

**THE RELATIONSHIP
BETWEEN NONAUDIT SERVICES
AND PERCEIVED AUDITOR INDEPENDENCE**

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SYNOPSIS

Recent expansion of nonaudit services (NAS) by public accounting firms has caused the Securities and Exchange Commission (SEC) to question whether auditors can remain independent of their clients to whom they provide both audit and NAS. However, as evidenced by the debate surrounding the SEC's recent restrictions on the provision of NAS, some disagree, contending that these services strengthen the auditor's independence. This study examined how the performance of NAS influences the perceptions of auditor independence held by investors, professionals from non-Big 5 CPA firms and professionals from Big 5 CPA firms. The materiality of the NAS fee and the type of NAS performed were varied. Results indicated that NAS had a positive influence on participants' perceptions of auditor independence, consistent with the contention that such services enhance auditor independence. Not surprisingly, Big 5 CPA firm professionals consistently rated auditor independence significantly higher than either non-Big 5 CPA firm professionals or investors. Finally, investors favored disclosure of the provision of NAS, while CPA firm professionals favored disclosure of the amount of NAS only if those services exceeded a specified threshold.

Key Words: *Audit Independence, Nonaudit Services.*

Data Availability: Data are available from the authors upon request.

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INTRODUCTION

“Growing business ties between [CPA] firms and their audit clients ... has raised new questions regarding the nature of the auditor-client relationship” (Jenkins and Lowe 1999, 74). Significant increases in consulting revenues generated by CPA firms during the 1990s led the Securities and Exchange Commission (SEC) to believe that the increased economic dependence on these services may potentially impair auditor independence. To bolster what the SEC perceives as the profession’s weakening independence, it recently issued rules intended to restrict firms’ ability to provide certain nonaudit services (NAS) to their audit clients. Accordingly, this study provides empirical evidence of how the provision of NAS to an audit client influences perceptions of auditor independence.

No consensus exists about whether NAS strengthens or hinders auditor independence (Schroeder 2000). On the one hand, all of the Big 5 CPA firms oppose the SEC’s efforts to some degree, while many non-Big 5 CPA firms support the SEC’s proposed rules. Goldwasser (1999) suggests the lack of consensus within the accounting profession mirrors that within the financial community. He summarizes the debate by noting that some believe NAS creates a working relationship between the auditor and the client that is too close, while others believe the provision of these services enhances the auditor’s knowledge of the client, thus increasing the auditor’s objectivity and independence. The importance of the relationship between NAS and auditor independence led the SEC to issue a letter to the American Accounting Association inviting researchers to investigate differences between investors’ and auditors’ views of how NAS influences auditor independence (Turner 1999). Given the ongoing debate within the profession, this study distinguishes possible differences between the perceptions of auditor

independence held by non-Big 5 and Big 5 CPA firm professionals. Moreover, this study answers the SEC's call by investigating whether the provision of NAS differentially influences perceptions held by CPA firm professionals and investors.

Auditor independence may be a more salient issue when a client generates a substantial amount of an office's or practice area's revenue (Wallman 1996). The SEC issued ASR 250 in 1978, which required companies to disclose the NAS fees and the audit fees paid to their auditing firms when those fees were "material" (i.e., exceeded a threshold of three percent of the total fees). While the SEC rescinded ASR 250 after only three years, the recent discussions of the SEC's proposed auditor independence rules have revived the issues of materiality and fee disclosure. Consequently, this study explores how the relative materiality of NAS fees influences perceptions of auditor independence and investigates the desirability of various forms of fee disclosure.

This study experimentally examines how the performance of NAS influences the perceptions of auditor independence held by investors, professionals from non-Big 5 CPA firms, and professionals from Big 5 CPA firms. Each participant reviewed two hypothetical situations: one in which an external audit firm provided audit services only and the second in which the firm additionally provided either a material or nominal level of one of four NAS for an audit client. Three of the NAS included in this study - actuarial services, internal audit outsourcing, and legal services - are among those specifically identified in the SEC's recently issued rule as proscribed services. The fourth service was software training, a commonly provided service.

BACKGROUND AND RESEARCH QUESTIONS

Nonaudit Services

Companies currently demand a broad set of NAS (Wallman 1996). CPA firms are responding by offering such varied services as investment banking, strategic management planning, human resource planning, computer hardware and software installation, and internal audit outsourcing services [AICPA 1997; Berton 1995]. Growth in the revenues earned from these services has been significant. In constant 1999 dollars, NAS fees grew from \$2.8 billion in 1990 to \$15.7 billion in 1999 – an increase of over 460 percent (Antle 2000).

