Determinants of Auditor Switching Decision in KASE

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Abstract: This paper provides empirical evidence on the association between auditor switching decisions and various factors reported from the prior literatures for KASE listed companies. In addition, survey results, based on the perception and experience of management and auditors, are offered of the influence of such factors for auditor switching decisions. This paper also sheds light upon the potential independence problems resulting in low audit quality and current barriers to audit researches in Kazakhstan. Based on the findings of extant researches and the survey results, hypotheses were developed regarding changes in management, types of audit opinions and type of auditors, industry expertise, audit tenure, and the size of controlling shares. The research indicates that management does not generally differentiate the quality or value of audit service among different auditors but only cares about the reputation of auditors. All other factors were found to be insignificant in predicting auditor switching in the next period audit. The purpose of this study is to infer the audit quality by identifying determinants of the auditor switching decision in KASE and to suggest improvements of regulation with regard to filing requirements and the quality of audit service.

Keywords: Auditor Switching, Audit Quality, Management Change, Audit Opinion, Auditor Independence, Industry Expertise, Audit Tenure, Controlling Shareholdings, Type of Auditors, Big 4

1. Introduction

Motivation for this study comes from a published fraud case of BTA, a state owned bank, and the controlling shareholder’s subsequent auditor selecting decision after the fraud scandal of the bank, where the new controlling shareholder reinstated the once-dismissed previous auditor in just five months. From observing this series of news events between BTA bank and incumbent auditor and from examining the audit report of BTA bank in 2009, the quality of audits by Big 4, especially for all State Owned Enterprises (SOE), becomes questionable. The rising concern for the decision of auditor switch and auditor independence and the absence of relevant studies in Kazakhstan (KAZ) of this issue called for research because investigating the factors that affect auditor change, which may impair auditor independence and ultimately audit quality, is very important to establish relevant policies for increasing auditor’s independence and improving the level of public trust in financial information. Considering the

1 Abbreviation of Kazakhstan Stock Exchange. It is used as the abbreviation of all listed companies in KASE in this study.
2 The case was briefly introduced in the Appendix with a series of news events.
3 The problematic contents of audit report in 2009 are briefly described in the Appendix.
fact that more than half of the listed companies in KASE are directly or indirectly owned SOE, which accounts for more than 70% of total assets in KASE listed companies, and ten of the bigger ones are directly controlled by Samruk-Kazyna, who is the controlling shareholder of BTA, and 100% of them are audited by Big 3, it is critical to identify any potential lack of independence of major auditors from the controlling parties of SOE for the development of real capital market of KAZ through peoples' IPO.

This empirical research adds to the extant auditor switching literatures the knowledge of association between auditor switching decision and the selected factors for KASE over the period of 2008 through 2011; i.e., changes in management, type of audit opinion, industry expertise, audit tenure, size of the ownership of controlling shareholders, and type of auditors. In addition, a survey result is briefly introduced to learn the perception or experience of managements and auditors about the determinants of auditor switching decision. In the questionnaire, many factors mentioned in prior literatures were presented for consideration; i.e., changes in management, audit fees, audit opinion, financial distress, industry expertise of auditors, audit quality, auditor’s qualification, other services, contribution to ICFR, and so forth. From the result of the survey, two independent variables, “changes in management” and “audit fees” were identified as the most important factors that affect the auditor selection decision.

The remainder of this paper is organized as following: The subsequent section presents literature review and hypotheses development. In the third section, methodology, including data collection and the models for data analysis, is outlined. The empirical test results and findings are presented in the section four. The final section summarizes discussions and conclusion of the paper.

2. Literature Review and Hypotheses Development

Understanding general demand for auditing and the related reasons for selecting and retaining an auditor is necessary for conducting a meaningful auditor change study (Williams 1988). Jensen and Meckling (1976) hypothesized that enforcement of the contract, which restricts manager's opportunistic behavior, requires monitoring of management's activities and this is a role of auditing. An audit will be successful in changing expectations and hence reducing the opportunistic behavior costs (agency costs) borne by the manager only if it is expected that the auditor will report some discovered breaches of contract. The probability that the auditors will report a discovered breach is effectively the auditing profession's definition of independence (Zimmerman 1983).

