

# AUDITOR CHOICE IN THE NONPROFIT SECTOR: A BEHAVIORAL PERSPECTIVE

Anne-Mie Reheul  
Hogeschool-Universiteit Brussel

*This study investigates auditor choice in Belgian nonprofit organizations from a behavioral perspective. I investigate whether auditor choice in favor of an auditor with a high (versus low) level of sector specialization is associated with the importance that nonprofit organizations attach to six auditor attributes: competence/integrity/deontology, working relationship with management, audit fee, practical execution of the audit, client oriented analysis and suggestions and sector expertise. In the extant literature auditor sector specialization has been found to improve audit quality and financial statement information, hence its importance. I find that nonprofit organizations attaching higher value to sector expertise and client oriented analysis and suggestions are significantly more likely to choose an auditor with a higher level of sector specialization. From this finding I derive a number of recommendations for the audit profession and for policy makers.*

## INTRODUCTION

In the wake of corporate scandals and failures the external audit function has attracted significant attention from legislators, regulators, and the media in recent years. Public policy makers have considered increased regulation of external audit all over the world (Sarbanes Oxley reforms in the US, Cadbury Committee in the UK, Code Tabacksblatt in the Netherlands, Code Lippens in Belgium). Audit quality and its information risk reducing role have become more important than ever to corporate investors and other stakeholders. The focus on for-profit, publicly traded corporations in prior audit research is caused by the fact that audit quality is particularly important for corporations that are dependent on external capital markets to raise funds. However, not only for-profit corporations, but also nonprofit organizations had their share of governance-related scandals (Hempel and Borrus 2004). Salmon (2002, A2) notes that an “unfolding list of questionable dealings ... has caused public confidence in charities to plummet. Financial reporting problems with nonprofit organizations have led legislators worldwide to examine governance and accountability issues in the nonprofit sector. ‘New Public Management’ is a global reform in governmental and nonprofit organizations to make financial reporting more transparent and to professionalize management. Nonprofit organizations have a significant role in many national economies. In Belgium they deliver about 5% of GDP and employ 11.5% of the total salaried workforce (Koning Boudewijn Stichting 2008). Their impact on the Belgian economy has increased since the start of the decade thanks to vigorous growth that has consistently outstripped the equivalent rate in the rest of the economy. Inspired by New Public Management the Belgian legislator imposed a legal requirement for all large nonprofit organizations to have their financial statements monitored by an independent external auditor starting from 2006. Given nonprofit organizations’ strong reliance on government grants, donations and volunteers, it is important to improve their accountability, to consider the monitoring provided by the external auditor and to understand the selection of the auditor.

The present study is performed among 312 Belgian nonprofit organizations and examines a number of behavioral criteria playing a role in nonprofits' choice decision in favor of an auditor with (more versus less) sector specialization. This choice decision is important because of its potential impact on audit quality, which regulators and legislators seek to address. The use of sector specialization as a proxy for audit quality has been supported in recent empirical auditing research. It has been found that sector specialists receive higher audit fees (Craswell et al. 1995), are better able to detect errors (Owhoso, Messier, and Lynch 2002) and are more likely to require compliance with auditing standards (O'Keefe, King, and Gaver 1994); firms audited by sector specialists have lower discretionary accruals and higher earnings response coefficients (Balsam et al. 2003; Krishnan 2003), demonstrate higher client satisfaction (Behn, Carcello, Hermanson, and Hermanson 1999) and apply higher disclosure levels (Dunn and Mayhew 2004). Also in the governmental sector empirical evidence confirms that industry specialization is an important audit quality characteristic. Deis and Giroux (1992) document a negative relationship between auditor specialization and quality control review outcomes

Given the legislative focus on external audit in nonprofit organizations in order to improve their governance and financial statement quality, and given the empirical evidence that auditors with sector expertise offer greater audit quality, my study focuses on the choice decision made by nonprofit organizations in favor of an auditor with (more versus less) sector expertise. I study this choice decision from a behavioral perspective. This perspective implies the identification of a number of relevant auditor attributes which are perceived (more versus less) important to clients in choosing an auditor. I identified a set of relevant auditor attributes through an extensive literature review, I operationalized each auditor attribute by means of multiple statements and I questioned these statements in a large-scale survey addressed to 1,000 nonprofit organizations. The aim is to detect whether the importance attached to certain auditor attributes during the most recent auditor choice decision process, is related to the current auditor's level of sector specialization. I control for the nonprofit organizations' resource dependence context.

Regression analysis reveals a significantly positive relation between the current auditor's level of sector specialization on the one hand, and the importance attached to the auditor attributes sector expertise (*SECTOR\_EXP*) and client orientation (*CLIENT\_FOCUS*) during the most recent auditor choice decision process on the other hand. More specifically, the results reveal that nonprofit organizations that have chosen an external auditor with higher levels of sector specialization, attach significantly greater importance to an auditor's number of clients in the same sector, to an auditor's understanding of the client's sector and organization, to an auditor's capability to provide added value, useful suggestions and guidance on accounting principles and to an auditor's willingness to conduct client service reviews. The main conclusions are that 1. non-profit organizations know which auditors are sector specialists and which are not, even in the relatively young Belgian non-profit auditing market, 2. There clearly is a segment of sector specialists, 3. Sector specialists could stress in company profile descriptions and tenders their sector expertise and their client oriented focus in order to gain full client potential, 4. sector specialists should invest in sector-specific training and in their client orientation in order to meet client expectations and to promote client loyalty, 5. policy makers could stress the importance of auditor attributes that are perceived to belong to sector specialists in order to encourage selection of a sector specialist and thus audit quality. The positive relationship between financial debt ratio, measuring resource dependence context, and choice of a sector specialist, supports that sector specialization is a proxy for audit quality.

## **SECTOR SPECIALIST AUDITORS AND BEHAVIORAL CHOICE CRITERIA**

Auditor choice has been widely studied in the extant literature. The large majority of auditor choice research focused on the choice for a BigN or a NonBigN audit firm and studied objective (non-behavioral) determinants of auditor choice, mainly grounded in agency theory. In the following paragraphs I justify and further elaborate my focus on the choice of a sector specialist adopting a behavioral perspective.