The AICPA has also identified new opportunities for auditors to expand traditional assurance service offerings. These services include risk assessment, business performance management, electronic commerce, and healthcare performance measurement among others [Elliott and Pallais 1997; Telborg 1996]. Notwithstanding the profession's efforts, the growth in assurance fees has not kept pace with the growth in NAS revenues. In constant 1999 dollars, fees from assurance services increased from \$6.5 billion in 1990 to \$9.2 billion in 1999 – a 42 percent increase (Antle 2000).

Nonaudit Services and Auditor Independence

Prior research suggests the impact of NAS on auditor independence is uncertain. One view is that these collateral services create a working relationship between the auditor and the client that is too close (Goldwasser 1999, Sutton 1997). As Wallman (1996) stated, auditor independence may be adversely affected by the provision of NAS if those services are perceived as escalating the economic bond between auditors and their clients. Economic theory suggests that the separation of firm ownership from the control of decisions held by management leads to the presence of asymmetric information, creating the need for mechanisms to monitor a firm's

financial reporting process. A commonly used external monitoring mechanism is the firm's hiring of an independent auditor to opine on the firm's financial statements (cf., DeAngelo 1981). Part of the value of this mechanism is dependent upon the auditor's *perceived* independence.¹ As SEC Chairman Arthur Levitt stated "(W)ithout confidence in an auditor's objectivity and fairness, how can an investor know whether to trust the numbers?" (Schroeder 2000).

Shockley (1981) and Knapp (1985) report evidence of NAS's adverse effects on perceived auditor independence. Shockley (1981) examined whether providing management advisory services (MAS) influences perceptions of auditor independence. He found that CPA firms providing MAS were perceived as having a higher risk of losing independence than those firms not providing such services. Knapp (1985) examined whether management's ability to affect a dispute resolution process is influenced by the purchase of MAS from its auditing firm. He found that management was perceived as more likely to obtain its preferred resolution when the audit firm provided MAS than when the audit firm did not provide MAS.

A second and opposing view holds that the provision of NAS enhances the auditor's knowledge of the client, thus increasing the auditor's objectivity and independence (Goldwasser 1999, Wallman 1996). DeAngelo (1981) argues that increased revenues generated by auditors from NAS lead to greater reputational capital. The desire to maintain this reputational capital will lessen the auditors' willingness to acquiesce to their clients (cf., Haynes, Jenkins, and Nutt 1998). Goldman and Barlev (1974) also suggest that the provision of NAS increases the auditor's independence because these services enhance the auditor's "uniqueness" to the client. This distinctiveness in turn increases the auditor's ability to resist management pressure and thus, maintain their independence.

Evidence of this positive relationship is reported by Schulte (1965) and Lowe, Geiger, and Pany (1999). Schulte (1965) investigated whether the provision of MAS affects confidence in auditor independence. He found that the majority of the respondents believed that MAS did not impair independence. Lowe et al. (1999) studied the implications of various internal audit outsourcing arrangements.² They found that the highest ratings of auditor independence and financial statement reliability, along with the greatest percentage of approved loans occurred when the company's CPA firm used separate staff members to perform the internal auditing services.

Non-experimental evidence of the positive relationship is reported in a survey of investors conducted by Penn, Schoen, and Berland [2000]. By an overwhelming four-to-one margin, surveyed investors believe that audits are "better" when the auditors know more about a company (as might be the case when auditors provide NAS). In addition, 59 percent of the investors believed that, if the SEC rules are implemented, audit quality might suffer because auditors will be less knowledgeable about their clients' business.

A final view holds that the provision of NAS has no effect on perceptions of auditor independence. In their reviews of prior studies of auditor independence, Kinney (1999) found no substantial evidence that investors are concerned about NAS, while Wallman (1996) encountered little evidence that the performance of these services impairs independence *in fact*. Similarly, Palmrose (1999) found that less than one-percent of the lawsuits against auditors between 1960 and 1998 included an allegation involving the provision of NAS. McKinley, Pany and Reckers (1985) examined whether the provision of MAS by CPA firms affects the decisions and perceptions of bank loan officers. They found that the performance of MAS did not significantly

affect loan decisions, financial statement reliability perceptions, or auditor independence perceptions.

The SEC recently issued rules to restrict firms' ability to provide NAS for their audit clients as a means of bolstering what it perceives as the profession's declining independence. Notwithstanding the SEC's concerns, there is a lack of consensus about the impact of NAS on perceptions of auditor independence among members of the accounting profession and the investing public. Given the debate surrounding NAS and the SEC's call for research on auditor independence, further investigation seems warranted. Therefore, this study examines how the provision of NAS affects perceptions of auditor independence.