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4 The national wealth fund who is owning 97.28% of BTA
5 In KASE, EY, Deloitte, and KPMG are the Big 3 in audit service. PWC is engaged mostly in consulting service.
6 The first people’s IPO was December in 2012 for Kaz Trans Oil whose auditor is also E&Y.
Most of past academic research focused on agency theory and signaling theory or the insurance and information role of auditor choice to explain why a client switches auditors. Signaling theory states that clients switch auditors when they want to convey or signal to the public the quality or reliability of their financial statements and they do this through the type of auditor they engage. The signaling theory may not be quite applicable in current KASE simply because there are not many investors who may care for the signal from the auditor switching. Accordingly, agency theory may better serve as a theoretical basis than signaling theory in KASE. The following quote from Jensen and Meckling (1976) seems to fairly reflect the current condition of KASE companies.

The directors of such [joint-stock] companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. — Adam Smith (1776)

However, one question still remains because more than half of KASE companies are SOE, where it is not clear to identify who is a real principal or controlling party regardless of the ownership percentage as in privately owned companies. As witnessed in the BTA case, the government agency as controlling shareholder may not function as a principal as expected in the agency theory in the case of SOE in a highly corrupted business environment.

Then, the decision to voluntarily switch auditors by a client firm may not be due to the principal-agent problem in separation of ownership and control of a firm (Jensen and Meckling 1976). Further, the separation of risk bearing, decision-making and control function in firms (Fama and Jensen 1983) may not be clear because both parties are merely agents of government and more complicatedly, the manager of SOE is most likely to be bonded with a real invisible hand that may not need a stringent external monitoring party. (This could be another contribution of this study, which investigates auditor switch decision under a centralized government. The results could be different from those of previous relevant studies, especially U.S.) In this case, in order for the managers to maximize their party’s self-interest at the expense of public interest, they are prone to employ more accommodating auditors for their interest as long as they can justify the employment of such auditors to any potential monitoring parties in terms of all auditor related factors such as audit fees, reputation and industry expertise of auditors and so on. Then the resulting audit opinion should be favorable to the management.

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7 All KASE companies are JSC (Joint Stock Company)
and audit fees should be maintained as low as possible within the budget while they are compensating the auditors with other fees for special consulting projects as bonding expenditures. Consequently, audit quality for those companies must have deteriorated year by year due to the lack of auditors’ independence and less amount of audit resources input. Further, the audit tenure of such auditors also must be extended and that of non-accommodating auditors must be shorter due to quick dismissal or resignation if there are fewer minority shareholders who may try to monitor the management appointed by the governing party. In the case of SOE in developing countries, where the corruption index is higher, this moral hazard cannot be solved only by designing, for the manager, incentive contracts which are more closely aligned with the interests of the shareholders as suggested by Williams (1988) since the stakes from bribes and kickbacks are incomparably higher than any contractual incentives from the government.

Based on the stewardship hypothesis from the agency theory literature (Jensen and Meckling 1976; and Ng 1978), a theory of auditor choice and auditor change was derived by Williams (1988). He reported that three concepts concerning the theory of auditor change (Change in Client Contracting Environment, Auditor Effectiveness, and Client Reputation) represent the theoretical basis for selecting variables to include in a model explaining auditor changes. Among ten operational variables he selected, he isolated three which aid in classifying clients who change auditors; namely, industry expertise and audit tenure as to auditor effectiveness, and the negative publicity of the management as to client reputation. The factor of changes in management, which is related to changes in client contracting environment, was not found to be significant in his study. However, this is not consistent with his finding for client reputation variable. If the negative publicity was found to be significant, changes in management variable also should be found significant because the chances are almost certain that those companies must have changed the management if it was publicized in the US. This might be caused because he considered a two prior period of auditor change as a change in agent. When there is a change in management, new managers may merely prefer another auditor with whom they have had some previous association (Schwartz and Menon 1985). Considering the relationship-oriented culture and less perceived value of audit service in Kazakhstan, if an auditor had not been switched in the year of the change in the management by engagement contract, the auditor is less likely to be switched because they would have more time to develop a positive relationship with the new management by accommodating them.