### ***Choice of a Sector Specialist Auditor***

BigN versus NonBigN membership as focus of auditor choice research (e.g. Tate 2007, Hope et al. 2008) is due to the consistent evidence in the Anglo-Saxon literature that BigN auditors are quality differentiated from NonBigN auditors. For example, accounting errors are less likely to be observed in financial statements of BigN clients (DeFond and Jiambalvo, 1991), BigN auditors are confronted with lower litigation rates (Palmrose, 1988), earnings response coefficients are significantly higher for BigN clients (Teoh and Wong, 1993) and BigN auditors use lower quantitative materiality levels (Blokdijk et al., 2003). In a Belgian context, however, Sercu et al. (2002) and Vander Bauwhede and Willekens (2004) were not able to detect quality differences between BigN and NonBigN audit firms. According to Khurana and Raman (2004) the perception of BigN performing higher-quality audits than non-BigN is primarily a function of the litigation environment. An auditor's insurance role ('deep pockets'), and consequently perceived quality, is magnified in a more litigious environment like the USA but is of less importance to investors in other environments like Belgium (Van Caneghem 2010). The Belgian stock market is very small (Weets and Jegers, 1997), which implies that the large majority of auditor clients are privately held firms, which decreases the threat of litigation. Moreover, in Belgium both Big4 and NonBig4 audit firms need to provide the same level of assurance: at maximum 3 million Euro for non-listed clients and 12 million Euro for listed clients. The Belgian Institute of Auditors primarily stresses the information risk reducing role of auditors, not their assurance role (De Wolf 2011). Given the Belgian context and given the recent stream of literature that supports the use of sector specialisation to proxy for audit quality (reduction of information risk), I focus on the level of sector specialization in this study. A sector specialist's extensive knowledge of the client's business environment, sectoral accounting practices and potential "abusive" accounting practices, is an information risk reducing factor for investors and other stakeholders. Structural shifts by audit firms in the direction of greater sector focus suggest that industry specialization plays an increasingly important role in enhancing audit quality (Hogan and Jeter 1999; Solomon, Shields, and Whittington 1999). Last but not least, in comparison with other European countries (France, Germany, The Netherlands and the UK), Belgium counts 2 to 5 times less auditors, taking into account differences in gross domestic product. Consequently, the 925 certified auditors in Belgium are able to fulfill the needed number of mandates that allows them to develop high levels of sector expertise (L'Echo 2011). I conclude that the choice of an auditor with sector specialization is a fruitful subject of research given the Belgian context.

I measure auditor sector expertise at signing auditor-level and based on the total number of nonprofit audits performed within the dataset of 3.353 audited Belgian nonprofit organizations. This measure solves some problems associated with the conventional measurement applied in the extant literature, being sector expertise at office or audit firm level based on sales within the specific client's sector. A measure of sector expertise at office

or audit firm level is mainly based on the assumption that auditors are homogeneous within the audit firm or within the practice office as all auditors within an audit office or firm are assigned the same expertise score. Though, auditor expertise is uniquely held by individual partners through their deep personal knowledge of local clients and cannot be readily captured and uniformly distributed by the firm to other offices (Carcello and Nagy 2004), even to other auditors/partners within the office (Chin and Chi 2009). In a related vein prior studies show that most of the knowledge in any organization, including an audit firm, is tacit knowledge (Bonner 2000; Knechel 2000). If an audit firm's culture norms encourage knowledge hoarding as a source of power or job security, auditors may refrain from sharing what they know (Vera-Munoz et al. 2006). In line with these arguments Chin and Chi (2009) revealed that sector expertise measured at signing auditor-level is more relevant than at audit-firm/office-level in explaining audit quality (preventing financial statement mis- and restatements). Next, the measure for sector expertise in this study is client-based, not sales-based. It is possible, and likely, that an auditor employed in a small audit firm performs many nonprofit audits, thereby being an expert, but he may not claim a larger share of sales within the nonprofit auditing market when compared to a non-expert auditor employed in a large international audit firm providing a few audits to larger nonprofit organizations. The very likely situation in a nonprofit setting where an auditor has a number of small nonprofit clients and has developed the knowledge base to be a specialist may be captured by a number-of-clients-based measure and not by a sales-based measure (Balsam et al. 2003, Tate 2007, Chin and Chi 2009). In line with these arguments I use a client-based measure of sector expertise to avoid a bias towards large clients.

By using a measure of sector expertise that is based on the number of clients at the level of the signing auditor I am able to study choice of a sector specialist in a dataset comprising both BigN and NonBigN clients without there being confounding with the Big4/NonBig4 concept. In comparison with other frequently used measures of sector expertise the current measure is namely less likely to be correlated with the Big4/NonBig4 dichotomy (.099 in the current dataset) Prior research on the choice (and audit quality) of a sector specialist almost exclusively focused on samples of clients audited by Big4 firms only due to the focus on firm- or office-level measures of sector specialization (Balsam 2003; Krishnan 2003; Ferguson et al. 2003; Francis et al. 1999, 2005; Chin and Chi 2009; Ettredge, Kwon and Lim 2009) <sup>1</sup>.

### ***Auditor choice from a behavioral point of view***

Prior studies examining the choice for a (Non)BigN or (non) sector specialist auditor focused on objective economic variables like debt ratio, growth and financial distress and mainly adopted an agency theory perspective to propose hypotheses. In contrast with the majority of prior research, I study the selection of an auditor with sector expertise from a behavioral perspective. I do control, however, for more conventional objective factors (reliance on

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<sup>1</sup>In the United States, the audit report of a publicly listed company bears the signature of the audit firm and indicates the city in which the audit firm is located, but does not include the signing auditor's identity. Therefore, the extant studies on sector specialisation are primarily based on firm- or office-level measures of sector specialisation. The latter type of measures have the disadvantage to be correlated with the Big4/NonBig4 dichotomy, leading Ettredge, Kwon and Lim (2009) for example to state that "Use of dependent variables that capture whether clients of «only» Big N auditors choose industry leaders avoids confounding the demand for Big N audits with demand for audits provided by industry specialists". The Belgian legislation, however, also requires audit reports to include the identity of the signing auditor. This regulation provides me with a setting to measure sector expertise at signing auditor level.

financial debt, reliance on government grants, firm size), which are grounded in resource dependence theory, basically being agency theory adapted to nonprofit organizations.