Investors' and Auditors' Views of NAS

Much of the prior research related to NAS (and MAS) and auditor independence has examined the perceptions of investment officers, loan officers, and financial analysts.³ However, there is a paucity of research investigating the perceptions of members of the accounting profession. Shockley (1981) examined whether the provision of MAS differentially influenced perceptions of auditor independence held by Big 8 partners and partners from regional/local firms. He found that regional/local partners weighed MAS more heavily in their independence assessments than did Big 8 partners – indicating that regional/local partners viewed the provision of MAS as increasing the likelihood of a loss of independence. Shockley suggests that this difference might result because the segregation of MAS and audit is less distinct in smaller firms.

While companies are demanding more NAS, all segments of the CPA profession are not sharing in this growth. In fact, Big 5 CPA firms and non-Big 5 CPA firms generate substantially different proportions of their total revenues from NAS. *Accounting Today* reported that for 2000, the Big 5 CPA firms generated approximately 52 percent of their total revenues from

NAS, while the remaining Top-100 accounting service providers earned just 25 percent of their revenues from these services (Accounting Today, 2000). In addition, the Big 5 CPA firms dominate the NAS market, earning over 92 percent of total NAS revenues generated by the Top-100 accounting service providers. Given the Big 5 CPA firms' greater reliance on NAS revenues, there may be a difference between Big 5 and non-Big 5 CPA firms with respect to their perceptions of how NAS influences auditor independence.

There is also a lack of research focused on investors' views of auditor independence. Wallman (1996) stressed that the public's (i.e., investors) perception of auditor independence has been of highest importance to regulators for some time now. Even more recently, the SEC has renewed the call for researchers to investigate how NAS influences investors' views of auditor independence (Turner 1999). Pany and Reckers (1984) is one of the few prior studies to investigate investors' views. They compared investors' and chartered financial analysts' evaluations of a CPA firm's audit independence when that firm also provided NAS. Pany and Reckers found that the views of investors and analysts did not differ in any significant way. The similarity of responses led them to conclude that "the 'Independent to who?' question may not be as intractable as might be feared" (1984, 96).

To address the SEC's call for research, the current study examines investors' perceptions of auditor independence. In addition, the study also investigates perceptions of professional CPAs from both non-Big 5 firms and Big 5 firms. The lack of consensus regarding independence regulations within the profession, as described by Schroeder (2000), suggests that the opinions of professional CPAs may vary more than previously thought.

Materiality and Disclosure of NAS Fees

The AICPA and the SEC do not delineate “the circumstances under which the revenues from the client impair the auditor’s independence” (Goldwasser 1999, 52). In 1978, the SEC issued ASR 250, requiring companies to disclose fees paid to their auditor for various services when those services exceeded 3% of total fees. However, shortly after the issuance of ASR 250, the SEC determined that investors were not receiving useful information from the additional disclosures, and consequently rescinded ASR 250. Academic research supported the SEC’s determination, finding no evidence that ASR 250 had any measurable effect on investors, auditors, or managers (Law and Economics Consulting Group, Inc. 1997).⁴

Recent concerns over the influence of NAS on auditor independence has led the SEC to rethink whether knowledge of the extent of the relationship between auditors and their clients may benefit investors. It has issued new rules requiring companies to disclose *all* fees paid to their auditor for audit, I/T consulting and all other services during the last fiscal year. In support of the requirement to disclose all fees, Penn, Schoen, and Berland (2000) found that 89% of investors surveyed felt that it is important to know if the company’s auditor also provides other services to the company [regardless of the level of service provided]. They concluded that “[i]nvestors are looking for as much credible information as possible when making investment decisions.”

Disclosure of NAS and the related fees may be necessary only when such fees are material. Perhaps, the magnitude of NAS fees is more relevant when they represent a larger proportion of the total fees paid to the auditor. Pany and Reckers (1988) investigated whether the *extent* of MAS (0 percent, 25 percent, 60 percent, or 90 percent of the audit fee) affects the decisions of bank loan officers and financial analysts. However, they found that the level of

MAS influenced only two of the 15 requested decisions (i.e., a loan decision and a 12-month investment-safety decision). Notwithstanding this research, the influence of materiality on the perceptions of investors and professionals has not been studied. Consequently, this study explores the effect of varying levels of NAS fees on perceptions of auditor independence and disclosure and investment decisions.

Types of Services

The profession has determined that the performance of certain services is detrimental to auditor independence. In general, members of the SEC Practice Section are prohibited from performing services such as executive recruiting, public opinion polls, merger and acquisition services, psychological testing, and actuarial services for insurance companies (AICPA 1981). In its recent ruling, the SEC has specifically prohibited or limited auditors' ability to perform bookkeeping, appraisal, actuarial, internal audit, managerial, human resources, broker/dealer, legal, and certain financial information systems services.