However, in the case of SOE, changes in management may not affect auditor switching unless the new management has full authority to select a new auditor or real controlling party instructs to do so. In this case, changes in controlling ownership percentage of companies may affect the decision more than changes in management. However, changes in controlling shareholding are not easily observable at this

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8Kazakhstan is ranked as 133rd out of 174 countries by Transparency International World Corruption Index, where China is ranked as 80th.
time. In any case, it should be much easier either to switch or retain an auditor when the size of controlling
shares is larger. Hence, we may infer that audit quality of such companies should be lower because the
auditors must be the accommodating one, in terms of both the type of opinion and audit fee if they were
retained for longer period and must be inexperienced auditor with specific clients if they were switched
often within three years.

DeAngelo (1982) suggests that industry effects can be particularly relevant to auditor-switching
studies. The Public Accounting Report (1985) considered industry specialization as a major
factor behind auditor changes. Williams (1988) argued that clients tend to change from auditors who lack
industry specialization to auditors with a higher industry specialization. Considering the KAZ economies
are heavily dependent on oil & gas and mining industries (OGME), special industry expertise should be an
important factor for the companies in the industry to select or retain an auditor. If this factor is significant
in making the decision, it can be inferred that the auditor’s with higher special industry expertise is less
likely to be switched. With a rationale that auditors with industry specialization and engagement longevity
may provide improved services by capitalizing on economies of scale (Williams 1988), we can infer the
audit quality is higher only when these two factors together are negatively associated with auditor
switching.

Managers who attempt to portray to the shareholders a positive picture of themselves as good stewards of
the shareholders’ investments could become dissatisfied with auditors who issue an audit opinion which
the agent perceives as undeserved, or as a result of a conflict over accounting principles (Williams
1988). Chow and Rice (1982) reported that there was positive relationship between the auditor switch and
qualified audit opinion. The same results were obtained by Gul, Lee and Lynn (1992). Vanstraelen and
Ann (2003) found that clients are four times more likely to switch auditors at the end of the mandatory
term if they receive a going-concern opinion in the final year of the term relative to the previous two years.

Hun (2002) proposed that auditor independence is surrogated by auditors’ propensity to issue going
concern audit opinions. These reports provide the rationale for a hypothesis that companies who got
standard opinion are less likely to switch incumbent auditors.

Auditor switch decision results in the choice of quality differentiated audit firms to realign the
characteristics of the audit firm, with the growing needs of clients under changing circumstances.
Companies that change auditors appear to be either dissatisfied with the quality of the predecessor firm or
perceive that the successor firm can exhibit audit efficiencies. Also, firms which seek to improve their
monitoring system have a higher tendency to change auditors. (Williams 1988) This may not be true in
KASE where the perceived audit value and litigation liability is lower, especially when the controlling
shareholder is also an agent.
Based on the above literatures, a survey was conducted for the above mentioned factors to 24 audit firms and the management of 115 listed companies, and the respond auditors selected “audit fee” and “changes in management” as the most significant reason for audit firm switch but showed widely varied responses for “relationship with the management” factor as the least to the most important one. This result is consistent with Eichenseher and Shields (1983) who reported that comfortable working relationships and the audit fee factor most affect companies’ auditor switching decision. Overall 26 out of 31 companies that had an auditor switch replied to the questionnaire. They also have selected “audit fees” and “change in management” as two most important factors. The audit opinion factor was identified as moderately important one with little varied answers among the respondents.

The following hypotheses were developed based on a result of the survey and conflicting reports in the prior literatures for auditor switching factors, and the observation of BTA case.

H1: The longer the auditor tenure, auditor’s reputation and industry expertise are less likely companies negatively associated with auditor switching are likely to switch auditors.

