) n = 21	50.81 (2.63) n = 39
<i>Voluntary</i>	49.85 (3.66) n = 20	48.55 (3.66) n = 20	49.20 (2.59) n = 40
Total	56.18 (2.17) n = 57	45.62 (2.10) n = 61	50.90 (1.51) n = 118

Panel B: ANCOVA Results

Source	SS	df	MS	F-value	p-value
Model	32612.49	7	4658.93	17.40	< 0.001
<i>AC POWER</i>	3266.48	1	3266.48	12.20	0.001
<i>PROCESS</i>	239.60	2	119.80	0.45	0.640
<i>AC POWER * PROCESS</i>	1575.11	2	787.55	2.94	0.057
<i>AMOUNT</i>	9553.75	1	9553.75	35.69	< 0.001
<i>RISK-RETURN</i>	7793.95	1	7793.95	29.12	< 0.001
Error	29445.99	110	267.69		

Panel C: Contrast Coefficients

High <i>AC POWER</i> ; <i>Rotation</i>	High <i>AC POWER</i> ; <i>Tendering</i>	High <i>AC POWER</i> ; <i>Voluntary</i>	Low <i>AC POWER</i> ; <i>Rotation</i>	Low <i>AC POWER</i> ; <i>Tendering</i>	Low <i>AC POWER</i> ; <i>Voluntary</i>
+1.5	+1.5	0	-1	-1	-1

Panel D: Planned Contrast Test

Source	df	F-statistic	p-value (one-tailed)
Contrast weights (+1.5, +1.5, 0, -1, -1, -1)	110	16.13	< 0.001

Panel E: Planned Pairwise Mean Comparisons

Mean Comparison		Mean Difference	S.E.	p-value
Test of H2a (Effect of <i>AC POWER</i> across <i>PROCESS</i> Conditions)				
<i>Voluntary</i>	High <i>AC POWER</i> versus Low <i>AC POWER</i>	1.30	5.18	0.401 (one-tailed)
<i>Rotation</i>	High <i>AC POWER</i> versus Low <i>AC POWER</i>	11.20	5.26	0.018 (one-tailed)
<i>Tendering</i>	High <i>AC POWER</i> versus Low <i>AC POWER</i>	19.15	5.26	< 0.001 (one-tailed)
Test of H2b (Effect of <i>PROCESS</i> across <i>AC POWER</i> Conditions)				
High <i>AC POWER</i>	<i>Rotation</i> versus <i>Voluntary</i>	8.44	5.25	0.055 (one-tailed)
	<i>Tendering</i> versus <i>Voluntary</i>	10.53	5.32	0.025 (one-tailed)
	<i>Rotation</i> versus <i>Tendering</i>	-2.09	5.38	0.699 (two-tailed)

(continued on next page)

TABLE 2 (continued)

	Mean Comparison	Mean Difference	S.E.	p-value
Low AC POWER	Rotation versus Voluntary	-1.46	5.19	0.780 (two-tailed)
	Tendering versus Voluntary	-7.32	5.12	0.155 (two-tailed)
	Rotation versus Tendering	5.86	5.15	0.258 (two-tailed)

The dependent variable is the likelihood that participants would recommend an investment in XYZ Industries on a scale from 0 percent to 100 percent. Audit committee appointment power (AC POWER) is manipulated between subjects as high or low. Auditor selection process (PROCESS) is manipulated between subjects as *rotation*, *tendering*, and *voluntary*. In all panel tests, we control and adjust for participants' recommended investment amount (AMOUNT) and their assessed risk-return profile of the investment target (RISK-RETURN).

consistent with our predictions of a greater AC POWER effect for *rotation* and *tendering* than for the *voluntary* process. However, we also expected a residual, albeit smaller, effect of AC POWER for the *voluntary* process, which we did not observe. We will discuss this unexpected result further in the Conclusions and Discussion. Hence, our results partially support H2a.

H2b predicts that *rotation* and *tendering* will lead to a higher investment recommendation *vis-à-vis* a *voluntary* selection process when AC POWER is high but not when AC POWER is low. As shown in Table 2, Panels A and E, when AC POWER is high, the respective differences between the *rotation* and *voluntary* conditions (58.29 versus 49.85; $\Delta = 8.44$, $p = 0.055$, one-tailed) and between the *tendering* and *voluntary* conditions (60.38 versus 49.85; $\Delta = 10.53$, $p = 0.025$, one-tailed) are both positive and (marginally) significant. In contrast, when AC POWER is low the respective differences between *rotation* and *voluntary* conditions (47.09 versus 48.55; $\Delta = -1.46$, $p = 0.78$, two-tailed) and between *tendering* and *voluntary* conditions (41.23 versus 48.55; $\Delta = -7.32$, $p = 0.155$, two-tailed) are not significant. Hence, the findings support H2b.¹⁵

Supplemental Analysis

One of our manipulation checks revealed that the perceived likelihood of current auditor reappointment differs only marginally when comparing *tendering* and the *voluntary* process. This finding is consistent with Fiolleau et al. (2013), who found that management, the audit committee, and the competing auditors all perceive that the incumbent auditor would most likely be selected again in a *tendering* process. Interestingly, however, in non-tabulated analyses we observe that this result is dependent on the appointment power of the audit committee. First, in the low AC POWER condition the perceived reappointment likelihood difference between *tendering* (65.24) and *voluntary* selection process (66.00) is nonsignificant ($\Delta = -0.76$; $t(39) = 0.09$, $p = 0.466$, one-tailed). However, in the high AC POWER condition, the difference (70.00 versus 51.67; $\Delta = 18.33$) is significant ($t(36) = 1.89$; $p = 0.034$, one-tailed), underlining the suggestion that a high power audit committee may contribute to enforcing the effectiveness of mandatory *tendering* by greater willingness to appoint a new auditor when viewed as necessary.