One of the few studies to compare the impact of various services on perceptions of auditor independence was conducted by Pany and Reckers (1984). The authors compared seven services in their study, including executive recruiting, actuarial services, purchase acquisition assistance, market feasibility studies, redesign of an accounting system, independent BOD recruiting, and client employment of firm employees. Pany and Reckers (1984) did not find a significant difference in perceptions of auditor independence across the different services.

Other prior studies have examined only one type of NAS at a time. Pany and Reckers (1988), McKinley et al. (1985), and Pany and Reckers (1987) examined NAS related to internal control systems (design and/or improvements). Lowe et al. (1999) instead examined outsourcing of internal audit, while Shockley (1981) examined the design and installation of accounting

information systems. Because there has been relatively little research comparing different types of NAS, the current study examines the impact of several different services on perceptions of auditor independence and disclosure and investment decisions.

RESEARCH METHODOLOGY

The Study

This study examined how investors and members of the profession (I & P) assess auditor independence when a CPA firm provides NAS to an audit client. To address this issue, I & P first read general instructions that defined auditor independence and then read two hypothetical cases concerning services provided to the CPA firm's clients.⁵ At the end of each case, participants answered a series of questions related to their perceptions of auditor independence. Finally, they were asked to complete a questionnaire regarding their backgrounds.

One of the hypothetical cases (hereafter referred to as the *audit only* case) described a scenario in which a CPA firm provided only audit services to a client.⁶ This case was used to provide baseline measures for participants' perceptions. The second case (hereafter referred to as the *nonaudit service* case) described a scenario in which a CPA firm provided one of four types of NAS in addition to audit services. The NAS were presented as representing either a material or nominal portion of the total client fees (40 percent compared to 3 percent). The four types of NAS used included actuarial services, internal audit outsourcing, legal services, and software training (See the Appendix for descriptions of each NAS).

A total of 323 investors, non-Big 5 CPA firm professionals, and Big 5 CPA firm professionals completed the study.⁷ The investor group consisted of 101 individuals with an average age of 37.3 years, and an average of 17.5 years of education. The non-Big 5 CPA firm group consisted of 139 practicing professionals, while the Big 5 CPA firm group consisted of 83

practicing professionals. The average age of each CPA firm group was 45.2 years and 30.7 years, respectively, and the average number of years of education were 17.6 and 17.2 years, respectively.

Investors' and Professionals' Perceptions

Three questions were asked at the end of each case to assess the participants' perceptions regarding auditor independence. These questions asked for perceptions regarding the degree of auditor independence, integrity, and objectivity. Participants indicated their perceptions by drawing a slash mark (/) through a line with endpoints of "Complete lack of independence/integrity/objectivity" and "Complete independence/integrity/ objectivity." To measure a participant's perceptions, each line was converted to a 100-point scale with 0 representing a "Complete lack of independence, etc." and 100 representing "Complete independence, etc." The difference between a participant's perceptions in the baseline *audit only* case and the *nonaudit service* case was used to measure the effect of NAS.

Three other questions were used to measure the impact of NAS on participants' future actions and opinions. After each case, participants were asked to indicate the degree of their reliance on the auditor's opinion using a 100-point scale with endpoints of 0 for "No reliance is possible" and 100 for "Complete reliance." The difference between perceptions in the *audit only* and the *nonaudit service* cases was used to measure the impact of NAS on the participant's reliance on the auditor's opinion. In addition, in the *nonaudit service* case, participants were asked to indicate the relevance of the NAS to their investment decisions on a 100-point scale with endpoints of 0 for "Not relevant" and 100 for "Very relevant." Finally, in the *nonaudit service* case, participants were asked to indicate which of several statements agreed with their opinion regarding the need to disclose the performance of NAS by the CPA firm.

RESULTS

Perceptions of Auditor Independence, Integrity, and Objectivity

Table 1 addresses the general research question of how the provision of NAS affects perceptions of auditor independence. The table presents mean, or average, differences in perceptions of auditor independence, integrity, and objectivity between the *audit only* and *nonaudit service* cases. The differences are -6.47 for independence, -1.30 for integrity, and -5.77 for objectivity. These negative differences indicate that nonaudit services positively influenced users' perceptions of independence, integrity, and objectivity. To test whether these average differences are statistically less than zero, t-tests were conducted and are also reported in Table 1. The t-tests indicate that the differences for independence and objectivity are significantly less than zero at the 0.001 level. However, the average difference for integrity is not significantly less than zero.

--- Insert Table 1 here ---

Further analysis was conducted to determine whether perceptions of auditor independence, integrity, and objectivity differed among I & P, the four types of NAS, and the two levels of materiality. Since the three types of perceptions are related, one multiple analysis of variance (MANOVA) was conducted using the average differences in these three perceptions as the variables of interest. The results of this analysis indicated that perceptions did not significantly differ among I & P, types of NAS, or levels of materiality.