H2: The type of audit opinion and Companies who got modified opinion in prior year audit CEO change in the year of the audit are positively associated with more likely to switching auditors.

H3: Auditors with higher reputation and industry expertise are less likely to be switched.

H4: Companies with CEO change in the year of audits are more likely to switch auditors.

3. Methodology

1) Data Collection and Samples

An empirical examination was conducted to identify the significant variables useful in predicting a company to have a high probability for an auditor switch. The study began with collecting data from audit report and other disclosures in KASE website for auditor names, audit opinions, total assets, management changes, industries, and share holdings for all firms once listed on the KASE for the years from 2007 to 2011.

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9 It was conducted as part of the thesis supervision of a MBA student in fall semester of 2012.
10 Use CEO and President as a proxy of management change because there is no consistent information for CFO or the Chairman of BOD among the companies available.
11 Use CEO and President as a proxy of management change because there is no consistent information for CFO or the Chairman of BOD among the companies available.
The first and only selection criterion was the most recent test period for which data were available. Only 94 companies out of 129 currently listed companies were selected because the rest of the companies lack all or part of the information for the selected variables due to new listings or delisting during the period. The final samples consist of 282 cases of all variables for three years of changed data from 2008 to 2011. Due to the lack of information and small number of auditor switch cases each year, all types of auditor switch case, either voluntary or involuntary, were included in the samples. Also, the direction of auditor switch was not considered for sample selection because only 2 cases represent a switch from Big 4 to small companies and all others were either lateral or upgrade switches.

In addition, a preliminary survey was conducted, where two different questionnaires were developed each for auditors and the management of the samples. However, the result of the questionnaire was used only to help develop hypotheses of this study in combination with the findings of other prior literatures on the research question because the bias of the responses from the survey was not measurable. These questionnaires were designed to identify the factors of auditor switching in priority from the viewpoints and past experiences of both auditor's and managements in KASE. The questionnaires were sent to 115 listed companies of which 31 companies had an auditor switch, 73 companies did not have an auditor switch, and 11 companies had no audit report from 2009 to 2011, and sent to 20 audit firms that conducted audits of listed companies who had an auditor switching in the same period. 29 out of 31 switched companies, 27 out of 84 non-switched or no-info companies, and 15 out of 20 audit firms replied to the questionnaire. Table 1 below shows the summary of variables for samples classified between SOE and private companies.

<table>
<thead>
<tr>
<th>Classification</th>
<th># of COs</th>
<th>Cases</th>
<th>Control %</th>
<th>Audit Tenure</th>
<th>Mgmt Change</th>
<th>Opinion (6)</th>
<th>Auditor (7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed</td>
<td>129</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td>(7)</td>
</tr>
<tr>
<td>No or partial year information</td>
<td>35</td>
<td>for 3 yrs</td>
<td>Current</td>
<td>for 5 years</td>
<td>Co # 3 yrs</td>
<td>Cases for 5 years</td>
<td>Co # as of 2011</td>
</tr>
<tr>
<td>Data available For 4~5 yrs.</td>
<td>94</td>
<td>282</td>
<td>70%</td>
<td>3.73</td>
<td>41</td>
<td>95</td>
<td>375</td>
</tr>
<tr>
<td>SOE</td>
<td>54</td>
<td>162</td>
<td>68%</td>
<td>3.85</td>
<td>19</td>
<td>49</td>
<td>221</td>
</tr>
<tr>
<td>Private</td>
<td>40</td>
<td>120</td>
<td>73%</td>
<td>3.58</td>
<td>22</td>
<td>46</td>
<td>154</td>
</tr>
<tr>
<td>No switch for 5 yrs</td>
<td>55</td>
<td>-</td>
<td>70%</td>
<td>5.00</td>
<td>22</td>
<td>89</td>
<td>186</td>
</tr>
<tr>
<td>SOE</td>
<td>33</td>
<td>-</td>
<td>67%</td>
<td>5.00</td>
<td>7</td>
<td>15</td>
<td>150</td>
</tr>
<tr>
<td>Private</td>
<td>22</td>
<td>-</td>
<td>75%</td>
<td>5.00</td>
<td>15</td>
<td>74</td>
<td>36</td>
</tr>
</tbody>
</table>
### 2) Data Analysis