The few existing behavioral studies in auditor choice (Addams and Allred 1994, 2002, Rummel, Davidson and Acton 1999, Stanny, Anderson and Nowak 2000, Sands and McPail 2003) demonstrate three shortcomings. First, they are restricted to identifying and rank ordering auditor attributes perceived important to clients when choosing an(y) auditor. These prior studies do not make the link with the specific choice made. The aim of this study is to identify perceptual choice criteria (auditor attributes) considered important by clients that choose a specific auditor, namely an auditor with sector expertise. A second shortcoming of prior behavioral auditor choice studies is that, with the exception of Sands and McPhail (2003), all these studies use one-item measures to capture auditor attributes. As suggested by Roberts (1999) I use multiple statements per auditor attribute to improve the reliability and validity of the underlying constructs. A third shortcoming is that the extant behavioral auditor choice literature exclusively focused on for-profit corporations (in the US and Australia). Given the argument of Tate (2007) that “ the culture, organizational structure, and financial needs of nonprofit organizations are different from that of the for-profit sector, and therefore, the monitoring needs provided by external auditors may be different” there are reasons to believe that the choice decision of non-profit organisations may be different from that of for-profit corporations. Hence, the contribution of studying auditor choice in nonprofits (in Belgium).

The advantage of a behavioral approach is that it enables me to formulate a number of recommendations in order to encourage the selection of a sector specialist. This might contribute to an increase in audit quality among nonprofit organizations. Governmental (e.g. subsidizing) authorities for example could promote the auditor attributes perceived to belong to sector specialists, and sector specialists could try to gain full client potential by stressing the auditor attributes desired by clients that are looking for a sector specialist.

In practical terms the behavioral perspective implies the identification of a number of relevant auditor attributes which are perceived (more versus less) important to clients in choosing an auditor. I identified relevant attributes of auditors on the basis of the behavioral auditor choice literature (Addams and Allred 1994, 2002, Rummel, Davidson and Acton 1999, Stanny, Anderson and Nowak 2000, Sands and McPail 2003), the behavioral auditor switching literature (Addams & Davis 1994, Beattie & Fearnley 1995, Addams, Davis & Mano 1996, Magri & Baldacchino 2004) as well as the behavioral professional services literature (Bojanic 1991, Higgins and Ferguson 1991, Scott and Van der Walt 1996). From aforementioned behavioral studies I identified the following relevant auditor attributes: technical competence, credibility (with dimensions like good reputation and integrity), customer focus (timely services, quick responses and proactivity), access/availability (proximity, accessibility to audit staff and partners, approachability in general sense), personal working relationship (individualized attention, personality fit), audit fee (fee level, fee structure, method of pricing), range of non-audit services (tax, legal, human resources...) and sector specialization (experience and expertise in the client's sector). I refer to Sands and McPhail (2003, p. 116) for a useful overview of the relevant behavioral literature and as a justification of the identified auditor attributes. Based on the auditing literature (Duff 2004, Sands and McPhail 2003) and a number of interviews with experienced members of the accounting profession and industry I operationalized each auditor attribute by means of multiple statements. I included the 44 developed statements in a survey and questioned by means of a 5 point scale to what extent each statement was important as a choice criterium during the selection process of the current auditor (1= not important at all, 5= very important). As the research technique applied in this study, factor analysis, has no means of

differentiating the relevant from the irrelevant items (Hair et al. 1998), I had to remove those statements that were considered not important in the choice of an auditor.

**TABLE 1**  
**Factor Analysis: Auditor attributes**

<b>Auditor attributes</b>	<b>Statements in the questionnaire</b>	<b>Cronbach's alpha</b>	<b>Eigenvalue (% of var. explained)</b>
Competence/ Deontology/ Reputation (COMP)	The audit firm is credible to third parties (.723)	0.867	11.657 (36.427%)
	The audit team is objective (.672)		
	The audit firm enjoys a good reputation (.650)		
	The audit team is conscientious (.643)		
	The audit team is highly competent (.596)		
	The audit team is independent of the Board of Directors (.528)		
Practical Execution (PRACT_EXECUTION)	The audit team operates to the highest standards of integrity (.643)	0.853	2.068 (6.461 %)
	The audit firm is willing to be flexible when scheduling the timing of audit visits (.692)		
	The members of the audit team are easily contactable (.666)		
	The composition of the audit team is stable over time (.604)		
	The audit firm delivers reports (e.g., the audit report) in time (.599)		
Relationship Management (RELATION_MGT)	Audit team staff create the minimum of disruption so far as practically possible (.414)	0.803	1.690 (5.281%)
	There is sufficient personal contact between the audit partner and the management of my organization (.681)		
	The audit partner actively participates at the annual meeting of shareholders where the financial statements of the organization are presented (.638)		
	The audit team and the audit committee of my organization cooperate well (.625)		
	The audit team considers the client's interests (.606)		
	There is a 'good fit' between the personality of the members of the audit team and the staff of my organization (.600)		
Audit fee (FEE)	The audit team communicates in an understandable manner (not too much technical jargon) (.497)	0.798	1.465 (4.577%)
	The audit firm charges a fair audit fee (.808)		
	The audit firm provides value for its fees (.791)		
	The audit firm provided a clear tender (.767)		
Client oriented analysis and suggestions (CLIENT_FOCUS)	The audit firm is willing to provide detailed cost information (.413)	0.814	1.308 (4.088%)
	The audit team regularly interacts with the management of my organization (.502)		
	The audit team regularly identifies examples of added value to the client (.699)		
	The audit firm conducts a client service review (.604)		
	The audit firm is keen to understand what is happening within the client's organization (.512)		
Sector expertise (SECTOR_EXP)	The audit team is willing to provide guidance on accounting principles (.406)	0.692	1.072 (3.349%)
	The audit firm has other clients in the same sector (.907)		
	The audit firm is very knowledgeable about the client's sector (.739)		

This table presents (i) a list of statements that are perceived more versus less important when choosing an auditor; and (ii) six resulting auditor attributes, derived from an exploratory factor analysis (with VARIMAX rotation) based on the list of statements. The numbers in parentheses after each statement represent the factor loadings. The statements are 5-point scales going from (1) not at all important to (5) very important.

