

The Influence Of Nonaudit Services On Perceptions Of Auditor Independence

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Abstract

This paper examines how nonaudit services influence public perceptions of auditor independence. Recent expansion of these services by public accounting firms has caused some to question whether auditors who provide nonaudit services to audit clients can remain independent of their clients. However, others view nonaudit services as enhancing the auditor's uniqueness to the client, thus strengthening the auditor's independence. Given the importance of auditor independence, a survey was conducted to assess the specific influence of six particular nonaudit services on the ratings of auditor independence from members of the general public, professionals from non-Big 5 CPA firms and professionals from Big 5 CPA firms. Results suggest that an expectations gap may exist between the general public and the accounting profession with respect to how they view the impact of nonaudit services on auditor independence. Implications of the survey as well as directions that future research may take are discussed.

Introduction

Recent years have seen public accounting firms expand their practices to include a wide array of nonaudit services. This expansion of services has led some to question whether and what extent the provision of these nonaudit services influence the public perception of auditor independence. Both the American Institute of Certified Public Accountants (AICPA) and the Securities and Exchange Commission (SEC) have rules that define behaviors or relationships that are deemed to compromise auditor independence. However, nonaudit services such as consulting about accounting, control, tax, risk, business, investment, regulatory or cultural matters are not proscribed per se (Kinney 1999). Nonetheless, the SEC and others question whether nonaudit services lead to the appearance of a lack of independence.

As a result of such concerns, the AICPA and

SEC jointly created the Independent Standards Board (ISB) in 1997. The ISB was charged with the responsibility of developing concepts, principles, and standards that can assure users of publicly-held companies' financial statements that auditors who comply with them are independent. The ISB currently has the matter of nonaudit services on its agenda to consider for future rule-making. In addition, the business press has called for regulators to "determine the extent to which various types of collateral services raise questions of impaired objectivity in the minds of financial statement users" (Goldwasser 1999). Accordingly, the present study surveys financial statement users on their perceptions of auditor independence when different types of nonaudit services are provided to an audit client.

The term "financial statement user" can encompass a wide range of individuals. Given the varying backgrounds of these users, a concern exists that different types of users may hold different perceptions of auditor independence. These

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perceptions are likely to be affected differently when the public accounting firm performs nonaudit services for an audit client. Therefore, the present study surveys three primary groups of financial statement users on their perceptions of auditor independence: members of the general public, non-Big 5 CPA firm professionals, and Big 5 CPA firm professionals.

Nonaudit Services

Companies currently receive a broad set of nonaudit services from accounting firms. Firms are 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). In addition, the AICPA Special Committee on Assurance Services has identified new opportunities for auditors to expand assurance services to include risk assessment, business performance management, electronic commerce, and healthcare performance measurement (Elliott and Pallais 1997; Telborg 1996).

Some believe that these collateral services create a working relationship between the auditor and the client that is too close. For instance, Goldwasser (1999) questions whether auditor independence is adversely affected by the provision of services such as bookkeeping, consulting or advising, internal auditing, and estimation/evaluation services. McKinley, Pany, and Reckers (1985) reported that early research related to financial statement users indicated that auditor independence is negatively affected when nonaudit services are performed for audit clients. Similarly, Shockley (1981) and Knapp (1985) both found that the provision of MAS negatively affected perceptions of auditor independence.

Still, others believe that the provision of nonaudit services enhances the auditor's knowledge of the client, thus increasing the auditor's objectivity (Goldwasser 1999, Wallman 1996). This view was espoused by Goldmen and Barley (1974), who stated that the provision of nonaudit services increases the auditor's "uniqueness" to the client. This distinctiveness in turn increases

the auditor's ability to resist management pressure, and enhances the auditor's independence. Studies finding this positive impact include Schulte (1965) and Hartley and Ross (1972).

Finally, there are studies indicating that the provision of nonaudit services has no effect on perceptions of auditor independence. Kinney (1999) reviewed 20 years of empirical research and found no *substantial* evidence that investors are concerned about nonaudit services. Wallman (1996) also encountered little empirical evidence that the performance of nonaudit services impairs independence *in fact*. McKinley, Pany, and Reckers (1985) found that providing consulting services to improve a company's internal control system did not significantly affect perceptions of financial statement reliability and auditor independence. A later study by Pany and Reckers (1988) found that increasing the level of management advisory services had no effect on the perceptions of financial statement reliability and auditor independence.

Current independence standards and rules are based on the belief that nonaudit services create the potential for conflicts of interest. Dramatic changes in the profession, brought about by factors such as globalization and information technology, have created the need to rethink independence standards, and therefore reinvestigate the impact of these services on auditor independence. Thus, the research question examined in this study is how the provision of nonaudit services affects financial statement users' perceptions of auditor independence.

