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## Research Report

# Is non-audit services a suitable proxy for auditor independence in the post-SOX period?

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## ABSTRACT

Before implementation of the Sarbanes Oxley Act (SOX) in 2002, researchers frequently used fees from non-audit services (NAS) as a surrogate for auditor independence. NAS is still used in this way, even though SOX has restricted the types of NAS that auditors may provide to their clients. Therefore, we pose the following question: What does the literature say about the continuing adequacy of NAS as a surrogate for auditor independence in the post-SOX era? This question is relevant to research in accounting regulation because, if NAS is no longer an adequate surrogate, then research on auditor independence may provide biased results. Overall, we find that many post-SOX studies using NAS have insignificant or counterintuitive results, whereas pre-SOX studies using NAS predominantly have significant results suggesting that NAS impairs auditor independence. Is this shift in findings because NAS is no longer an adequate proxy for independence? We discuss this issue and provide our conclusions, citing relevant research where applicable.

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## Introduction

Auditor independence has been a critical issue for financial statement users, preparers, and auditors for many years. One key concern for all of these stakeholders is the structure of the auditor–client relationship in the United States. The client firm hires, pays, and can fire the auditor. One major issue that has been of concern to the regulatory and user communities is the potential for client firms to use payments to the auditor for non-auditing-related advisory services (hereafter, NAS) as a tool to coerce auditor acceptance of their questionable accounting practices. As far back as 1984, Simunic demonstrated that payments in the form of audit fees and NAS have the potential to create economic bonds between the auditor and the client. This economic bonding could, he noted, impair the auditor's independence. In fact, NAS, or NAS plus audit fees, has often been used as a

surrogate for auditor independence in accounting research. However since 2002, the Sarbanes Oxley Act (SOX) has restricted the amount of NAS that auditors may provide to their clients. In the light of this restriction, can NAS still be a suitable proxy for auditor independence in the post-SOX environment? Does the literature show that NAS remains an appropriate surrogate for independence? This issue is relevant to research in accounting regulation because, if NAS is no longer an adequate surrogate, then research on auditor independence may yield biased results. We limit ourselves to this one issue rather than summarize the entire literature on auditor independence since Gramling, Jenkins, and Taylor (2010) have already provided an in-depth analysis of auditor independence research.

## Background

The justification for the use of NAS as the surrogate for auditor independence is aptly summarized by Ashbaugh (2004). Ashbaugh noted that NAS creates a strong economic bond (more so than tenure) between the auditor

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and the client, a bond that could impair the auditor's objectivity.<sup>1</sup> Proponents of this school often argue that provision of NAS has long been more profitable for audit firms than fees from auditing since the former is rather unique in content, whereas the audit itself is frequently described as a low-margin commodity. Accordingly, researchers continue to use NAS as a surrogate for auditor independence. However, we ask: "Is the use of NAS still adequate in the post-SOX environment?" Perhaps a more suitable proxy could be audit fees. In that case, why were audit fees not previously used as a proxy by researchers? The likely reason is that researchers had only limited access to data on audit fees and fees from non-audit services until the SEC promulgated regulations that directly impinged on audit research (SEC, 2000). To increase auditor independence, the SEC prohibited CPA firms from providing certain types of NAS for their audit clients. In addition, the SEC required that firms disclose the audit fees and some NAS fees that they pay to the auditor. This gave accounting researchers the opportunity to examine the extent to which provision of NAS could potentially affect the auditor's independence. Frankel, Johnson, and Nelson (2002) found that the median NAS fees were nearly 100% of median audit fees, thus making a compelling case for using NAS as a surrogate for auditor independence in the pre-SOX period. Most audit researchers still use NAS rather than audit fees as a surrogate for independence, even though median NAS fees as a percentage of audit fees should have declined due to SOX prohibitions on the type of non-audit services that audit firms can now provide. One area for research should be to examine the extent that NAS has declined as a percentage of audit fees. This should provide indirect evidence on whether NAS is still a suitable surrogate for auditor independence.

The Enron scandal in 2001 and the subsequent passage of SOX in 2002 made further profound changes in the audit environment, which have implications for research on auditor independence. Specifically, SOX imposed additional restrictions on the auditor's provision of NAS. The now forbidden services included financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit, management and human resources functions, investment services, legal services and expert advocacy services unrelated to the audit. Although SOX now limited the type of services that could be provided, there was still no ceiling on revenues that could be generated from permissible services. Thus, the use of NAS as a surrogate in accounting research could still be justified.

In 2003, the SEC made more changes to fee disclosure regulations. It now required the disclosure of fees for (1) audit services; (2) audit-related services; (3) tax services; and (4) all other NAS services not restricted by SOX. Since NAS information was now both readily available and of theoretical interest, researchers continued to use NAS as a surrogate for auditor independence. But, should they?

In the light of the restrictions imposed by SOX, should NAS still be used as a research proxy for auditor

independence? After SOX, what have researchers found that is pertinent to regulators and financial statement users regarding auditor independence? In the next section we discuss relevant research that relates to this issue.

### Implications from extant research

The literature discusses two issues regarding auditor independence: *independence in appearance* (which relates to perceived independence) and *independence in fact* (which relates to actual independence). The effect of providing NAS to audit clients on perceived independence has been examined mostly via surveys and experiments using auditors and financial statement users as subjects. A few studies used stock market reactions to NAS disclosures to measure independence in appearance. The effect of providing NAS to audit clients on independence in fact has been examined through archival research, such as data on NAS provision and abnormal accounting accruals. In this paper, we do not discuss the vast literature using surveys and experiments, but rather focus on archival studies. We separate these studies into the pre-SOX and post-SOX periods and then categorize research in both periods into studies involving perceived independence and independence in fact. Generally, we found that, compared to the pre-SOX period, empirical studies in the post-SOX period have failed to produce unequivocal results for the effects of NAS on auditor independence.

#### Pre-SOX studies

In this section, we examine studies using pre-SOX data. In the first subsection, we examine studies reporting research concerning NAS and auditor independence in fact. In the second subsection, we examine studies reporting research concerning NAS and auditor independence in appearance. The studies examined here are further summarized in Appendix A.

#### Pre-SOX studies examining independence in fact

In a classic pre-SOX study, Frankel et al. (2002) used NAS as a surrogate for auditor independence and concluded that lower levels of auditor independence impaired the credibility of financial statement disclosures as measured by discretionary accruals. These results are of course contingent on NAS being a suitable surrogate for auditor independence. However, this finding was not without controversy. Ashbaugh, LaFond, and Mayhew (2003) replicated the Frankel et al. study with key differences in research design. They observed that the accrual variable used to measure earnings management in the Frankel model may result in violations of a statistical assumption for the procedure used, i.e. that the data be normally distributed. Therefore, Ashbaugh et al. transformed their dependent variable by taking the natural log of the discretionary accruals. After this correction, the findings indicated that there was no evidence that the reliability of financial statement disclosures is affected by the level of auditor independence. Despite the results of Ashbaugh et al., other studies have found a positive association between NAS as a surrogate for auditor independence and the "earnings quality" of financial statements as measured by discretionary accruals (Gul, Jaggi, & Krishnan,

<sup>1</sup> This is a theme studied many years ago by Beck, Frecka, and Solomon (1988). They found differing results by year (1978, 1979) studied, using NAS data that was only available for a very short period of time. The SEC repealed the data availability rule in early 1981.

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