This reduction process resulted in ten statements being deleted, including eight statements regarding non-audit services, and two statements regarding respectively international scope and proximity of the audit firm. The auditor's ability to provide non-audit services clearly is not an important choice criterion among Belgian nonprofits. The other relevant auditor attributes identified from the literature, were still represented by at least two statements. The remaining 34 statements were reduced to a smaller number of factors using factor analysis. Both the Kaiser-Meyer-Olkin (K-M-O) measure of sample accuracy (0.924) and the Barlett test (4799.231\*\*\*) indicate that the input correlation matrix is amenable to factor analysis. A Varimax rotation of the factor matrix yielded six significant factors with an eigen value greater than one (Table 1). These factors together accounted for over 60% of the variance in the scale items. A loading factor of 0.45 or higher (Hair et al. 1998) was used for item selection resulting in 29 statements loading significantly onto six factors or auditor attributes. The six factors or auditor attributes also were tested for reliability using Cronbach's coefficient alpha. The six auditor attributes exhibited well over the 0.60 reliability level suggested by Hair et al. (1998). The six resulting auditor attributes demonstrate good comparability with the attributes identified in the prior literature (Beattie & Fearnley 1995, Magri & Baldacchino 2004, Sands and McPhail 2003). My aim is to identify those auditor attributes of which the perceived importance matters in the nonprofit organizations' choice decision in favor of an auditor with (more versus less) sector expertise. In the next section, I develop a number of hypotheses for the auditor attributes identified through the factor analysis.

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

In spite of the Belgian non-profit auditing market being quite young, the responses to the survey (cfr. infra) suggest that Belgian nonprofit organizations have clear perceptions regarding the auditing market and its auditors. Around 45% of the respondents indicated in the survey that auditor choice was based on positive word-of-mouth and recommending by colleagues, subsidizing authorities or others. Word-of-mouth as a communication tool in the Belgian auditing sector is of considerable importance due to the prohibition of advertising. The importance of personal recommendations to accountants and auditors has been stated in the literature as well (Young and Denize, 1995). Further, about 15% of the respondents selected an auditor based on prior experiences with the auditor. There is thus quite extensive communication and experience regarding auditors and their attributes in the nonprofit sector, implying that the resulting perceptions may drive auditor choice. This fact legitimates the behavioral/perceptual approach adopted in this study.

While the six auditor attributes, identified by means of factor analysis, are probably attractive to all clients, I will try to identify those auditor attributes that are significantly more (or less) attractive to clients selecting an auditor with more sector specialization. I will subsequently develop hypotheses for the auditor attributes competence/deontology/reputation (COMP), relationship with management (RELATION\_MGT), client-oriented analysis and suggestions (CLIENT\_FOCUS), practical execution (PRACT\_EXECUTION), audit fee (FEE) and sector expertise (SECTOR\_EXP).

Technical competence (Eichenseher and Shields 1983) and **Integrity-Competence-Reputation** (Beattie and Fearnley 1998a) have been revealed in prior research as most important auditor characteristic wanted by clients. There is evidence that the latter criterion

should exist in any individual audit firm before the firm is considered as a potential auditor (Sands and McPhail 2003). Therefore, while an auditor's competence/deontology/reputation is a very important choice criterion, I do not expect this attribute to matter in the choice between an auditor with more versus less sector specialisation. Both sector and non-sector specialists should possess a level of knowledge and integrity that is consistent with professional standards. I hypothesize that:

*H1: The importance that clients attach to an auditor's competence/deontology/reputation is not related to the choice of an auditor with more sector expertise.*

In order to identify potential perceptions with regard to how sector and non-sector specialists differ in their **working relationship with management**, I rely on some generally acknowledged characteristics of high-performance and expert auditors as (imperfect) proxies for sector specialist auditors. This proxy is not perfect, but nevertheless one can assume that a sectorspecialist will attain higher levels of performance and expertise than a non-sector specialist in performing an audit in that specific sector. The literature on high-performance and expert auditors captures these constructs by means of performance evaluations that auditors achieve and auditors' self-perceptions regarding expertise in a certain audit domain (Abdolmohammadi et al. 2004, Abdolmohammadi and Shanteau 1992, McKnight and Wright 2011, Tan and Libby 1997). It is revealed in this literature that high-performance and expert auditors differentiate themselves by their interaction and communication skills, their proactivity, their inclination to take responsibility and their client business awareness. Technical knowledge and ability is the least distinguishing factor between high and low performance and expert auditors (which is in line with H1). On the basis of these findings I expect that sector specialists are more likely to have interaction with management, to be aware of and to consider the client's interests and to take up their responsibilities regarding the general meeting of shareholders and the audit committee. Given the high degree of word-of-mouth and communication regarding auditors and their attributes in the Belgian nonprofit sector, I hypothesize that:

*H2: The importance that clients attach to an auditor's relationship with management is positively related to the choice of an auditor with more sector expertise*

**Audit fee** relates to a fair audit fee in accordance with the delivered audit work, and to a clear tender substantiated by detailed cost information. Results regarding the impact of auditor industry expertise on the level of audit fees to date have been contradictory, both in the for-profit (Pearson and Trompeter, 1994; Craswell, Francis and Taylor, 1995; Cullinan, 1998) and the non-profit sector (Ward and Elder 1994, Deis and Giroux 1996). Thus, overall, the evidence for an "expertise" audit fee premium is somewhat mixed. Counteracting forces are at work. On the one hand, clients may be willing to pay more for an auditor with perceived expertise in the sector (market-based approach) and sector specialists need to keep their sector knowledge up to date, which requires training and sector-specific investments, increasing costs and thus audit fees (cost-based approach). On the other hand, sector specialists benefit from economies of scale, reducing the cost per client and consequently audit fees (cost-based approach) (Cullinan 1998).