A logistic regression model is necessary when the dependent variable is dichotomous and there is a mixture of numerical and categorical independent variables. Moreover, it is more statistically robust and it avoids some of the strong assumptions (e.g., normal distribution of independent variables and equality of the variance-covariance matrix). Hence, the following binary logistic regression model was constructed:

\[
\text{SWITCH} = \beta_0 + \beta_1 \text{CHANGE}_M + \beta_2 \text{AUDITOR} + \beta_3 \text{TENURE} + \beta_4 \text{EXPERT} + \beta_5 \text{OPINION} + \beta_6 \text{CONTROL} + \beta_7 \text{SIZE} + \beta_8 \text{SOE} + \beta_9 \text{INDUSTRY} + \epsilon,
\]

where

- **SWITCH**: auditor switching (value of 1 if company switched and 0 if not)
- **CHANGE_M**: change of CEO in the year of audit (value of 1 if company changed managers in the current year of audit and 0 if not)
- **AUDITOR**: type of auditor (value of 1 if Big 4 and 0 if small firms)
- **TENURE**: audit tenure during 2007–2011 (min 1, max 5)
- **OPINION**: audit opinion (value of 1 if the opinion of previous audit report is a modified opinion including unqualified opinion with going concern paragraph or changes in accounting principles, and 0 if a standard opinion)
- **EXPERT**: market share in the industry (value of 1 if the auditor’s market share in the previous year was #1–3 with less than 5% difference, and 0 if below 3rd)

**Control variables** were included to capture certain characteristics of the firms; i.e., **CONTROL** (ownership percentage of a controlling shareholder), **SIZE** (log of total assets), **SOE** (ownership type, value of 1 for state owned enterprise, 0 for private company), **INDUSTRY** (1 for financial service, 2 for oil & gas, mining, energy, 3 for all others).
4. The Result and Findings

A test of full model against a constant only model was statistically significant, indicating that the predictors as a set reliably distinguished between switched companies and no-switched ones (Chi square = 51.0, p <0.000 with df =9). However, Nagelkerke’s R2 of 0.285 for the model indicated only 28.5 % relationship between prediction and grouping. Overall prediction success was 83.3% without predictors (100% for no switch and 0% for switch) and was improved only by 32.6% to correctly predict the switched ones with the predictors. Although all variables have shown the same directional signs as predicted, only the type of auditors and size of controlling shares are statistically significant, which is partly consistent with the response in the survey and prior studies. EXP(B) value indicates that when CONTROL % is higher, the odds ratio is increasing and therefore companies are 252% more likely to switch the auditors, and when auditor is one of Big 4, 86% less likely switch auditors respectively.

