

Preliminary Evidence on the SEC's Independence Hypothesis

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Abstract

With very little direct evidence on whether auditor opinions had been tainted by the increase in non-audit service fees, the SEC changed auditor independence rules in November 2000. For eight years, the revenue mix of auditing, tax and other non-audit (primarily consulting) services had declined for auditing and increased for consulting. This suggested a decline in auditor independence by appearance. This study tests the hypothesis as to whether this appearance proxied that of fact.

This decline in the percentage of audit revenue is compared to two observable proxies for independence in fact, (1) the corrective actions imposed by the SECPS Peer Review Committee (PRC) and (2) the SECPS Quality Control Inquiry Committee (QCIC) recommendations. Correlated also is (3) the change in audit firms by year to determine the effect of the decline fees on auditor changes. These eight years indicate a negative, though not statistically significant, correlation between the percentage of audit fees and the PRC corrective actions, but no correlation with the QCIC recommendations. As anticipated, as the audit fees decrease, the change in audit firms statistically increases, and at least descriptively, the PRC corrective action measure increases. This is consistent with the SEC hypotheses, which once seemed unsupported but now is becoming generally accepted given recent national auditing failures.

Key Words: Auditor independence, Independence Standards Board, Securities and Exchange Commission, Public Oversight Board. **Data Availability:** The data are available from public sources. A list of data collected is available from the authors

INTRODUCTION

The United States Securities and Exchange Commission (SEC) requires auditors under its jurisdiction to be independent in both fact and appearance (Rule 201 (b)). An auditor independent in fact is unbiased by the interests of the client, but this is not directly observable. An auditor independent in appearance will appear to be unbiased (Olazabal et al., 2001, 69) from “those factors that compromise, or can reasonably be expected to compromise, an auditor’s ability to make unbiased audit decisions” (McGrath et al., 2001, 2). Lesser degrees in appearance imply lesser degrees of independence in fact.

In the absolute, this makes the “assumption that auditors who serve client interests and public interests simultaneously do so accidentally.” Both the AICPA and the SEC rules require the auditor to appear to first serve the public trust (Olazabal et al., 2001, 69). However, as a practical matter, it is the client who pays the auditor’s fees to abide by these rules, so the Public Oversight Board has acknowledged that absolute independence cannot be achieved (PAE 2000, 130).

Appearance measures include the auditing firm’s fee sources and sizes of revenue amounts. The change in sources and sizes of revenue mix from auditing to non-auditing fees for the largest accounting firms in the United States has created lesser degrees of independence in appearance from 1990 through 1998. Accounting and auditing fees have declined from 53 to 34 percent while consulting fees have increased from 20 to 44 percent for all clients (Public Accounting Report, 2001). This increase in the percentage of non-audit services to the same client (Lowe et al., 2000, 90) suggests a decline in the perception of auditor independence.

Contrarily, the Big Five accounting firms claim independence in fact is unaffected by large fees for services, even though some of the firms have spun off their consulting

parts in the face of the SEC's new requirements (Middlemiss, 2001, 27). They hold that the public is more sophisticated than as represented by the SEC, i.e. the market for information is efficient and provides financial information about public companies from many different sources (AICPA 2001a, 21). Given this, it still relies on auditors to provide assurance that financial information is unbiased (AICPA, 2001b, 54). The large firms argue that the more consulting proxies for increases in audit fees since it provides for more inquiry into the client's business strategy, processes and value chain, and this in turn leads to reduced audit risk (Bell et al. 1997).

This study examines the relationship between observable measures of independence in appearance and fact. It questions whether this change in revenue mix for non-audit service fees, a decrease independence in appearance, also implies a corresponding increase in two indirect measure levels of independence in fact: (1) corrective actions imposed by the SECPS Peer Review Committee (PRCs) to ensure that quality control deficiencies are corrected and (2) the listing of the SECPS Quality Control Inquiry Committee (QCICs) recommendations from 1991 through 1998. [In 1999 the SEC investigations prompted the firms to change their revenue mix.] These are used to determine whether allegations of audit failure against SECPS member firms involving SEC registrants indicate a need for these firms to take corrective actions to strengthen their quality control system or to address personnel deficiencies. The SEC hypothesis would imply that an increase in both the QCIC total activity and PRC activity to improving quality (independence) during this nine year period have followed the increase in non-audit service fees. The results limited to only eight years and not statistically significant, at least descriptively support the SEC hypothesis.