Next, I expect that if a potential future mandate is within the domain of expertise an auditor is better able to assess the risks associated with this task, and to assess the evidence needed to address this risk. Consequently, I expect that sector specialists are able to provide more detailed tenders and cost information.

Given the mixed evidence regarding audit fee and the lack of prior empirical evidence regarding detail of cost information I do not propose a hypothesis.

**Client oriented analysis and suggestions** refers to the auditor focusing on the client's problems, needs and being proactive. Sector specialisation enables auditors to identify and address sector specific problems and issues more thoroughly than auditors who do not have that domain-specific knowledge (Brown and Raghunandan, 1995). Further it is revealed by Abdolmohammadi et al. (2004) and McKnight and Wright (2011) that high-performance and expert auditors demonstrate higher levels of proactivity and client business awareness. It is thus very likely that sector specialists are better able to provide clients with help and suggestions regarding their sector- and organization-specific problems. Therefore, I hypothesize that:

*H3: The importance that clients attach to an auditor's client oriented analysis and suggestions is positively related to the choice of an auditor with more sector expertise.*

The **practical execution** of the audit relates to flexibility in scheduling audit visits, minimization of disruption, stability in the composition of the audit team, approachability and timely delivery of reports. There is no evidence in the literature that sector specialists would score differently on these dimensions than non-sector specialists. Possibly, these dimensions rather differ between large and small audit firms. A lack of audit team stability for example is primarily found among Big4 audit firms (Magri and Baldacchino 2004). I hypothesize that:

*H4: The importance that clients attach to an auditor's practical execution of the audit is not related to the choice of an auditor with more sector expertise.*

The last auditor attribute identified from the factor analysis is **sector expertise**, implying good knowledge of the client's sector and serving other clients within the client's sector. If clients attach importance to the latter dimensions they would normally be more inclined to choose an auditor with higher levels of sector expertise. The necessary condition, however, is that the auditors with higher levels of sector expertise are known. As the survey responses suggest extensive communication (word of mouth) regarding auditor attributes in the nonprofit sector I expect that there is a well-known segment of sector specialist auditors, and thus I hypothesize that:

*H5: The importance that clients attach to an auditor's sector expertise is positively related to the choice of an auditor with more sector expertise.*

Prior research related to auditor choice has adopted an agency theory framework to develop and test hypotheses. From an agency theory perspective the demand for auditing results from the information asymmetry between contracting agents in organizational settings (Jensen and Meckling 1976). In the case of high information asymmetry, the degree and quality of required external monitoring is higher. Higher auditor quality results in better information (Teoh and Wong, 1993; Balsam et al., 2003; Dunn and Mayhew, 2004). Auditing will reduce agency risk (information risk) through better quality information. An auditor's extensive knowledge of the client's business environment, sectoral accounting practices and potential "abusive" accounting practices is perceived by stakeholders/investors as an information risk reducing factor. Hence, higher agency problems are associated with the choice of an auditor with sector specialization. The unique characteristics of nonprofit organizations suggest that

this principal-agent conflict-based approach must be modified for the nonprofit setting because of the absence of owners (Vermeer et al. 2006, Tate 2007). In nonprofits the mix of revenue sources greatly affects the contracting environment, and this is expected to have an effect on an organization's auditor choice decision (Tate 2007). We use a resource dependency theory framework (Pfeffer and Salancik 1978) to identify a number of control variables (Vermeer et al 2006, Tate 2007). Two of the primary sources of funding for nonprofits are governments (grants) and creditors (debt), resulting in two control variables capturing respectively reliance on grants and reliance on debt.

Nonprofits that receive government grants need to meet additional reporting and internal control requirements, need to demonstrate that they are fiscally responsible with government-provided resources and are subject to greater scrutiny from legislators, the media, and the public (Vermeer et al 2006). Accordingly, nonprofits that receive government grants demand for increased monitoring, which they can satisfy by choosing a higher quality auditor (e.g. DeFond 1992).

Also the reliance on financial debt introduces a need for increased monitoring (Jensen and Meckling 1976). The reliance on financial debt causes creditor-borrower conflicts because the borrower has incentives to take risks in using the borrowed funds to carry out the objectives of the nonprofit that conflict with the desires of the creditor (Vermeer et al. 2006). The existence of debt is thus likely to be associated with the choice for an auditor with sector expertise.

A third control variables is the size of the nonprofit organization. Larger organizations are more complex, are more likely to be scrutinized by the public and the media and hence can have increased demand for monitoring. Audits of larger firms are likely to involve greater complexities than are those of smaller firms (Gist, 1992). Beattie and Fearnley (1995) find evidence that the need for auditors' industry specialization is more important to larger firms than to smaller firms..

## **METHODOLOGY**

### ***Research Population and Data collection***

The research population comprises all Belgian nonprofit organizations that had their financial statements monitored by an external auditor during the period 2006-2008. On the basis of archival research at the Belgian Institute of Auditors 3,353 nonprofit organizations that meet this criterion have been identified. The sample population has been established by reducing the 3,353 organizations by means of random selection to 1,000 nonprofit organizations.

The data to conduct this study are collected from three sources: a national survey addressed to these 1,000 Belgian nonprofit organizations, the nonprofit organizations' financial statements, and archival research at the Belgian Institute of Auditors.

The survey, sent in the summer/autumn of 2010 and addressed to the nonprofits' chairmen of the board, yielded a response rate of 31.2% or 312 responses. The questionnaire contained three sections. In the first section, respondents had to provide some general information (i.e., the name and unique number of the organization; and the respondent's function within the organization). In the second section, respondents had to provide the following information with respect to the financial statement audit: (i) name of the auditor (for the period 2006 up to 2009); (ii) the reason for the external financial statement audit; (iii) whether the financial records of the organization are screened by another external party; (iv) the perceived benefits

of an external financial statement audit ; and (v) scores with respect to their level of satisfaction with and loyalty towards the audit firm. The third section contained a 44-item 5-point Likert scale, questioning the degree of importance attached to 44 auditor dimensions during the auditor choice process relating to the current auditor (i.e. relating to auditor appointments in 2008, 2009 or 2010 given the Belgian compulsory three-year auditor mandate).