The model identified only two variables as statistically significant in the Table 2 and all other variables were determined as not contributing to the prediction power of the model. You need to show complete results of regression analysis.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Predicted sign</th>
<th>B</th>
<th>S.E.</th>
<th>Wald</th>
<th>df</th>
<th>Sig.</th>
<th>Exp(B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>TENURE</td>
<td>-</td>
<td>-0.310</td>
<td>0.186</td>
<td>2.770</td>
<td>1</td>
<td>0.096</td>
<td>0.743</td>
</tr>
<tr>
<td>AUDITOR</td>
<td>-</td>
<td>-1.963</td>
<td>0.485</td>
<td>16.385</td>
<td>1</td>
<td>0.000</td>
<td>0.140</td>
</tr>
<tr>
<td>CHANGE_M</td>
<td>+</td>
<td>0.433</td>
<td>0.453</td>
<td>0.908</td>
<td>1</td>
<td>0.341</td>
<td>1.542</td>
</tr>
<tr>
<td>OPINION</td>
<td>+</td>
<td>0.444</td>
<td>0.404</td>
<td>1.210</td>
<td>1</td>
<td>0.271</td>
<td>1.559</td>
</tr>
<tr>
<td>EXPERT</td>
<td>-</td>
<td>-0.241</td>
<td>0.455</td>
<td>0.281</td>
<td>1</td>
<td>0.596</td>
<td>0.786</td>
</tr>
<tr>
<td>CONTROL</td>
<td></td>
<td>1.260</td>
<td>0.626</td>
<td>4.055</td>
<td>1</td>
<td>0.044</td>
<td>3.526</td>
</tr>
<tr>
<td>SIZE</td>
<td></td>
<td>0.057</td>
<td>0.168</td>
<td>0.116</td>
<td>1</td>
<td>0.733</td>
<td>0.944</td>
</tr>
<tr>
<td>SOE</td>
<td></td>
<td>0.012</td>
<td>0.369</td>
<td>0.001</td>
<td>1</td>
<td>0.974</td>
<td>0.988</td>
</tr>
<tr>
<td>INDUSTRY</td>
<td></td>
<td>0.196</td>
<td>0.220</td>
<td>0.797</td>
<td>1</td>
<td>0.372</td>
<td>1.217</td>
</tr>
</tbody>
</table>

Table 4.2 Variables in the equation

The analysis does not support the relationship that companies with a new CEO are more likely to switch incumbent auditors than the ones with previous management and that companies who got modified opinion are more likely to switch auditors than the companies who got standard opinion. These findings support the contention that auditor changes are not triggered by opinion shopping for a lenient auditor. The result indicates that industry specialization also may not be highly valued factor when companies switch auditors in KASE. In addition, there were some cases of switching to auditors with lower market share in the industries.

5. Conclusion and Discussions
This is the first study that investigated auditor switching decision in Kazakhstan, a centralized government.

The result seems to reflect fairly the current circumstances of capital market and legal environment in Kazakhstan, which is somewhat different from those of previous relevant studies, especially in the US.

Prior studies reported conflicting results on the association between change in management and audit opinion factors and auditor switching. This study shows changes in management and opinion factors are not significant on auditor switching decision for KASE listed companies. The result may indicate that managements are not much concerned about who does audit or the result, types of opinion. This does not support a report that managers who attempt to portray to the shareholders a positive picture of themselves as good stewards of the shareholders' investments could become dissatisfied with auditors who issue an audit opinion which the agent perceives as undeserved, or as a result of a conflict over accounting principles (Williams 1988). This probably is due to the big difference in the attitude between a management of a private company in an active capital market and a management of SOE in non-active one, who is evaluated in totally different perspectives such as loyalty or relationship. If the managements or controlling shareholders are committed to the quality of audit, they should have changed the auditor when a deficiency in the audit was revealed as in the BTA case. However, the controlling shareholders do not seem to care for audit quality or public interest, and auditors are almost free from legal liabilities for their significant negligence for the duties required by ISA12. Considering the composition of the listed companies in KASE13, a generalization of BTA case might not be illogical.

This can be supported if audit fee factor is proven to be the only significant factor to change auditors in a future research. In fact, the audit fee of KazMunaiGaz, whose auditor is EY, has not been increased for the period of 2009 till 2011, while unit costs of the audits must have substantially increased. This may indicate that audit quality have deteriorated for the three years in terms of audit resources input. In addition, the management responded in the survey that switching from one audit firm to another does not affect the quality of the audit reports based on their experiences. They commented that the employees’ professionalism and the quality of the services depend on the size of the audit firm, but is generally the same for all audit firms, whether it is Big 4 or a small audit firm. This is true in Kazakhstan where the competition is high among Big 4s. They are simply trying to increase the market share with dumping price over local audit firms. This must be not a bad situation for the management of SOE who can enjoy relatively low prices for the services provided by international firms because they do not bear any negative consequences of less audit quality. Consistently, Ministry of Finance also doesn’t seem to be proactive to

12 ISA 240 clearly specifies auditor’s responsibility to perform the procedures to assess the risk of material misstatement due to fraud.