The remainder of this paper is organized as follows: Section II presents the background behind the question, Section III, the design of this study, Section IV the data and its analysis, and Section V the summary and conclusion .

BACKGROUND

In its August 2000 presentation to the American Accounting Association (AAA), the SEC discussed the issue of auditor independence and the appearance of independence. The results seemed mixed. Because the SEC views the independent auditor as being charged with enhancing the investor confidence in financial information the SEC expressed concern about the public perception of independence given the significant change in the mix of the revenue of accounting firms during 1990-1999. As indicated in Table 1, this mix shows a decline in the percentage of audit fees (A) and a corresponding rise in non-audit (consulting) fees (N) from 1990-1998 for the five (six) largest accounting firms.

Wines (1994, 75) conducted a study that suggests that auditors are less likely to qualify an opinion when these or higher levels of non-audit services are provided to the client. In contrast the AICPA reported that only 25% of audit clients receive non-audit services from their auditing firms (Weil, 2001, C1) and typically, the fees for non-audit services will be 25% to 40% of total revenue (Weil, 2002, C2). In the early part of 2000, the Financial Executives Institute (FEI) conducted a survey and its results showed 85% of the companies responding paid their audit firms for services other than audits, 56% paid more than one-half of the total fee for non-auditing services (*Investor Relations Business*, 2000, 2).

The SEC had asked the Public Oversight Board (POB) to convene a Special Panel on Audit Effectiveness to examine whether recent changes in the audit process continue to serve and protect the interests of investors (PAE 2000, 257). Subsequently, the PAE issued a 275- page report on the issues of user expectations and the relationship of audit and non-audit services (PAE 2000).

Prior to the issuance of its report, the Panel on Audit Effectiveness reviewed 126 audits of SEC companies, held focus group meetings, reviewed 42 comment letters regarding its exposure

draft, held two days of public hearing, and analyzed academic and professional literature (PAE, 3-5). After reviewing 37 audit engagements where the accounting firm also provided non-audit services to the audit client, not one instance was reported where non-audit services “had a negative effect on audit effectiveness.” In addition, 25% of the audits reviewed indicated a positive effect of providing non-audit services (Melancon 2000, 27). The PAE expressed concern about the increase of non-audit services being provided to the same audit client (PAE, 112).

Because of survey results and other information obtained from a study of CFO’s, auditors, buy-side investors, sell-side investors, audit committee chairs, and regulators (Cheney, 2000), the SEC held four days of public hearings regarding the proposed changes in auditor independence rules. Approximately 700 pages of oral testimony were gathered, more than 3,000 comment letters received, and over 100 witnesses heard (*Investment News*, November 20, 2000, 1-3.). Although a moderate perception problem probably will exist tomorrow, the information indicated that no real problem exists today regarding auditor independence and objectivity (Cheney 2000).

A 1996 report from the General Accounting Office (GAO) stated that none of the studies related to auditor independence “reported any conclusive evidence of diminished audit quality, or harm to the public interest, as a consequence of accounting firms providing non-auditing services to their audit clients” (Melancon, 2000,6) In addition, the SEC never mentioned in its last ten annual reports to Congress any concerns about accounting firms offering non-audit services to the same client (Melancon, 2000, 27).

The final rules regarding auditor independence issued in November 2000 became effective in February, 2001 (www.sec.gov). In addition to the areas of specific relationships such as financial and employment, the proxy disclosure requirements were changed (www.aicpa.org/members, p.1). Public companies must now disclose in annual filings with

the SEC the total fees for auditing, consulting and other services provided by the outside auditing firm (Schroeder, 2000, 1). This represented a compromise between the SEC and the five largest CPA firms and ended the threatened lawsuits by some accounting firms as well as Congress attempting to block the new rules (St. Louis Post, 2000, 1-2).

