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Non-audit services and audit quality – the effect of Sarbanes-Oxley Act

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ABSTRACT

There has been controversy over the restrictions that SOX imposes on non-audit services. Using accounting conservatism as a proxy for earnings quality of financial statements, the paper investigates whether the offerings of non-audit services by auditors impairs earnings quality. And then, to validate the effects of SOX, this paper also explores the association between non-audit services and accounting conservatism before and after SOX enacted. The empirical results show that non-audit services do impair earnings quality before SOX, but yields no conclusive results whether the provision of non-audit services affects earnings quality. This result supports the positive effects of the regulations of SOX in governing the independence of auditors.

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1. Introduction

Since the occurrence of the Enron scandal, the U.S. passed the Sarbanes-Oxley Act in 2002 in order to restore confidence in the capital market. The Act imposes new regulations on auditor independence in order to ensure and improve audit quality in response to the offering of the extensive non-audit services by Arthur Andersen to Enron. In 2001, Arthur Andersen charged Enron US\$25 million for auditing services and \$27 million for non-audit services. The U.S. juridical authorities believe that the offering of non-audit services hampers the independence of auditors. Therefore, the Sarbanes-Oxley Act specifies the scope of non-audit services to clients by auditors, and stipulates the annual disclosure of audit fees and non-audit service fees.

Opinions are divided regarding the restrictions that the Sarbanes-Oxley Act place on non-audit fees. Proponents indicate that, if the percentage of non-audit service fees is too high, auditors are likely to yield to clients regarding the loss of concentrated incomes, thus, losing their independence; while opponents argue that the demand for non-audit services naturally increase with the diversified developments of the corporate world. Meanwhile, non-audit services may cause clients to become even more dependent

on auditors; hence, the independence of auditors is augmented. In fact, non-audit services enhance the auditors' understanding of clients, and their ability to identify issues, which improves audit quality without compromising the independence of auditors.

Literature suggests that increased non-audit service offerings enhance the economic dependence of auditors regarding specific clients, while challenging the independence of auditors (Simunic, 1984). However, concern over reputation and litigation costs is a gating factor to the integrity of auditors' independence (Davis & Simon, 1992). In sum, whether the delivery of non-audit services by auditors affects audit quality is a contentious issue. Empirically, Frankel, Johnson, and Nelson (2002) referred to earnings management as an indicator, and found that increased percentages of non-audit fees, as well as a rise in the absolute amount of non-audit fees, have negative effects on audit quality. However, Ashbaugh, LaFond, and Mayhew (2003), Chung and Kallapur (2003), Larcker and Richardson (2004), and Ruddock, Taylor and Taylor (2006) did not suggest that the existence of non-audit services affect audit quality and earnings quality. Krishnan, Sami and Zhang (2005), and Francis and Ke (2006), examined the 2001 data, taken before the Sarbanes-Oxley Act, the results suggested that the audit quality of firms is poorer if the percentage of non-audit service fees is high. Lim and Tan (2008) reviewed the same annual data and concluded that the presence of non-audit services is detrimental to audit quality.

Criticism of the Sarbanes-Oxley Act holds that the act is overly stringent, detailed, and cumbersome, causing extra governance costs to companies. Article 404 in particular increases listing costs and litigation risks, and damages the competitiveness of U.S. capital

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markets. Dispute over the causal relation between non-audit services and audit quality centers on whether such a relation changed after the updated regulations of the Sarbanes-Oxley Act in 2002 regarding the independence of auditors and restrictions over the scope of non-audit services. Therefore, this paper examines whether the rendering of non-audit services within the regulatory framework, post Sarbanes-Oxley Act, continues to affect auditors' independence and audit quality.

Discretionary accrual have been used in a number studies to proxy for audit quality (Ashbaugh et al., 2003), however Cohen, Dey and Lys (2008) indicate that while the Sarbanes-Oxley Act reduces discretionary accruals earnings management, it causes managers to use other means to manage earnings. Thus for the exploring of the influence of SOX on audit quality, discretionary accrual is not a fully appropriate proxy for audit quality. Audit quality is reflected by financial reporting quality, and accounting conservatism is one of the major factors that determine financial reporting quality. Watts (2003a, b) regarded accounting conservatism as one of the key factors that determine financial statements' quality, the rendering of audit quality. Therefore, this paper refers to the level of accounting conservatism as an indicator of audit quality. This paper refers to the method developed by Ruddock et al. (2006), and uses accounting conservatism as the indicator of audit quality. The purpose is to examine whether the increased the percentage of unexpected non-audit service fees damages audit quality around 2002, the year Sarbanes-Oxley Act enacted. The empirical results suggest that audited firms continue to exhibit accounting conservatism, and it is conclusive that the rendering of non-audit services affects audit quality. The results are consistent to Krishnan et al. (2005), and Francis and Ke (2006), that companies with a high percentage of non-audit service fees report worse audit quality before the Sarbanes-Oxley Act. But the results prove non-conclusive that the rendering of non-audit services affects audit quality. This paper concludes that the regulations in tend to Sarbanes-Oxley Act regarding the independence of auditors have positive effects.