Next, two separate MANOVAs were used to examine the average perceptions of auditor independence, integrity, and objectivity for the *audit only* case and the *nonaudit service* cases.⁸ For both cases, average perceptions significantly differed among I & P at the .001 level. The average perceptions for the *audit only* case and the *nonaudit service* case for investors, non-Big 5

CPA firm professionals, and Big 5 CPA firm professionals, along with the corresponding F-statistics, are reported in Panels A and B of Table 2, respectively. As shown in Panel A, Big 5 CPA firm professionals consistently perceived auditors as having significantly higher degrees of independence, integrity, and objectivity than either the non-Big 5 CPA firm professionals or investors. For example, Big 5 CPA firm professionals' average rating of independence was 72.50 (on a 100-point scale) as compared to 55.69 for non-Big 5 CPA firm professionals and 55.02 for investors.

--- Insert Table 2 here ---

Panel B of Table 2 provides similar data for the *nonaudit service* case. Big 5 CPA firm professionals perceived auditors as having significantly higher degrees of independence, integrity, and objectivity than either the non-Big 5 CPA firm professionals or investors. Moreover, the non-Big 5 CPA firm professionals rated these same dimensions significantly higher than investors. To illustrate, Big 5 CPA firm professionals' ratings of integrity were 79.58 as compared to 69.02 for non-Big 5 CPA firm professionals and 58.69 for investors.

Reliance on the Auditor's Opinion

Table 3 presents the average differences between the two cases in participants' degrees of reliance on the auditor's opinion. The average difference is -4.03 , indicating participants placed a higher degree of reliance on the auditor's opinion when NAS were provided to the audit client. A t-test, also reported in Table 3, indicates that this average difference is significantly less than zero at the 0.013 level. Further analysis was conducted to determine whether reliance on the auditor's opinion differed across I & P, the four types of NAS, and the two levels of materiality. The results of this analysis indicated that the degree of reliance differed significantly among I & P ($p=0.020$).

--- Insert Table 3 here ---

Table 3 also provides the average reliance ratings for the *audit only* case and the *nonaudit service* cases. Separate analyses of variance (ANOVAs) indicated that the average reliance ratings in both cases differed significantly for investors, non-Big 5 CPA firm professionals, and Big 5 CPA firm professionals at the 0.002 level. As shown in Table 3 for both cases, Big 5 CPA firm professionals indicated that they would place a higher degree of reliance on the auditor's opinion than either the non-Big 5 CPA firm professionals or investors. Moreover, in the *nonaudit service* case, the non-Big 5 CPA firm professionals indicated that they would place a higher degree of reliance on the auditor's opinion than investors.

Investment Relevance

Participants were also asked to rate the relevance of the performance of NAS to their investment decisions. An ANOVA was conducted to determine whether investment relevance ratings differed significantly for I & P, types of NAS, and levels of materiality. Results indicated that investment relevance ratings were significantly different only for I & P and across levels of materiality. Table 4 presents the average investment relevance ratings by I & P and by level of materiality. Both the non-Big 5 CPA firm professionals and investors considered the performance of NAS to be more relevant to their decision to invest in the company than did the Big 5 CPA firm professionals (average ratings of 46.03 and 49.29 compared to 29.16). In addition, participants who were given a material level of NAS rated the performance of those services as more relevant to their investment decisions (mean rating of 50.92) than those participants who were given an immaterial level of NAS (mean rating of 34.71).

--- Insert Table 4 here ---

Disclosure Preferences

Finally, given the findings related to investment relevance, participants' opinions as to the need for disclosure (or non-disclosure) of the performance of NAS were examined. The initial analysis, presented in Panel A of Table 5, compared the percentage of participants in each group favoring disclosure of the performance of NAS to the percentage of participants favoring no disclosure. An overwhelming majority of investors, 92.9 percent, favored disclosure, while only 49.6 percent of the non-Big 5 CPA firm professionals and 47.0 percent of the Big 5 CPA firm professionals favored disclosure.

--- Insert Table 5 here ---

As a follow-up, participants were provided four forms of disclosure from which to select: disclosure of the amount of NAS exceeding a specified threshold, disclosure of the amount of NAS along with the amount of audit fees with the total fees exceeding a specified threshold, disclosure of the amount of NAS regardless of the amount, and disclosure of the amount of NAS along with the amount of audit fees regardless of the total amount. Panel B of Table 5 presents the percentage of participants within each group who favored each form of disclosure.⁹ Over 47 percent of investors favored disclosure of the amount of NAS along with the total audit fees, regardless of the amount. However, the non-Big 5 CPA firm professionals and the Big 5 CPA firm professionals favored disclosure of the amount of NAS alone and only if those services exceeded a specified threshold (34.4 percent and 45.7 percent, respectively).