Besides the survey data, this study also makes use of archival data collected at the Institute of Auditors (to measure sector specialization), and of publicly available financial data (to measure total assets).

The respondents are representative for the research population of 3,353 firms. First, chi-square tests reveal no significant differences between respondents and non-respondents with respect to firm size and nonprofit subsector. There is, however, a small overrepresentation of the education subsector. Second, independent sample t-tests and chi square tests reveal no differences between early and late respondents with regard to the main construct measures (the choice of a sector specialist, the importance attached to the various auditor dimensions) . The idea behind the latter tests is that late respondents (respondents to the follow-up survey) are more likely to resemble non-respondents than do immediate respondents (Moore and Tarnai, 2002). We conclude that non-response bias is not a major concern in this study.

### ***Statistical Model and Operationalisation of variables***

To test the hypotheses I run the following OLS regression:

$$\text{CHOICE\_SECTOR\_SPECIALIST} = \beta_0 + \beta_1 * \text{COMP} + \beta_2 * \text{RELATION\_MGT} + \beta_3 * \text{FEE} + \beta_4 * \text{PRACT\_EXECUTION} + \beta_5 * \text{CLIENT\_FOCUS} + \beta_6 * \text{SECTOR\_EXP} + \beta_7 * \text{SCREENING\_SUBS\_AUTH} + \beta_8 * \text{FIN\_DEBT\_RATIO} + \beta_9 * \text{LNTA}$$

The dependent variable *CHOICE\_SECTOR\_SPECIALIST* equals the natural logarithm of the chosen auditor's number of nonprofit clients relating to book year 2008. Sector expertise is thus measured at the level of the chosen signing auditor (not the audit firm), and is based on the total number of nonprofit audits that he/she performed in book year 2008 within the 3.353 audited Belgian nonprofit organizations. The survey, sent in the summer/autumn of 2010, questioned choice criteria relating to the current auditor. Given the compulsory three-year auditor mandate in Belgium, this study comprises auditor choices made in 2008, 2009 and 2010, which relates to verifications of financial statements of book years 2007, 2008 and 2009. Sector specialist data dating from verifications of book year 2008 are thus appropriate to cover this period. I note that the correlation between *CHOICE\_SECTOR\_SPECIALIST* and the Big4/NonBig4 dichotomy is very low in the present dataset (.099), which excludes interference with the Big4/NonBig4 concept.

The main independent variables relate to the importance attached to six auditor attributes: competence/deontology/reputation, relationship with management, audit fee and tender, client-oriented analysis and suggestions, practical execution of the audit, and level of sector expertise. The dimensions underlying these auditor attributes were questioned in a survey. By means of a factor analysis on these dimensions, six auditor attributes have been established. These auditor attributes are included in the regression analysis by means of their

rotated factor scores, respectively *COMP*, *RELATION\_MGT. FEE*, *CLIENT\_FOCUS*, *PRACT\_EXECUTION*, *SECTOR\_EXP*.

As control variables I consider a number of objective characteristics that relate to the nonprofit's resource dependence context: reliance on financial debt, reliance on government grants and size of the nonprofit organization. Reliance on financial debt is captured by means of the financial debt ratio (*FIN\_DEBT\_RATIO*) equaling bank debt divided by total assets, averaged over the years 2008 and 2009. Reliance on government grants is proxied by a dummy variable screening by a subsidizing authority (*SCREENING\_SUBS\_AUTH*), with 1 implying that there is a (complementary or overlapping) screening of the financial statements by a subsidizing authority, and 0 implying that there is no such screening. This quite rudimentary variable is used as an alternative for the percentage of subsidies in total operating revenue. Due to a wide divergence of subsectoral regulations within the nonprofit sector, financial reporting in the Belgian nonprofit sector is far from uniform (Verbruggen et al. 2011). This lack of uniformity makes a correct and consistent calculation of the latter variable impossible. The size of the organization (*LN\_TA*) is calculated as the natural logarithm of total assets in year 2008.

## EMPIRICAL RESULTS

### *Descriptive Statistics and Correlations*

I begin by presenting descriptive statistics (Table 2) and pair-wise correlations (Table 3) of the regression variables. With regard to the dependent variable Table 2 reveals that a Belgian auditor who is active in the nonprofit sector (i.e. performs at least 1 audit in this sector) on average performed 15.76 nonprofit audits in 2008. There is wide variation in auditor sector specialization as the number of nonprofit audits per auditor ranged from 1 to 56 nonprofit audits in 2008.

**TABLE 2:**  
**Research Variables – Descriptives**

	Actual range	Mean	Std. Dev.	Cronbach's $\alpha$
CHOICE_SECTOR_SPECIALIST (ln number of nonprofit audits)	0 - 4.03	2.26	1.09	
Number of nonprofit audits	1-56	15.76	1.43	
Importance attached to competence / deontology / reputation <sup>a</sup>	1-5	4.32	0.70	0.87
Importance attached to audit fee and tender <sup>a</sup>	1-5	4.19	0.86	0.80
Importance attached to practical execution <sup>a</sup>	1-5	4.08	0.79	0.85
Importance attached to working relationship with management <sup>a</sup>	1-5	3.82	0.91	0.80
Importance attached to client orientation <sup>a</sup>	1-5	3.78	0.99	0.81
Importance attached to sector expertise <sup>a</sup>	1-5	3.75	1.09	0.69
SCREENING_SUBS_AUTH (0/1)	0/1	0.56	0.50	
FIN_DEBT_RATIO (%)	0 - 97	18.89	25.69	
LN_TA (Euro)	11.31-19.14	15.19	1.43	

<sup>a</sup> Averaged scales, not rotated factor scores

N=282

Descriptives with regard to the six established auditor attributes reveal that clients attach much to very much importance to the attributes competence/deontology/reputation, audit fee/tender and practical execution. The auditor's working relationship with management, client orientation and sector expertise is perceived somewhat lower in importance (between neutral and important). Apparently, there is a potential opportunity to improve the appeal of sector expertise as valuable auditor attribute. At first glance, nonprofit clients seem likely to be prone to such efforts as they demonstrate a positive attitude towards the external audit (more than 80% of the respondents consider the external financial audit as useful for increasing the quality of financial statements, more than 50% consider the financial audit as useful to legitimate grants, 18% undergo an external audit on a voluntary basis). Concerning the control variables the descriptives reveal that 56% of the nonprofits in the dataset undergo a screening of their financial statements by a subsidizing authority. The financial debt ratio is on average 18.89% and ranges from 0% to 97%. Mean total assets equal 11 million Euro. Total assets range from 82,000 Euro to 200 million Euro in the dataset.