CONCLUSIONS AND DISCUSSION

Mandatory audit firm *rotation* and *tendering* have been considered or enacted by the PCAOB and the EU, respectively, as a means to strengthen audit quality and thereby enhance investor confidence and resulting investment decisions. However, there is little empirical research to examine whether these proposed auditor selection processes accomplish these objectives. Another important mechanism to enhance audit quality is the audit committee, since one of its main responsibilities in many countries is to select the auditor. Drawing on Source Credibility Theory (Birnbbaum and Stegner 1979) and Power Theory (French and Raven 1959), we predict that the effect of the auditor selection processes on investment recommendations depends on the level of audit committee appointment power, and *vice versa*.

We test our predictions in an experiment with a rich subject pool of investment professionals. Participants respond positively to an audit committee with high appointment power when mandatory *rotation* or *tendering* is present, but not when auditor selection is *voluntary*. This finding confirms that audit committee appointment power is highly salient to investors only when periodic auditor reconsideration is mandated. When auditor selection is *voluntary*, investment professionals assume that an auditor change is unlikely, rendering the audit committee appointment power irrelevant.

¹⁵ We also conducted two additional robustness checks: (1) including the 18 eliminated participants ($n = 136$) (see footnote 11), and (2) controlling for case-based measures as covariates (see footnote 12). In both checks the overall results are robust and equivalent to our primary results, except that H2b does not hold for the difference between *rotation* and *voluntary* selection given high AC POWER: (1) $\Delta = 6.39$; $p = 0.115$, one-tailed; (2) $\Delta = 6.26$; $p = 0.119$, one-tailed). All other mean comparisons are consistent with the primary results.

FIGURE 2
AC POWER by PROCESS on Recommendation Likelihood
Observed Interaction Plot (Adjusted Means)

Plotted means are adjusted for participants' recommended investment amount (*AMOUNT*) and their assessed risk-return profile of the investment target (*RISK-RETURN*).

Second, when the audit committee has low appointment power, all three auditor selection processes lead to an equally low investment recommendation likelihood, suggesting that neither *tendering* nor *rotation* will be viewed by investors as effective in a weak corporate governance setting. That is, the auditor selection process and audit committee appointment power are considered complements, not substitutes, in enhancing audit quality. Accordingly, we also find that in the *tendering* selection process investors assess the likelihood of auditor reappointment to be lower than the *voluntary* selection process, but only when the audit committee has high appointment power. Albeit with respect to independence in appearance, in all, our results confirm the recent claim by Fiolleau et al. (2013, 865): "If management, with private information and interests, continues to have substantial influence over hiring the auditor, the regulatory reforms for audit firm rotation and/or audit committee empowerment are likely to be ineffective."

As noted, audit committee appointment power is not currently publicly disclosed information. However, a recent SEC (2015) concept release, inviting comments on a proposal to enhance audit committee disclosures of its role in the appointment of the auditor, suggests that this may change in the near future. An important feature of our experimental method is the ability to test the effect of disclosing this governance information. Our findings highlight that information about audit committee appointment power has a significant effect on the impact of alternative auditor selection processes on investment recommendations, but also that the effect of auditor selection processes is contingent on audit committee appointment power. Thus, it is important for regulators to establish policies to ensure investors have confidence that sound corporate governance mechanisms are in place to optimize the effects of auditor selection processes. The results further suggest that the disclosures proposed by the SEC (2015) concept release have decision relevance and are important.

As with any study, there are limitations that should be considered in interpreting the findings. As noted, we manipulate audit committee appointment power, while such information is not currently publicly disclosed. This manipulation may, thus, be viewed as a limitation to external validity. However, an important feature of our experimental study is a proactive examination of the impact of such information on investors' judgments, an especially relevant issue given the recent proposal by the SEC (2015) for increased disclosures on the auditor appointment process. Also, we note the possibility that professional investors, such as the participants in the current study, may obtain some information on the appointment power of the audit committee through knowledge of the composition and individual members of the supervisory board, investor calls, and one-on-one meetings with board members.

Further, the potential costs of a change in auditor were not made explicit to participants in the experiment, such as potentially lower auditor effectiveness with a new auditor who does not know the client well or the additional transition costs by the client and the auditor (e.g., learning). However, professional investors such as those involved in this study are likely aware of these costs. Finally, some of the primary findings deviate from our predictions (e.g., H2a: we did not find a difference

between high and low AC POWER for the *voluntary* process) and two of the robustness checks do not replicate the primary results (i.e., H2b: we did not find a difference in investment recommendation between *rotation* and the *voluntary* process when AC POWER is high; see footnote 15).

The major finding in this study is that investors do not view mandatory audit firm *rotation*, mandatory *tendering*, or *voluntary* auditor selection in isolation of a company's internal corporate governance mechanisms. These findings have important practice and policy-making implications, suggesting that in order to give market participants greater comfort about audit quality, both auditor selection processes and corporate governance must be jointly considered. Since the focus of the current study is on investor perceptions and assessments, future research is needed to examine how the auditor selection process and corporate governance together impact preparer reporting behavior, as well as auditor independence in fact.

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APPENDIX A

Table 1_Gold, Klynsmitt, Wallage, Wright: <http://dx.doi.org/10.2308/ajpt-51808.s01>

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