Summary and Future Research

This study addressed the general research question of how the provision of NAS affects perceptions of auditor independence. The results of prior studies on the impact of NAS on perceptions of auditor independence are equivocal, and even today, the profession continues to

debate this fundamental issue (Schroeder 2000). The question was addressed by examining the difference between participants' perceptions of auditor independence, integrity, and objectivity in an *audit only* case and a *nonaudit service* case. The results indicated that NAS had an incremental, or positive, influence on perceptions of auditor independence and objectivity. Moreover, the auditor's provision of NAS had a similarly positive influence on participants' willingness to rely on the auditor's opinion. Such findings are consistent with the contention that NAS enhances auditor independence (e.g., Goldwasser 1999, Wallman 1996, and Goldman and Barlev 1974).

A secondary question examined in this study addressed whether perceptions of auditor independence differ across investors and the accounting profession. Not surprisingly, Big 5 CPA firm professionals consistently rated auditor independence, integrity, and objectivity and their reliance on the auditor's opinion significantly higher than either non-Big 5 CPA firm professionals or investors in both an *audit only* case and a *nonaudit service* case. For the *nonaudit service* case, non-Big 5 CPA firm professionals also rated auditor independence, integrity, and objectivity and their reliance on the auditor's opinion significantly higher than investors. These results suggest that the Big 5 CPA firm professionals may have a fundamentally different perception of "auditor independence" than either non-Big 5 CPA firm professionals or investors. Given that an increasing proportion of the Big 5 CPA firms' revenues are derived from NAS, such perceptions may be a consequence of the shifting focus of these large international firms. As a result, more attention may need to be given to understanding each group's perceptions of auditor independence and the implications of such differences.

The performance of NAS was also found to be relevant to investment decisions. Non-Big 5 CPA firm professionals and investors considered the performance of NAS to be

significantly more relevant to their investment decisions than did the Big 5 CPA firm professionals. Big 5 CPA firm professionals may believe that the performance of NAS is less relevant to an investment decision. Alternatively, their belief that the provision of NAS is less relevant may result from a perception of “auditor independence” that differs from the perceptions held by non-Big 5 CPA firm professionals and investors.

Finally, participants’ disclosure preferences were influenced by the performance of NAS. A significantly larger percentage of investors favored disclosure than did either the non-Big 5 CPA firm professionals or Big 5 CPA firm professionals. Specifically, investors favored disclosure of the amount of NAS fees along with the total audit fees, regardless of the amount. However, the non-Big 5 CPA firm professionals and Big 5 CPA firm professionals favored disclosure of the amount of NAS fees only if those services exceeded a specified threshold. The findings related to investors’ disclosure preferences are consistent with survey results reported by Penn, Schoen, and Berland (2000). Moreover, these results lend support to the SEC’s recently imposed proxy disclosure requirement of fees paid to a company’s auditor.

Materiality of NAS was only relevant to investment decisions. Specifically, participants given a material level of NAS rated the performance of those services as more relevant to their investment decisions than participants given an immaterial level of NAS. The fact that level of materiality did not significantly affect perceptions of auditor independence/integrity/objectivity, degrees of reliance on the auditors’ opinion, or disclosure preferences is consistent with findings reported by Pany and Reckers (1988). This combination of materiality results may indicate that the extent of NAS is not as salient an issue as expected.

A number of avenues exist for the researchers to continue examining auditor independence. One interesting possibility centers on the focus of independence. That is, should

auditors be independent of a *client* or of *information* prepared by the client as has been proposed by the AICPA (Kinney 1999)? Another issue of potential interest relates to *who* in the public accounting firm is most affected by a particular independence issue. As Wallman (1996) suggests, independence concerns may be most appropriately addressed by considering the potential influence of a particular set of circumstances on an individual auditor, a local office, a region, or the entire firm.

Appendix

Nonaudit Services (Assuming a material level of nonaudit service fees)

Legal Services

Given Haversham's prosperous past, management is considering changes to the company's executive compensation plans to protect its interest in certain key members of management, including the need for non-compete agreements. Prior to the current year's audit, Haversham engaged the public accounting firm which performs its audit to provide legal consulting services related to the changes in executive compensation plans. These services were provided by firm personnel not involved in the audit of the company. Of the total fees collected from Haversham for all services, a material portion is related to the provision of legal consulting services by the public accounting firm.