The correlation matrix (Table 3) demonstrates very small correlations between the independent variables. Multicollinearity is thus not an issue. The independent variable, CHOICE\_SECTOR\_SPECIALIST, is significantly and positively correlated with the importance attached to an auditor's sector expertise and client focus and with the financial debt ratio, which is in harmony with the expectations.

**TABLE 3:**  
**Correlation Matrix**

	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.
1. CHOICE_SECTOR_SPECIALIST	1,00	-0,02	0,07	-0,06	-0,08	0,11*	0,38***	0,03	0,17***	0,07
2. COMP <sup>a</sup>		1,00	-0,03	0,06	-0,04	0,02	0,02	0,03	0,00	0,05
3. RELATION_MGT <sup>a</sup>			1,00	0,00	-0,04	-0,07	-0,03	0,01	0,08	0,02
4. FEE <sup>a</sup>				1,00	0,14**	-0,04	-0,02	0,06	-0,02	-0,06
5. PRACT_EXECUTION <sup>a</sup>					1,00	0,00	0,01	0,08	-0,04	-0,10*
6. CLIENT_FOCUS <sup>a</sup>						1,00	0,05	-0,05	-0,15**	0,24
7. SECT_EXP <sup>a</sup>							1,00	0,07	0,14**	0,05
8. SCREENING_SUBS_AUTH								1,00	0,01	-0,03
9. FIN_DEBT_RATIO									1,00	0,05
10. LN_TA										1,00

<sup>a</sup> factor scores

### **Main Results**

The regression results are presented in Table 4. A first finding is that nonprofits attaching importance to an auditor's sector expertise are significantly more inclined to engage an auditor with higher levels of sector specialization. More specifically, nonprofits considering it important that an auditor has good knowledge of the sector and has many clients in the sector eventually choose an auditor with a higher level of sector specialization. This finding confirms hypothesis H5. This finding indicates that there is a segment of auditors specialized in the nonprofit sector and that this segment is well known to the nonprofit organizations.

The nonprofit audit market is a young market, but apparently nonprofit organizations are well informed. The extensive reliance on word-of-mouth and knowledge from prior experiences, mentioned by the survey respondents, probably accounts for this finding.

**TABLE 4:**  
**OLS regression explaining the chosen auditor's degree of sector specialization**  
**(DV = CHOICE\_SECTOR\_SPECIALIST)**

	Unstandardized Coefficients		Standardized Coefficients
	B	Std. Error	Beta
Constant	2,79	0,72	
COMP	-0,05	0,07	-0,04
RELATION_MGT	0,09	0,07	0,08
FEE	-0,05	0,07	-0,04
PRACT_EXECUTION	-0,09	0,07	-0,07
CLIENT_FOCUS	0,19**	0,07	0,17
SECT_EXP	0,40***	0,07	0,36
SCREENING_SUBS_AUTH	-0,01	0,13	-0,01
FIN_DEBT_RATIO	0,87***	0,26	0,20
LN_TA	-0,04	0,05	-0,05
F	7.469***		
R <sup>2</sup>	0.22		
Adj. R <sup>2</sup>	0.19		

A second finding is that nonprofits granting high value to an auditor's client orientation eventually choose an auditor with a higher level of sector specialization. This implies that nonprofit organizations perceive sector specialists to be more likely to understand what is happening within the client's organization, to provide useful suggestions and to identify examples of added, to provide guidance on accounting principles and to conduct client service reviews. This finding is in line with hypothesis H3. As expected, an auditor with a high degree of sector specialization is more able to understand the client's organization, to provide useful suggestions and to provide auditor assistance that goes beyond basic GAAP (Behn et al., 1997). They possess sector specific knowledge and expertise that they can cost effectively use to assist clients.

The importance attached to an auditor's competence/integrity/deontology, practical execution of the audit, relationship with management, and audit fee is not related with a choice decision in favor of an auditor with (more versus less) sector specialization. These auditor attributes are relevant when choosing an auditor (Table 2), but do not differ between sector and non-sector specialists according to the perceptions of nonprofit organizations. Presumably the competence/deontology/reputation attribute is considered an essential auditor attribute that every auditor should possess. This insignificant finding is in line with hypothesis H1 and with prior studies (Beattie and Fearnley 1998a, Sands and McPhail 2003, McKnight and Wright 2011).

Further, the value attached to an auditor's relationship with management is not found to be associated with auditor choice in favor of (more versus less) sector specialization, which is in contrast with hypothesis H2. Sector specialists are thus not perceived to communicate better with the organization's management or to take up their responsibilities better towards the organization's management.

Finally, the analyses revealed that the importance attached to an auditor's practical execution of the audit and the importance attached to audit fee do not matter in auditor choice. Apparently, sector- and non-sector specialists are not perceived to differ concerning these attributes, which is in harmony with the expectations.

