CHAPTER – I

INTRODUCTION

INTRODUCTION

Many companies that start as small family businesses have their owners as managers. This means that the managers are involved in up-to-date activities of the business and have full power to access all the necessary companies. Later, through business expansion resulting from increased trade the owners may find they are not able to be physically present in all the activities of their company (Lee, 1970). Also, they may need funds to deal with the cost of expansion. Therefore, they decide to employ qualified and experienced people to run the business affairs of these companies. After the industrial revolution, many companies had managers who did not invest in the same companies. In such cases, managers may facilitate the financial statements for some other purposes. In such a situation, the need for external auditors is necessary. According to Chandler et al. (1993), the need for external auditors is a response to the problems of the agency and the audit function is a mechanism to attest the accountability and stewardship of company management to reduce the possibility of innocent mistakes and deliberate mis-statements such as fraud and management manipulation. One of the key factors of the auditors is independence, without which audit practice is undermined.

According to the American Institute Certified Public Accountants (AICPA) (1997), independence is defined as an “absence of interest that creates an unacceptable risk of bias with respect to the quality or context of information that is subject of an audit engagement”. As the above definition emphasizes, independence is the cornerstone of audit practice. Therefore, independent auditors should be unbiased. In a nutshell, the users of financial statements expect auditors to be independent professionals who have neither mutual nor conflicting interest with their audit client.
Nowadays, auditing firms also perform other related services. This may be reasonable because business practice has become more complex. Hence, it is natural for companies to seek advice from professional auditors and services such as management advisory. The provision of non-audit services by auditors to their audit clients reduces total costs and increases technical competence and motivates more intense competition. However, in recent corporate collapses all over the world, the apparent audit failures have threatened the credibility of auditors and affected the public perception of the quality of accounting information in financial reports and auditors’ independence. One of the factors which affects the independence of an auditor is non-audit services. With regard to non-audit services, questions are raised concerning the activity and accountability of the auditors’ performance.

CONCEPT

It was found that auditors believe that an auditor’s work would be used as guidelines for investment, evaluation of companies and predicting bankruptcy. However, in recent years the same auditors have provided non-audit services. Therefore, the main question that arises is, when do auditors provide both audit and non audit services? In other words, the question would be whether the auditors are able to conduct auditing impartially or not. According to the Sarbanes Oxley Act (2002) the following items are non-audit services:

1. Book keeping or other services related to the accounting records or financial statement of the audit clients.
2. Financial information systems, design and implementation.
3. Appraisal or valuation services, fairness opinions or contribution-in-kind reports.
4. Actuarial services.
5. Internal audit outsourcing services.
6. Management functions or human resources.
7. Broker or dealer, investment adviser or investment banking services.
8. Legal services and expert services unrelated to the audit.
9. Any other service that the accounting Board determines, by regulation, is permissible.

Provision of some of these services may cause a real threat to independence in case of the audit client. The principal threats which arise from the provision of non audit services are:

1. Self interest: The increase in economical benefit dependence.
2. Self review: Taking management decisions and auditing one’s own work.
3. Advocacy: Acting for the client’s management in adversarial circumstances.
4. Familiarity: Becoming close to the of clients management through the range of services offered.

The fundamental importance in understanding the conflict of interest that arises from the provision of non audit services to audit clients is the fact that doing the audit work is really serving two different set of clients: management consulting services and the audit committee, shareholders and all those who rely on the audited financials and the firm’s opinion in deciding whether to invest in the case of audit (Levine and Karnish, 2000).

Today, non-audit services are in fashion and managers are paying big money for these services. For example, the Enron debacle brought this debate to the forefront when it was disclosed that Arthur Anderson received $25 million as audit fees and $27 million as non-audit service fees (Beattie and Fearnely, 2003). In the Enron case, not just non-audit fees but fees in general, exceeding $50 million, raised questions about economic dependence of the audit firm to its client. Arthur Anderson’s U.S. Net Revenue was $3,600 million for their fiscal year ended August 31, 2000. This means Enron alone would constitute 1% of the firm’s annual revenue. The number of partners of the firm for the same time period totaled 1,313 which would mean the average partner revenue stream to the firm would be $27 million, indicating that the partners on the engagement for Enron
would have placed a high value on retaining the client and its associated revenue stream. A study conducted by Genetic (2002) revealed that the investor responsibility research center found that 75% of fees paid to accounting firms in 2000 were for consultancy services. Another survey revealed startling ratios of consulting fees including Motorola 16:1 Gap Inc 13.5:1, Apple computer Inc. 12.6:1 and Kmart Corporation 10:4:1 (United Brother, head of carpenters pension fund analysis 2000, Gentile, 2002).

AUDITING IN IRAN

Pursuant to the Islamic revolution of Iran in 1979, according to a bill ratified by the revolutionary council, many enterprises came under direct supervision of the government. In 1983, an act was ratified by the parliament to merge and embody all three big audit firms together with audit companies to establish Audit Organization. The main functions of the Audit Organization are:

1. Audit and statutory examination (for those corporations where 50% or more of their equity belongs to the government.

2. Financial and management consultancy services (for design and implementation of financial systems and rendering management advisory services).