Software Training

In the recent past, Haversham has experienced significant growth that has revealed inadequacies in its current accounting system. Consequently, the company has purchased a new accounting software package from a reputable software vendor. Prior to the current year's audit, Haversham engaged the public accounting firm which performs its audit to provide certain consulting services related to the initial training and instruction of Haversham employees on the new software. These services were provided by firm personnel not involved in the audit of the company. Of the total fees collected from Haversham for all services, a material portion is related to the provision of consulting services by the public accounting firm.

Internal Audit Outsourcing

While pleased with Haversham's rapid expansion, management is concerned about their ability to evaluate the operational effectiveness of company policies. Currently, the company has a limited internal audit function to assist management. Prior to the current year's audit, Haversham engaged the public accounting firm which performs its audit to provide internal auditing services aimed at evaluating operational effectiveness of company policies. These services were provided by firm personnel not involved in the audit of the company. Of the total fees collected from Haversham for all services, a material portion is related to the provision of internal auditing services by the public accounting firm.

Actuarial Services

To reward employees for its profitable past, Haversham recently adopted a stock option plan. Given its inexperience with such plans, management decided to seek outside advice and guidance. Prior to the current year's audit, Haversham engaged the public accounting firm which performs its audit to provide actuarial services – to be based upon certain assumptions made by company management – related to the adoption of the stock option plan. These services were provided by firm personnel not involved in the audit of the company. Of the total fees collected from Haversham for all services, a material portion is related to the provision of actuarial services by the public accounting firm.

Table 1
Average Differences in Investors' and Professionals' Perceptions of Independence, Integrity, and Objectivity

| | <u>Independence</u> ¹ | <u>Integrity</u> ¹ | <u>Objectivity</u> ¹ |
|---------------------|----------------------------------|-------------------------------|---------------------------------|
| Non-Big 5 CPA Firms | -10.49 | -3.96 | -8.76 |
| Big 5 CPA Firms | -5.14 | -2.03 | -4.86 |
| Investors | -2.00 | 3.02 | -2.36 |
| | | | |
| Average Difference | -6.47 | -1.30 | -5.77 |
| | | | |
| t-statistic | -4.06 | -0.93 | -3.99 |
| (p-value) | (<0.001) | (0.352) | (<0.001) |

¹ Perception of dimension given *Audit Only* case minus perception of dimension given *Nonaudit Service* case.

Table 2
Average Ratings of Investors' and Professionals' Perceptions of Independence, Integrity, and Objectivity

Panel A: Average Ratings for *Audit Only* Case

| | <u>Independence</u> | <u>Integrity</u> | <u>Objectivity</u> |
|--------------------------|---------------------|-------------------|--------------------|
| Non-Big 5 CPA Firms | 55.69 | 64.85 | 57.15 |
| Big 5 CPA Firms | 72.50 | 78.50 | 71.97 |
| Investors | 55.02 | 61.47 | 56.81 |
| | | | |
| Average Rating | 59.80 | 67.29 | 60.89 |
| | | | |
| F-statistic (p-value) | 8.93 (<0.001) | 10.40 (<0.001) | 8.26 (<0.001) |

Panel B: Average Ratings for *Nonaudit Service* Case

| | <u>Independence</u> | <u>Integrity</u> | <u>Objectivity</u> |
|--------------------------|---------------------|-------------------|--------------------|
| Non-Big 5 CPA Firms | 66.18 | 69.02 | 66.16 |
| Big 5 CPA Firms | 77.64 | 79.58 | 76.87 |
| Investors | 56.86 | 58.69 | 59.02 |
| | | | |
| Average Rating | 66.24 | 68.52 | 66.71 |
| | | | |
| F-statistic (p-value) | 14.50 (<0.001) | 16.49 (<0.001) | 11.17 (<0.001) |

Table 3
Average Ratings of Investors' and Professionals'
Degree of Reliance on the Auditor's Opinion

| | <u>Difference</u> ¹ | <u>Audit Only</u> | <u>Nonaudit</u> |
|--------------------------|--------------------------------|-------------------|-------------------|
| Non-Big 5 CPA Firms | -8.09 | 59.02 | 67.10 |
| Big 5 CPA Firms | -4.97 | 72.50 | 77.47 |
| Investors | 2.39 | 59.20 | 56.70 |
| | | | |
| Average Rating | -4.03 | 62.54 | 66.55 |
| | | | |
| t-statistic (p-value) | -2.50 (0.013) | | |
| | | | |
| F-statistic (p-value) | 3.96 (0.020) | 6.17 (0.002) | 14.61 (<0.001) |

¹ Rating of dimension given *Audit Only* case minus rating of dimension given *Nonaudit Service* case.