13 54 companies are SOE out of 94 sample companies in KASE.
impose a strengthened disclosure requirement on audit firms to disclose audit fees and all other fees of each client as in the case of the US and elsewhere.

Thus, if the government truly wants to further develop the capital market, it should enhance the level of assurance for public interest in the market by improving the quality of the financial reporting and audit quality with enhanced disclosure requirement and by strengthening the authority of independent audit inspection by Chamber of Auditors. Choi et al. (2008) reported that National legal environments are likely to influence clients’ reporting incentives and auditors’ assessments of audit risks.

In the US, auditors’ exhibit letters are filed as part of reporting requirements for auditor changes. The auditor’s exhibit letter, in which the auditor is required to comment on client disclosures in the initial 8-K, is intended to ensure accurate reporting by the client particularly on potentially troublesome conditions such as reportable events, disagreements, and resignations. The result of prior research indicates auditor’s exhibit letter contributes positively to the monitoring of corporate disclosures concerning auditor changes. Market tests also indicate that the market response to the initial 8-K is negative for non-concurrent filings (filings that do not contain the auditor’s letter), but not for concurrent filings (filings that include the letter), suggesting that investors take an adverse view of the absence of the auditor’s letter (Krishnan 2002).

Therefore, Audit Law of KAZ and KASE filing requirement should specify to include these two reports for the users of audit reports and financial statements. Further, Ministry of Finance should mandates audit firms to disclose the audit and non-audit fees for all companies which are subject to audit by the Audit Law. Further, an independent inspection should be performed on an auditor who was in public scandal and the audit law should reflect a mandatory change of auditors or other sanctions in case the inspection revealed the audit failure. The Chamber of Auditors (CoA) should disclose in public the regular inspection report including the nature of deficiencies in the audits.

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14Form 8-K is a very broad form used to notify investors of any material event that is important to shareholders or the United States Securities and Exchange Commission. This is one of the most common types of forms filed with the SEC. After a significant event like bankruptcy or departure of a CEO, a public company generally must file a Current Report on Form 8-K within four business days to provide an update to previously filed quarterly reports on Form 10-Q and/or Annual Reports on Form 10-K. Form 8-K is required to be filed by public companies with the SEC pursuant to the Securities Exchange Act of 1934, as amended.

15These two reporting requirements (an initial 8-K filing by the client and the AICPA notification letter sent by the auditor) was the subject of prior work (Schwartz and Soo 1996; Ettredge et al. 2001)

16Unlikely from the US, UK, Australia, and many other countries following SOX, Kazakhstani companies are not required to disclose the audit fee information in KASE.

17By the State Audit Law, Chamber of Auditors (CoA) is acting as the supervisory role in Kazakhstan as a full member of International Federation of Accountants (IFAC). Currently, they disclose the ranks of the quality of the each audit firms in a scale of 5 as the highest to 2 as the lowest based on their inspection result. However, this disclosure is not for the public but for the member firms only.
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**APPENDIX: BTA Case**

“Bank Turan-Alem” (BTA) is a state owned bank with 78.8% holdings by Samruk-Kazyna, the national wealth fund of the Republic of Kazakhstan (“Kaz”). In 2008, before it was turned over to the State, a big scandal around BTA’s ex-CEO Muhtar Ablyazov, who allegedly committed huge misappropriation of assets and money laundering during the period of 2006 through 2008, was revealed in public. It was reported that he and his management team of “BTA” fraudulently diverted 8–12 billion dollars to overseas entities, whose interests were subsequently taken over by him and his parties. Considering the fact that Kazakhstan GDP (PPP) was 190 billion dollars in 2009, he had stolen approximately 5% of Kazakhstan GDP.

During the period of 6th of April in 2009 till August 27, 2009, a series of action against E&Y, who is the auditor of BTA bank since 2006, were publicized as following.