4. Training, research and publications.

In 1993, the Institute of Chartered Accountants of Iran was passed by parliament, and was established in 2001. The main functions of the Institute of Chartered Accountants of Iran are financial control on all enterprises (manufacturing enterprises, businesses enterprises, service businesses) as well as ensuring the reliability of financial statements of the above-mentioned enterprises in order to protect the benefits of stakeholders.
STATEMENT OF THE PROBLEM

External auditors play an important role in the capital markets by providing a service to protect the interests of the investing public. This public watchdog function requires that accounting firms remain independent of the audit client and act on behalf of the public, not the audit client. However, in recent years, after several collapses in national and international dimensions, the credibility of audit practice was brought into question. The question is, why are investors hiring auditors and paying them good money whereas, the auditors’ work nowadays is not precise.

Recent collapses reveal that the auditors are not independent, in fact, as well as in appearance. The shareholders claim that without independence there is no value for audit work. In such situations the question is why do auditors indulge in non-audit services and why do they themselves fall from grace in their audit profession.

NEED FOR THE STUDY

In general, funds raised through the share market are one of the main sources of investment in any economy. This process facilitates share price and company earnings, and company auditor independence plays a vital role in determining the quality of those earnings. However, auditor independence may be threatened when an auditor provides both audit and non-audit services. In this condition it damages not only auditing and accounting professions, but also capital market. Regulations in developed countries recently issued newer rules and regulations on auditor independence and in particular, restricted auditors from supplying certain types of non-audit services to their clients, assuming that provision of such services were likely to jeopardize independence of an audit. However, till now those regulations do not have any more efficiency in developed countries. So far, in developing countries there are no such reactions regarding NAS and impairment of independence. In Iran, assumed as a developing country, till now there is no academic and professional research regarding non-audit service as well as regulatory reactions.
OBJECTIVES OF THE STUDY
The present study has the following objectives:
1. To study Iranian auditors practicing non-audit services.
2. To evaluate the effect of non-audit services on the independence of auditors.
3. To study the relationship between corporate scandals and non-audit services in Iran, and
4. To propose appropriate suggestions for non-audit services in the Iranian corporate sector.

HYPOTHESES OF THE STUDY
The following were the hypotheses for the study:

H1: “NAS reduces the credibility of audit opinions”.

H1a: “Brokers, auditors and investors differ significantly in their opinion on ‘NAS reduces the credibility of audit opinions’ “.

H2: “NAS provisioning enhances the competence level of auditors”.

H2a: “Brokers, auditors and investors differ significantly in their opinion on ‘NAS provisioning enhances the competence level of auditors’”.

H3: “There is a positive relationship between size of auditing firm and audit quality”.

H3a: “Brokers, auditors and investors differ significantly in their opinion on ‘There is a positive relationship between size of auditing firm and audit quality’”.

H4: “There is positive relationship between size of auditing firm and auditor independence”.

H4a: “Brokers, auditors and investors differ significantly in their opinion on ‘There is positive relationship between size of auditing firm and auditor independence’”.

H5: “There is a positive relationship between NAS provisioning and corporate frauds”.

H5a: “Brokers, auditors and investors differ significantly in their opinion on ‘There is a positive relationship between NAS provisioning and corporate frauds’” and
H6: “Government auditors and Chartered Accountants differ significantly in their opinion on ‘NAS reduces the credibility of audit opinions’”.

**RESEARCH METHODOLOGY**

The study envisages an analysis of the perceptions of the auditors, investors and brokers in effect of NAS on auditor independence, competence and the effect of audit size on audit quality and the effect of NAS on fraud.

**Data Source**

The study relies upon primary and secondary sources. The conceptual analysis of non-audit services practiced by Iranian auditors will be based on primary information sources. Primary data was collected from the city of Tehran, capital of Iran. The primary source of information is used to empirically test the perceptions of the auditors, investors, and brokers towards the effect of NAS on auditor independence, competence and the effect of audit size on audit quality, also the effect of NAS on fraud. Based on the objectives of the study and hypothesis developed, the data related to non-audit services will be collected through a structured questionnaire which will be based on a pilot survey. The research theme will be based on secondary information sources which will be collected from books, journals, internet sources, and published papers.