THIS STUDY

This study attempts to show directly what has not been shown, that the revenue mix indicated in Table I, the decline in the percentage of audit fees (A) and a corresponding rise in consulting fees (N) is related to direct measures of auditor independence. The regulation of auditors involves the Securities and Exchange Commission's administrative hearings, the SEC Practice Section (SECPS) of the AICPA, and the Public Oversight Board (POB). The SEC administrative hearings have the power to discipline auditors of public companies by imposing fines, limiting audit practice, and if necessary pursuing criminal charges.

The SEC Practice Section (SECPS), created in 1977 as part of the Division for CPA Firms of the AICPA, was created "to protect the public interest by improving the quality of practice by CPA firms before the SEC" (PAE, 2000, 188). New requirements were established, such as peer review, which monitors compliance. Currently, 1,300 members belong to the SECPS, it encompasses approximately 95% of all SEC companies, and is mandatory for all firms which audit SEC clients. In 1999, the 5 largest CPA firms audited approximately 76% of all U. S. public registrants, the next 3 largest firms audited approximately 6% of the U.S. registrants, and the remaining estimated 45,000 local and regional accounting firms audited approximately 18% of U. S. public registrants (PAE, 2001, 182-184).

Two important parts of the SECPS are the SECPS Peer Review Committee (PRC) and

the SECPS Quality Control Inquiry Committee (QCIC). The PRC was established in 1977 to ensure the existence of an adequate system of audit quality controls over the auditor's independent judgment within CPA auditing firms. The Committee may take corrective actions if certain quality controls on independence are inadequate. During the 1999-2000 peer review year, 441 SECPS peer reviews were performed, including 261 reviews of firms that audit SEC registrants and 180 reviews of firms that had no SEC clients (Public Oversight Board, 2000). Each auditing firm must undergo a peer review every three years or more often if necessary. The entire peer review process is reviewed by the POB which issues an annual report on required PRCs. Since its inception and through June 30, 2000, a total of 958 corrective actions have been imposed. These serve as our first source of indirect evidence.

The QCIC, established in 1979, investigates allegations of audit failures, misstatements unrecognized by the auditor, and other allegations pertaining to deficiencies against auditing firms that audit SEC registrants and others (Public Oversight Board, 2000). Firms who are members of the SECPS must report to the QCIC all alleged audit failures regarding SEC clients within 30 days after notice. The QCIC conducts four distinct phases of these allegations and assigns different ratings before actions are recommended. Since its inception and through June 30, 2000, a total of 352 recommendations have been made, allocated among actions related to firms, standards, or individuals. These serve as our second source of indirect evidence.

Complaints against auditors should lead to auditor dismissals found in form 8-K, a report required by Sections 13 or 15 (d) of the Securities and Exchange Act of 1934. This information is relevant and timely to the investing public, as the 8-k report is required to be filed within five business days from the event. Table 1 shows the Form 8-Ks that were filed from 1991 through 2000 because of changes in accountants (CA).

Table I shows the change in revenue mix as it relates to peer review corrective actions (P), quality control committee recommendations (Q), and the number of SEC registrants that filed Form 8-K (C) from 1991-1998. The revenue mix is the change in the percentage of revenue obtained for audits and non- audit services from 1991 through 1998 for the largest CPA firms (from 6 to 5 firms) as shown in Table 1.

THE DATA

Table 1 presents the details of the revenue mix, the percentage of fees that are audit (A), Tax, and non-audit service (N) fees of the Big Five (Six) CPA Firms, Quality Control Inquiry Committee Recommendations (Q), Peer Review Committee corrective Actions (P), and the number of Form 8-Ks filed by SEC registrants because of change in accounting firms (CA). The changes due to the years 1999-2000 are separated since these represent responses to the SEC actions against auditors and corresponding changes to audit practices. 1999 represents the year of the largest change in accounting firms and the end of the audit fee percentage decline. Also, the 1999-2000 period is the period of the rapid rising and falling of stock prices from new Internet companies and other economic forces.