Users of Financial Statements

Since "financial statement users" encompasses individuals of varying backgrounds, there is a need to examine how perceptions of auditor independence differ across groups of users. One group of users whose perceptions are of importance to regulators and members of the profession is the general public (Wallman 1996). In addition, the perceptions of professional CPAs from both non-Big 5 CPA firms and Big 5 CPA firms can provide insight into the existence of any gap in perceptions between the general public and finan-

cial statement “preparers.” Thus, the current study examined the general public’s perceptions of auditor independence along with those of professional CPAs.

Research Methodology

The survey was administered to a total of 289 individuals who were members of the general public, professionals from non-Big 5 CPA firms and professionals from Big 5 CPA firms. The general public user group consisted of 65 members of various service and civic organizations as well as graduate business students at a large public university. The average age of this group was 40.7 years, and the group had an average of 17.1 years of education. The non-Big 5 CPA firm user group consisted of 141 practicing professionals, while the Big 5 CPA firm user group consisted of 83 practicing professionals. The average age of each group was 45.3 years and 30.7 years, respectively, while the average education was 17.5 years and 17.2 years, respectively.

Survey Materials

Participants received a survey questionnaire that included general instructions, the perception survey, and a demographic questionnaire. The general instructions provided a brief introduction to the survey, as well as a definition of independence as stated in the *AICPA Professional Standards* (AU § 220.03) to control for possible differences in participants’ understanding of auditor independence. All participants completed a demographic questionnaire that elicited background information.

The survey asked participants to rate six different nonaudit services to reflect their perceptions of the independence that a public accounting firm generally maintains when providing that particular nonaudit service to an audit client. The rating scale had endpoints of -5 to +5, with negative ratings indicating a detrimental effect and positive ratings indicating a favorable effect. The six nonaudit services included appraisal/valuation, legal consulting, outsourced internal auditing, bookkeeping, general consulting, and tax return preparation. The first three services

– appraisal/valuation, legal consulting, and outsourced internal auditing – are on the ISB agenda, while the remaining services represent nonaudit services that are commonly provided to audit clients by public accounting firms.

The survey materials were distributed to participants either in person or via mail. Data were collected from the general public by one or both of the authors during regularly scheduled meetings. Data were collected from the non-Big 5 CPA firm professionals during two continuing professional education conferences in a southeastern state. Data were collected from the Big 5 CPA firm professionals after materials were mailed to a contact person within each firm, who then distributed and collected the materials on behalf of the research team.

Results

Table 1 addresses the general research question of how the provision of nonaudit services affects financial statement users’ perceptions of auditor independence. Because the independence rating scales were bounded by -5 and +5, t-tests were conducted to determine whether participants’ independence ratings were significantly different from zero (no effect). The first three services in Panels A and B of Table 1 are nonaudit services under consideration by the ISB (referred to as *ISB services*) while the last three services are nonaudit services commonly provided by public accounting firms (referred to as *common services*).

As indicated in Panel A for *ISB services*, the mean independence rating for legal consulting services was significantly less than zero while the mean independence ratings for appraisal/valuation and outsourced internal auditing services were not significantly different than zero. For *common services*, the mean independence rating for bookkeeping services was significantly less than zero. On the other hand, the mean independence ratings for general consulting and tax return preparation services were significantly greater than zero.

Panel B of Table 1 presents the mean independence ratings for each nonaudit service by

Table 1
Mean Rating of Participant Perceptions of Audit Firm Independence
 (Scale: -5 very detrimental effect to +5 very favorable effect)

Panel A: Overall Independence Ratings

	Type of Nonaudit Service	Rating	t-statistics	Pr > t
ISB Services	Appraisal/Valuation	0.17	1.15	0.252
	Legal Consulting	-0.62	-3.97	<0.001
	Outsourced Internal Auditing	-0.04	-0.25	0.800
Common Services	Bookkeeping	-0.69	-4.16	<0.001
	General Consulting	0.79	6.03	<0.001
	Tax Return Preparation	0.81	5.45	<0.001

Panel B: Independence Ratings by User Group

	Type of Service/User	Rating	t-statistics	Pr > t
ISB Services	Appraisal/Valuation:			
	Non-Big 5 CPA Firm	0.08	-0.36	0.718
	Big 5 CPA Firm	-0.15	-0.68	0.499
	General Public	0.83	2.61	0.012
	Legal Consulting:			
	Non-Big 5 CPA Firm	-1.09	-4.58	<0.001
	Big 5 CPA Firm	-0.40	-1.71	0.091
	General Public	0.13	0.39	0.700
	Outsourced Internal Auditing:			
Non-Big 5 CPA Firm	-0.38	-1.54	0.127	
Big 5 CPA Firm	0.10	0.38	0.709	
General Public	0.57	1.72	0.090	
Common Services	Bookkeeping:			
	Non-Big 5 CPA Firm	-0.49	-2.15	0.033
	Big 5 CPA Firm	-1.66	-6.09	<0.001
	General Public	0.18	0.46	0.648
	General Consulting:			
	Non-Big 5 CPA Firm	0.78	4.13	<0.001
	Big 5 CPA Firm	0.57	2.90	0.005
	General Public	1.12	3.31	0.016
	Tax Return Preparation:			
Non-Big 5 CPA Firm	0.94	4.45	<0.001	
Big 5 CPA Firm	0.95	4.87	<0.001	
General Public	0.32	0.76	0.448	