- On April 6, 2009, Mr. Aitekenov, who was a Managing director of Samruk-Kazyna, the national wealth fund and controlling shareholder with 78.8% of interests, gave an order to not enter into a contract with E&Y because the firm collaborated with the ex-management during the period of fraud.
- On June 5, 2009, Mr. Botabaev, who was the Deputy Chairman of the Board of BTA bank, gave a unilateral notice to the Director General of Ernst & Young, LLC to terminate the audit service contract for the bank.
- On August 7, 2009, Ms. Elena Bakhmutova, who was the Chairman of the committee of financial supervisory board (ex-AFS), declared in an interview with “Business and Government” that “I want to say that we actually have a claim to the auditor because they prepared the report on BTA bank for the period of 2007 and 9 months of 2008. It’s apparently their negligence that they didn’t find obvious violations”.

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18 It is approximate amount shown in various news articles. None of them was confirmed for the exact amount in public yet.
On August 17, 2009, Mr. Saidenov, the newly appointed Chairman of the board of BTA, in an
interview with KazTAG said…“ the fact that the loans were rewritten in the company’s pacifier
in offshore companies, the auditors, E&Y, faced in documentary level and it was noticed during
the completion of the audit in 2008. From my point of view, to talk about that in the middle of
last year, they saw no fraud, and in the first quarter of this year, they had opened their eyes, is a
little bit wrong.”

On August 19, 2009, by the decision of the board of directors of BTA, Mr. Botabaev was
terminated from the position of Deputy Chairman
of the Board.

On August 20, 2009, E&Y submitted to BTA a “Supplemental Agreement” to the existing audit
service contract, where they asked 80% of advance payment of next year audit fee as if the
termination notice was never delivered and in effect.

On August 27, 2009, an extraordinary general shareholder’s meeting was held to approve only
agenda of the nomination of E&Y as the audit firm of BTA. The controlling shareholder,
Samruk-Kazyna, approved E&Y as the auditor of BTA even after the obvious public scandal.

Further, in the 2009 audit report of BTA, E&Y explained the reason for more than US 7 Billions of
impairment loss and write-offs of Loan Receivable as following,

As described in Note 5, during the fourth quarter of 2008 and at the beginning of 2009, the quality of the
Bank’s loan portfolio has significantly deteriorated as a result of circumstances and actions taken before
the current management of the Bank were appointed by the controlling shareholder. Certain loan
documentation, including collateral and associated additional agreements, primarily relating to financing
of projects outside Kazakhstan, is no longer available. In addition, many loans were transferred to new
borrowers that do not have adequate sources of repayment. Moreover, no collateral was provided by these
new borrowers. Consequently all transferred loans are unsecured. A number of significant borrowers,
primarily registered outside Kazakhstan, have ceased servicing their loans, have not allowed the Bank to
monitor collateral or failed to provide information about their financial performance.

During 2009, the quality of the Bank’s loan portfolio continued to deteriorate as a result of the following
circumstances and actions taken before the current management of the Bank were appointed by the
National Welfare Fund Samruk-Kazyna - a controlling shareholder of the Bank: ......................(deleted the
details)

........ In addition, the ongoing financial crisis and devaluation of Tenge by 25% have affected the
borrowers’ ability to service their obligations and the value of collateral. (If the overseas borrowers were
to repay in fixed Tenge amount, the ability to service the obligation was actually increased by devaluation)

As a result of the above, in 2009 the Bank has recorded impairment loss on loans in the amount KZT
706,944 million. ...... (The rest of the details for loan receivables were skipped)
In this statement, the incumbent auditor did not specifically indicate any fraudulent transactions of the previous management that they should have detected and informed to the relevant parties by the requirement of ISA standards for the periods before 2009 audits because the majority of those loans should have not been recorded as receivables when there were no appropriate arrangements to secure the collaterals by the realization principle and if recorded, should have been recognized impairment losses from the required impairment test each year.

However, the auditor inappropriately applied IAS 39 in 2009 at once to the assets, which were already arranged to be misappropriated in the years before 2009 by simply taking advantage of the worldwide financial crisis.