With regard to the control variables, only the financial debt ratio is found to be significantly related to auditor choice in favor of a sector specialist. This finding indicates that creditors (banks) view audits provided by sector specialists as having higher quality, which is in line with prior research (Owhoso, Messier, and Lynch 2002, O'Keefe, King, and Gaver 1994, Balsam et al. 2003, Krishnan 2003). The reliance on government grants, proxied by screening by a subsidizing authority, is not found to be significantly related to the choice of a sector specialist. Potential reasons for this unexpected finding are threefold. First, the agency problems faced by subsidizing governments may be lower than those faced by for example banks, implying that subsidized organizations do not demand a higher quality auditor. Second, the proxy used to measure reliance on government grants is too crude and may rather capture the existence of other monitoring mechanisms. Related to this, the existence of governmental screening may reduce the need for an additional high quality monitoring mechanism (Vermeer et al. 2006) and thus the need to appoint an auditor with a high level of sector expertise. Organizational size is not found to be related to the choice of a sector specialist. Prior research did reveal that larger organizations are more likely to appoint higher quality auditors (e.g. Tate 2007), but measured higher quality auditors in terms of Big4/NonBig4 membership. Given the lack of correlation between Big4/NonBig4 membership and sector specialization in the present dataset, it is not surprising to find a non-significant relationship.

### *Sensitivity analyses*

I performed several sensitivity analyses.

First, I considered two alternative measures for the dependent variable. On the one hand a more accurate measure, considering specialization at the level of six nonprofit subsectors, and on the other hand a sector specialization measure at the office level (instead of at the signing partner level). The latter measure is commonly used in the Anglo Saxon literature (Ettredge et al. 2009). The main results of this paper relate to (signing) auditor sector expertise in nonprofit audits at a broad level. (Signing) auditors may also specialize in the types of nonprofits they audit. For example, one auditor might specialize in colleges and universities or hospitals, while another might specialize in religious or environmental organizations. In Belgium 6 nonprofit industries can be distinguished, defined by the Belgian umbrella organizations. When (signing) auditor sector expertise is measured at the level of nonprofit subsectors (the number of audits performed by an individual auditor in a specific nonprofit subsector), the regression results reveal exactly the same findings. When sector specialization is measured at the office level the importance attached to client oriented analysis and suggestions loses significance in explain the choice of a sector specialist auditor.

Second, a number of additional control variables were added to the regression model.

The growth of the nonprofit organization has been included because growth leads to a relatively greater need for additional external financing. Anticipating the need for financing, managers of such organizations may retain higher quality auditors to signal to capital suppliers that their financial statements are of higher quality. Also ROA has been included. Five dummy variables representing the six nonprofit subsectors have been included as well. Certain nonprofit subsectors are subject to many more governmental regulations than other nonprofit subsectors. Hence, it is possible that in certain subsectors it is more likely to engage a sector specialist. None of these additional control variables appeared to be significant, and inclusion of these variables did not alter the main regression results.

## CONCLUSION

The external audit function has recently attracted significant attention from legislators, regulators, and the media. Although most of the focus has been on for-profit corporations, legislators have started to examine governance and accountability issues in the nonprofit sector as well. One element of governance and accountability is external audit. The choice of an external auditor with a high level of sector specialisation is an important dimension of audit quality and could improve governance, accountability and financial reporting quality among nonprofit organizations. Given the Belgian research setting, auditor sector specialization is a more relevant measure for audit quality than the Big4/NonBig4 dichotomy (Sercu et al. 2002, Vander Bauwhede and Willekens 2004).

The goal of this study is to identify behavioral choice criteria playing a role in nonprofit organizations' decision to engage an auditor with a higher or a lower level of sector specialization. More specifically, I investigated whether auditor choice more versus less in favor of a sector specialist is associated with the importance that nonprofit organizations attach to six auditor attributes: competence/integrity/deontology, working relationship with management, audit fee, client oriented analysis and suggestions, practical execution of the audit and sector expertise. I identified these six behavioral auditor attributes (factors) by means of factor analysis out of 44 auditor dimensions, which were questioned in a large scale survey, addressed to 1,000 Belgian nonprofit organizations (response rate 31.2%). I also made use of archival data collected at the Belgian Institute of Auditors and of financial data publicly available through the Belfirst database.

This study revealed that nonprofit organizations attaching great value to the auditor attributes 'sector expertise' and 'client oriented analysis and suggestions' eventually choose an auditor with a higher level of sector specialization. However, the importance attached to the choice criteria 'competence/integrity/deontology', 'practical execution of the audit', 'relationship with management' and 'audit fee' does not drive the auditor choice decision.

This study leads to a number of conclusions. First, the finding that nonprofit organizations' importance attached to auditor sector expertise ultimately leads to the selection of an auditor with sector expertise learns that in the perception of clients there is undoubtedly an auditor category with the reputation of sector specialist and that this perception is correct. Despite the Belgian nonprofit auditing market being relatively young and despite the prohibition of advertising by audit firms, this type of information is apparently well known. The survey answers reveal that auditor choice decisions are very often based on good references by colleagues, board members, accountants, ... or on prior experiences with the auditor. Perceptions regarding auditors are thus shaped by substantial levels of communication and

word-of-mouth among clients, and by prior experiences with auditors. Second, my findings provide ways not to lose the reputation of being a sector specialist auditor. The results revealed that clients perceive and expect sector specialists to perform high on sector expertise and client orientation. Consequently, in order to avoid client dissatisfaction, reputation loss and auditor change, sector specialists should strive to exhibit these two auditor attributes at maximum when performing the audit. More specifically, they should invest on a continuous basis in sector specific expertise (training, software,...) and they should focus on understanding the client's organization, answering questions, and providing useful suggestions. Third, in order to encourage the choice of sector specialists and thus audit quality in the nonprofit sector, policy makers and (subsidizing) governments could promote the auditor attributes that characterize sector specialists. These auditor attributes, sector expertise and client focus, are on average perceived lower in importance than the other four auditor attributes by nonprofit organizations (Table 2). There is thus quite some potential in this respect to increase the appeal of sector specialists. To this end governments could stress the value that sector specialists can provide to clients, for example by providing client oriented advice during the audit (e.g. as a solution for non-profit organizations' lack of specialized accounting personnel) or by increasing disclosure quality. Fourth, as the relationship between the financial debt ratio (proxy for monitoring demand) and choice in favor of a sector specialist is found to be positive, sector expertise is considered an indicator of audit quality in the Belgian non-profit auditing market.

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