user group. For *ISB services*, the general public's mean independence rating for appraisal/valuation services was significantly greater than zero while the mean independence ratings for non-Big 5 and Big 5 CPA firm professionals were not significantly different than zero. For legal consulting services, the mean independence rating for the non-Big 5 CPA firm professionals was significantly less than zero while the mean independence ratings for the Big 5 CPA firm professionals and the general public were not significantly different than zero. For outsourced internal auditing services, the mean independence ratings for all three groups were not significantly different than zero.

For *common services*, the mean independence ratings for the non-Big 5 and Big 5 CPA firm professionals for bookkeeping services were significantly less than zero while the mean independence rating for the general public was not significantly different than zero. For general consulting services, the mean independence ratings for all three groups were significantly greater than zero. Finally, for tax return preparation services, the mean independence ratings for the non-Big 5 and Big 5 CPA firm professionals were significantly greater than zero while the mean independence rating for the general public was not significantly different than zero.

ANOVAs were conducted on the independence ratings for each nonaudit service to determine whether the independence ratings varied across the three user groups. The ANOVAs indicated significant differences across the three user groups for two *ISB services*: appraisal/valuation ($F_{2,245}=2.63$, $p=0.074$) and legal consulting ($F_{2,241}=4.93$, $p=0.008$). Pairwise comparisons using means from Panel B of Table 1 indicated that professionals from the non-Big 5 and Big 5 CPA firms rated independence for appraisal/valuation services lower than did members of the general public. When legal consulting services were provided, professionals from the non-Big 5 CPA firms rated independence lower than did professionals from Big 5 CPA firms, and professionals from Big 5 CPA firms rated independence lower than did members of the general public. Mean independence ratings for the *ISB service* of out-

sourced internal auditing did not differ significantly across user groups.

Significant differences also existed across user groups for one of the *common services*: bookkeeping services ($F_{2,246}=8.57$, $p<0.001$). Pairwise comparisons of Table 1, Panel B means indicated that when bookkeeping services were provided, professionals from the Big 5 CPA firms rated independence lower than did professionals from non-Big 5 CPA firms, and professionals from non-Big 5 CPA firms rated independence lower than did members of the general public. Mean independence ratings for the common services of general consulting and tax return preparation did not differ significantly across user groups.

Discussion and Conclusions

This study examined how the provision of nonaudit services affects financial statement users' perceptions of auditor independence. Based on the prior literature in this area, nonaudit services could have a detrimental, favorable, or no effect on these perceptions. Three nonaudit services that were examined are under consideration by the ISB: appraisal/valuation, legal consulting, and outsourced internal auditing services. Interestingly, only one of these services, legal consulting, evoked negative perceptions of auditor independence from the financial statement users, while the other two services failed to produce any significant response. Moreover, the negative perception for legal consulting services was held only by CPA firm professionals and not by members of the general public. Such a finding may reflect the profession's current prohibition against many types of legal advisory services and the profession's allowance of appraisal/valuation and outsourced internal auditing services.

Three commonly provided nonaudit services were also examined: bookkeeping, general consulting, and tax return preparation services. Bookkeeping services evoked negative perceptions of auditor independence from the financial statement users, while the other two services favorably influenced participants' perceptions. Each of the three services significantly influenced

the perceptions of CPA firm professionals, while only the provision of general consulting services significantly influenced perceptions of the general public. The negative reaction for bookkeeping services is not unexpected given the profession's prohibition of auditors acting in a managerial capacity. On the other hand, general consulting and tax return preparation services are widely accepted as appropriate advisory services that do not impair audit independence.

Our findings suggest that an *expectations gap* may exist between members of the accounting profession and the general public with respect to their perceptions of the influence of nonaudit services on auditor independence. Given the crucial nature of independence in the audit function, such an expectations gap may lead to deterioration in the public's confidence in the financial reporting process. Thus, it is imperative that the profession understands the gap in perceptions and takes appropriate precautionary measures. In addition, our findings can provide additional evidence to the ISB for use in their deliberations related to nonaudit services.

Suggestions for Future Research

A number of avenues exist for research to continue examining auditor independence. One interesting possibility centers around 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. □□

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