**Sampling Design**

In this study, the sample was drawn from three different groups, auditors, investors and brokers as a financial analysis. Also in this study, managers and experts of investments’ companies used investors because they are more wide spread. Also most probably ordinary investors do not have enough knowledge about the NAS and audit quality. The distribution of the sample including 409 companies, has been selected among auditors, in the Tehran stock market; from 33 investment companies (including managers and experts) numbering 330 as investors and from 52 brokerage houses (including managers and experts) numbering 312 as a financial analysis. In total, 450 samples, out of 1050, have been selected. The random sampling method has been adopted by the researcher.
Developing the Questionnaire

In the background of the objectives and hypotheses for the study, a pilot questionnaire was prepared on Likert’s five-point scale that the respondents were required to tick their perceptual levels with “1” as strongly agree, “2” as agree, “3” as moderately agree, “4” as disagree, “5” as strongly disagree, and served to elicit the opinions from 30 auditors. The questionnaires were collected from 26 respondents. Based on the opinions of the pilot survey, the final questionnaire was prepared and served personally to elicit the responses. However, 550 questionnaires were distributed totally, and 465 questionnaires were received from the sample respondents. The verification of filled-in questionnaires revealed that there were 32 incomplete questionnaires and these were removed and 433 were retained as they were complete with responses. Thus the response rate was 78 percent.

Data Analysis

In order to analyze the perceptions of different groups, the data from the questionnaires were collated on the basis of ten independent variables, which comprised of gender status, marital status, age status, experience status, education status, investment pattern status, security investment status, significance of audit report status, occurrence of scandal because of NAS status, and importance of annual reports status.

Use of Statistical Tools

For data analysis and testing the hypotheses the Statistical Package for Social Sciences (SPSS) tool has been employed. For this purpose some statistical techniques such as frequency, percentage, Mean value, ANOVA, ‘t’ test and Fisher’s index value have been used.

Locale of the Research

The empirical analysis of perceptual differences will be based on respondents chosen from Tehran as there is a high level confluence of professionals and users of accounting information, and the locale is the capital of
Iran. Also, in this study, managers and experts of investment companies used as investors because investors are more wide spread; also most probably, ordinary investors do not have enough knowledge about the NAS and audit quality, and managers and experts of brokerage houses used as financial analysis.

**OPERATIONAL DEFINITIONS**

In carrying out the present study the following operational definitions for independent variables consisting of audit quality, auditor independence, competence, the Sarbanes- Oxley Act, non audit services (NAS), an audit committee, internal control, and fraud are as follows.

i. **Audit quality:** Audit quality refers to how well an audit detects and reports material misstatements of financial statements, reduces information asymmetry between management and stockholders and therefore helps protect the interests of stockholders.

ii. **Auditor independence:** Auditor independence refers to an absence of interests that create an unacceptable risk of bias with respect to the quality or context of information that is the subject of an audit engagement.

iii. **Competence:** Competence refers to needs to be undertaken by experts in the field of auditing (this expertise may extend beyond auditing to industry specific, asset/liability or transaction expertise) and may involve the necessity of having competent audit technologies and processes to undertake the audit.

iv. **The Sarbanes- Oxley Act:** Also known as the Public Company Reform and Investor Protection Act of 2002. SOX is a United States federal law enacted on July 30,2002 in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, and worldCom. These scandals, which cost investors billions of dollars when the share prices of the affected companies collapsed, shook public confidence in the nation’s securities markets.

v. **Non Audit Services (NAS):** NAS refers to Section 201 which outlines a list of prohibited activities that can be done by auditors. According to the Act, it is unlawful for a registered accounting firm that provides audit service to also
provide any of the following non-audit services during the same time frame as the audit:

1. Book-keeping or other services related to the accounting records or financial statement of the audit clients.
2. Financial information systems design and implementation.
3. Appraisal or valuation services, fair opinions or contribution-in-kind reports.
4. Actuarial services.
5. Internal audit outsourcing services.
6. Management functions or human resources.
7. Broker or dealer, investment adviser or investment banking services.
8. Legal services and expert services unrelated to the audit.
9. Any other service that the accounting Board determines, by regulation, is permissible.

vi. **Audit committee:** An audit committee refers to a committee (or equivalent body) established by and amongst the board of directors of an issue for the purpose of overseeing accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.

vii. **Internal control:** The internal control refers to an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

viii. **Fraud:** The term “fraud” refers to an intentional act that results in a material misstatement in financial statements that becomes the subject of an audit.

**LIMITATIONS OF THE STUDY**

1. In this study the researcher’s study is limited to Tehran city only, so it may not cover all of Iranian auditors as well as third parties, because top companies and experts are in Tehran city.
2. In this survey the researcher uses the questionnaire as an instrument for a sample population; therefore, this study may not gather all the information from the whole Iranian non-audit service population.

3. The sample of investors is drawn only from the manager and experts of investment companies because investors are more widespread, also most probably ordinary investors do not have enough knowledge about the NAS and audit quality.

4. The respondent group includes three main categories—auditors, investors, and brokers.

5. The study focuses mainly on professional analysis of respondent group of NAS on audit independence, competence, effecting of auditing firm on audit quality and the effect of NAS on fraud.

CHAPTERISATION

This study is undertaken with the following chapterisation scheme:

Chapter – I Introduction

Chapter – II Review of Literature

Chapter – III Accounting, Auditing and Non-Audit Services: An Overview

Chapter – IV Audit practices in Iranian enterprises

Chapter – V Analysis and interpretation of data

Chapter – VI Summary of major findings, suggestions and conclusions