2. Literature review and hypothesis development

2.1. Non-audit services and audit quality

Auditing aims to ensure the credibility of the financial statements. According to the definition by DeAngelo (1981), audit quality is the joint probability of auditors finding and reporting frauds in the financial statements. It is relevant to the professional ability and independence of auditors.

From the professional perspective, the delivery of non-audit services enhances the auditors' understanding of clients and empowers the ability to identify frauds. That is, it should elevate audit quality without compromising the auditors' independence. Arruñada (1999) proposed that the rendering of non-audit services equips auditors with additional understanding of their clients, and such knowledge spillover of non-audit services improves the efficiency and quality of audits. Jenkins and Krawczyk (2000) found that the delivery of non-audit services allows auditors to better understand their clients and improve audit quality.

Regarding independence, Reynolds and Francis (2001) suggested that the impact of non-audit services on audit quality is a trade-off between economic bonds and reputation maintenance. Economic constraints mean a growing reliance resulted from overly high percentage of incomes from non-audit services, which imposes pressure on auditors to refrain from expressing their true opinions in a fair and objective manner for fear of income loss. As a result, they lose the independence they are supposed to have (Simunic, 1984; Frankel et al., 2002). The more the percentage of fee

income from the particular clients as a total of the firm's income, the greater the reliance on the clients, and the stronger the economic constraints. In order to retain these clients, auditors continue to express unqualified opinions of poor-quality financial statements (DeAngelo, 1981). However, Emby and Davidson (1998) held a contrasting view, and indicated that the professionalism of non-audit services provides auditors with economic power. As a result, auditors tend not to give in to pressure from clients concerning financial statements. Regarding reputation maintenance, Davis and Simon (1992) indicated that high-profile auditors risk their reputation if they compromise their independence to retain certain clients, and other clients may not be willing to pay higher fees. Dopuch, King and Schwartz (2001) also suggested that the offering of non-audit services adds to reputational stakes and enhances auditors' independence, and therefore, reduces the likelihood of misstatement of financial reports.

Empirical literature does not provide consistent views regarding whether the rendering of non-audit services impairs auditor's independence, audit quality, or financial statements' quality. Reynolds and Francis (2001) did not think auditors issued favorable opinions to important clients. Ashbaugh et al. (2003) extended the results of Frankel et al. (2002), and argued that after controlling company performances as a factor, there is no positive correlation between non-audit services and unexpected accruals. Chung and Kallapur (2003) examined the percentages of all fee incomes and non-audit fee incomes from a single client against the firm's total incomes in the evaluation of client's importance. In their study, client's importance was considered a proxy for the motivation for auditors to impair their own independence. The research concluded that client's importance is irrelevant to abnormal accruals. Kinney, Palmrose, and Scholz (2004) referred to the restatement of financial statements as the proxy for the quality of financial reporting in order to examine the relationship between restatements and non-audit service fees. The results did not suggest a significantly positive correlation between non-audit service fees and restatements. Larcker and Richardson (2004) indicated that the limitation of reputational effects on auditors does not facilitate earnings management. Ruddock et al. (2006) referred to accounting conservatism as an indicator of earnings quality presented in financial statements in the examination of whether an increase of unexpected non-audit service fee percentage jeopardizes the independence of auditors and affects the information quality of financial statements. They applied the methods used by Basu (1997), and Ball and Shivakumar (2005), in order to evaluate accounting conservatism and validate whether an increase in the percentage of unexpected non-audit service fees reduces the level of accounting conservatism. The results did not prove any relationship between the percentage of unexpected non-audit service fees and the level of accounting conservatism.

However, Simunic (1984), Beck, Frecka and Solomon (1988), and Beeler and Hunton (2001), observed the relationship between non-audit services and earnings management in order to examine whether non-audit services reduce the earnings quality of financial reporting. The results suggested that the delivery of non-audit services strengthens the economic constraints between auditors and clients. Clients exert pressure on auditors according to their opinions, which renders auditors tolerant of earnings management. The result is greater leeway for earnings manipulation by clients. Frankel et al. (2002) found that an increased percentage and the absolute amount of non-audit service fees leads to more earnings management. Gul, Tsui, and Dhaliwal (2006) proposed that non-audit service fees augment the auditors' economic reliance on clients. The pressure to retain clients facilitates the behavior of earnings management and the release of misleading earnings information. Krishnan et al. (2005), and Francis and Ke (2006),

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