Table 4
Average Investment Relevance Ratings of
Investors' and Professionals'
by Level of Materiality (Percent of Total Client Fees)

| | <u>Immaterial (3%)</u> | <u>Material (40%)</u> | Average Ratings |
|---------------------|------------------------|-----------------------|--------------------|
| Non-Big 5 CPA Firms | 35.16 | 58.25 | 46.04 |
| Big 5 CPA Firms | 25.00 | 33.41 | 29.16 |
| Investors | <u>42.53</u> | <u>55.65</u> | 49.29 |
| Average Ratings | <u>34.71</u> | <u>50.92</u> | |

F-statistics (p-values):

I & P: 10.53 (<0.001)

Materiality: 15.69 (<0.001)

Table 5
Investors' and Professionals' Disclosure Preferences for Nonaudit Services

Panel A: Percentage of Participants Favoring Disclosure or Nondisclosure of Nonaudit Services

| | <u>Disclosure</u> | <u>No Disclosure</u> |
|---------------------|-------------------|----------------------|
| Non-Big 5 CPA Firms | 49.6 | 50.4 |
| Big 5 CPA Firms | 47.0 | 53.0 |
| Investors | <u>92.9</u> | <u>7.1</u> |
| Overall Average | <u>62.3</u> | <u>37.7</u> |

Chi-Square Statistic on I & P Group: $X^2_{2,318}=57.32$, $p<0.001$

Panel B: Percentage of Participants Favoring Different Forms of Nonaudit Service Disclosure

Disclose Dollar Amount of Nonaudit Services (NA) if:

| | Amount Exceeds Threshold: | | Regardless of Amount: | |
|---------------------|----------------------------------|-----------------|------------------------------|-----------------|
| | <u>NA Only</u> | <u>NA+Audit</u> | <u>NA Only</u> | <u>NA+Audit</u> |
| Non-Big 5 CPA Firms | 34.4 | 18.7 | 25.0 | 21.9 |
| Big 5 CPA Firms | 45.7 | 20.0 | 17.1 | 17.2 |
| Investors | <u>8.0</u> | <u>23.9</u> | <u>20.5</u> | <u>47.7</u> |
| Overall Average | <u>24.1</u> | <u>21.4</u> | <u>21.4</u> | <u>33.1</u> |

Chi-Square Statistic on I & P Group: $X^2_{6,180}=31.15$, $p<0.001$

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Endnotes

¹ Generally accepted auditing standards require auditors to be independent *in fact* and *in appearance* (AU §220.02). Auditors are independent *in fact* when they maintain an attitude of judicial impartiality. On the other hand, auditors achieve independence *in appearance* when third parties observe their behaviors and have confidence in that independence.

² The specific variations included internal auditing services that were not outsourced, outsourced to another external auditor, outsourced to the company's own external auditor with the CPA firm also performing management functions, outsourced to the same personnel at the company's external auditor, and outsourced to different personnel at the company's external auditor.

³ Investment officers were surveyed in Schulte (1965). Loan officers were surveyed in Schulte (1965), Shockley (1981), Knapp (1985), McKinley et al. (1985), Pany and Reckers (1988) and Lowe et al. (1999). Financial analysts were surveyed in Schulte (1965), Shockley (1981), Pany and Reckers (1984), and Pany and Reckers (1988).

⁴ Specific studies referred to include Scheiner (1984) and Glezen and Millar (1985).

⁵ The definition of auditor independence was obtained from the *AICPA Professional Standards* (AU § 220.03) and was included in the instructions to ensure that all participants were aware of the profession's definition of the term "auditor independence".

⁶ The CPA firm in both cases was portrayed as a large international CPA firm which has audited the company for several years. McKinley, Pany, and Reckers (1985) found that the then Big 8 CPA firms provided audit opinions that were believed to be more reliable than those provided by smaller firms and that such firms were generally viewed as more independent than smaller firms.

⁷ Members of the investor group completed the cases during regularly scheduled meetings of

civic groups or graduate school classes. Non-Big 5 CPA firm professionals completed the cases as part of a continuing professional education conference. Big 5 CPA firm professionals completed the cases in their offices as their schedules permitted.

⁸ All analyses were re-conducted by including various demographic information, such as age, number of years of education, public accounting and auditing experience, participation in corporate and personal investment decisions, experience reading financial statements and financial publications, and the understandability and interest in the experiment materials. The results were not significantly changed by the inclusion of this information.

⁹ Thirteen of 321 users (4.1%) selected a fifth option that provided that the amount of nonaudit services be disclosed and then allowed an open-ended response to the precise form of disclosure. These users are included in the disclosure group in Panel A of Table 5, but are not included in the Table 5, Panel B analysis. The 13 users included five non-Big 5 CPA firm professionals, four Big 5 CPA firm professionals and four investors.