Table 1

Revenue, QCIC Activity, Peer Review Committee Actions, and Form 8-Ks

Filed by SEC Registrants

Year	Total Revenue Big 5-6	Audit Revenue Big 5-6	Tax Revenue Big 5-6	Consulting Revenue Big 5-6	QCIC Total Activity	PRC Acctg Activity	Change in firms
	(N)	(A)	(N)	(N)	(Q)	(P)	(CA)
	%	%	%	%			
2000	27,148	10,479	6,588	10,081	29	66	464
1999	24,082	9,262	5,804	9,016	27	60	599
1998	26,253	7,952	4,968	13,333	23	58	417
1997	20,776	6,860	4,191	9,725	18	60	340
1996	17,571	6,311	3,561	7,699	16	45	305
1995	15,292	5,873	3,046	6,373	19	65	255
1994	13,520	5,942	2,743	4,835	21	21	195
1993	12,386	5,604	2,783	3,999	16	46	208
1992	11,862	5,754	2,714	3,394	22	49	224
1991	11,430	5,592	2,697	3,141	19	49	316

Source: The total revenue, audit revenue, tax revenue and consulting revenue from 1991 through 2000 from Public Accounting Reports, in millions of US dollars. Quality Control Inquiry Committee (QCIC) Activity and Peer Review Committee (PRC) Actions from Annual Reports of the Public Oversight Board from 1991 through 2000. 8-K information from Compustat Data Base.

Table 2
Revenue Mix of the Big 5 (6)
Accounting Firms

	1990 All Clients	1990 SEC Audit Clients	1999 All Clients	1999 SEC Audit Clients
Accounting and Auditing	53%	71%	34%	48%
Tax	27%	17%	22%	20%
Consult.	20%	12%	44%	32%
Total	100%	100%	100%	100%

Source: Compiled from annual reports submitted by firms to the SECPS. From "Special Supplement: Annual Survey of National Accounting Firms – 2000", Public Accounting Reports, March 31, 2000.

Table 3
The Pearson Linear Correlation Matrix (and t Coefficients) for
Revenue (Audit%, A; Non-Audit%, N) versus
QCIC Activity (Q), PRC Activity (P) and Change in Accounting Firms (CA)
For the Years 1991 Through 1998

	A	N	Q	P	CA
A	1	-0.99 (-23.516)	0.0 (-0.037)	-0.45 (-1.246)	-0.71 (-2.442)
N		1	-0.42 (-1.133)	0.30 (0.775)	0.43 (1.181)
Q			1	-0.25 (-0.635)	-0.37 (-0.972)
P				1	0.43 (1.157)
AF					1

SUMMARY

Table 2 shows the degree of auditor revenue mix change for SEC clients, from 71% in 1990 to 48% in 1999. As would be anticipated, Table 3 shows a significant (p-value=0.00) correlation ($r=-0.99$) of audit (A) and non-audit (N) service fees. Although not statistically significant with the QCIC recommendations (Q), the audit fee percentage (A) is nearly so with the PRC corrective actions ($r=-.45$, with $t=-1.24$). With only eight years of data this can be expected, but at least the sign is in the right direction and descriptively speaking, the correlation with PRC corrective actions is not small. [The non-parametric correlations not presented here are even smaller.]

The decline in audit fees (A) is statistically related (pvalue=0.05) to the change in audit firms ($r=-.71$, $t=-2.442$), and more so than non-audit service fees (N) or any other quality (Q) or corrective measure (P). This is consistent with departure of auditors because of lower fees rather than the demand for consulting (N) or auditor dismissal because of complaints (from Q or P). Clearly auditor departures need more evidence, as only eight years are given here, with a beginning decline from 1991 to 1994 and then a rise, consistent more with the economy than other forces, but the change in auditors still less related ($r= 0.43$) to non-audit service fees. This appears to present clients not paying higher fees for higher quality audits and this fact is consistent with the defenses made to the SEC by the auditing firms, rather than as suggested by the SEC, that firms leave for higher consulting fees.

CONCLUSIONS

This study presents only eight years of meaningful data. As this information is not inflation adjusted nor adjusted for the increase in the number of audits (although the number of SEC audits remained the same, about 13,000), this preliminary information though incomplete

presents some descriptive evidence consistent with the SEC's hypothesis that appearance proxies fact. The SEC hypotheses that once seemed unsupported at the time did actually have some preliminary evidence. This is important given the subsequent and now on-going investigations into nationally recognized auditing failures.

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