CHAPTER – II

REVIEW OF LITERATURE

INTRODUCTION

Generally, because of public concerns about possible links between the provision of NAS and auditor independence, for more than 30 years, accounting researchers have examined issues relating to the auditor’s provision of NAS. The fees generated by NAS have been rising more rapidly than audit fees. This has led to widespread beliefs that the provision of NAS can cause the auditors to compromise on their independence.

There are two main concerns. First, some contend that NAS enhances the auditors’ knowledge of the client, leading to a more efficient and effective audit. Simunic (1984), Beck et al. (1988a) and Ryan et al. (2001) argue that restricting NAS can inhibit the auditor’s acquisition of task-specific knowledge capital, thereby reducing auditor competence and lowering audit quality. Second, however, even assuming these benefits, the value of NAS by auditors depends upon the cost/benefit (tradeoff), with compromises in auditor independence as one of the most critical potential costs. For example, auditors may not stand up to management because they wish to retain the additional income from NAS which is the management’s gift. This concern, magnified in recent years as NAS fees, (relative to audit fees) skyrocketed and also that NAS may create an economic bond between the auditor and client, which some counter, can cause the auditor to lose objectivity (Ashbaugh, 2004). Apart from concerns about auditor objectivity, regulators also must consider whether NAS affects users’ perceptions of independence. Over the years, to ensure financial reporting quality and enhance investor confidence, auditor independence has been a long-standing issue for regulators resulting in numerous studies on the subject on how to enhance it and various rules that attempt to ensure it, (e.g. Choen report, 1978; Accounting Series Release (ASR), 250, 1978, SEC Rule 2000, SOX Act 2002). The SOX was in response to a flood of accounting scandals in 2002 and prohibits accounting firms
from offering NAS because Congress concluded that they impaired auditor independence and therefore their opinions.

**BACK GROUND OF NON AUDIT SERVICES**

The auditing profession is organized around a central ethical conflict. The client hires the auditor and pays his fees but the auditor is supposed to conduct the audit in an independent manner adhering to the profession’s “covenant with society” (Briloff, 1990) to audit in the interests of the public. The appearance of independence is maintained by a number of detailed rules about forbidden commercial and familial relationships between auditor and client. Independence in fact, or the reality of the auditor’s independence of judgment, has proved more difficult to legislate.

The American Association of Public Accountants (AAPA), formed in 1887, had no formal recognition of independence. In 1907, the by laws mentioned the desirability of avoiding incompatible or inconsistent occupations. The American Institute of Accountants (AIA) formed in 1916 was not actively concerned with ‘independence’ issues until the 1930’s. Carey (1969) notes that despite frequent references in professional literature to the independence of auditors in certifying financial statements, the word independent had not yet appeared in the Rules of Professional Conduct.” As accountants came to apply the concept of independence to them, it was generally assumed to mean integrity, honesty, and objectivity.

The Council of the Institute debated a rule against dual relationships, such as serving on the board of directors of an audit client, in 1931, but the proposed rule was defeated in 1932. A resolution adopted by the Council in 1934, after the passage of the 1933 Securities Acts began the relationship between the profession and market regulators. These acts were in response to the stock market crash of 1929 and were based on the belief that inferior accounting and financial reporting practices had contributed to the crash (Eccles, Herz, Keegan and Phillips, 2001). The purpose of the acts was to standardize reporting and create a third party
review of financial reports the independent audit. The original draft of the 1933 Securities Act did not mandate audits by independent auditors, but this provision was incorporated into the Act after Senate hearings (Cooper, 1982).

Early on, the Securities Exchange Commission (SEC) introduced rules designed to foster independence in appearance. Originally, any financial interest in the client was barred, but this was revised in 1936 to cover only significant interests (Berryman, 1978). However, it was not until 1941 that the Institute adopted prohibitions on stock ownership of the client that was partially like the SEC (Carey, 1970). In 1947 the AIA Committee on Auditing Procedure issued a tentative statement of Auditing Standards with an emphasis on independence in fact. In 1950 the SEC banned any financial interest in the audit client, largely as a matter of administrative convenience given the large number of inquiries about the significance of various holdings and the profession, followed in 1962. (Berryman, 1978).

In its 1957 annual report the SEC voiced the earliest concerns about the breadth of services that auditors should provide and extend, whether an auditor could become so closely identified with the client that he would make decisions that should be made by the management. In 1959, the SEC’s chief accountant commented on the possibility of an auditor becoming so deeply involved in performing managerial services for the client that he would lose the objectivity needed for audit.

Concerns regarding audits performed by firms also offering NAS go back to Mautz and Sharaf (1961) and they concluded that the Management Advisory Services (MAS) and tax services tend to reduce the appearance of independence. They recommended that the audit function be sharply separated from other services provided by a firm.

In 1963, the American Institute of Certified Public Accountants’ (AICPA) committee on professional ethics, issued opinion No. 12 and reasserting a 1947
statement by, the AICPA council, that independence is an attitude of mind. Opinion No. 12 added that there is no ethical prohibition against a CPA’s performing MAS for an audit client so long as he does not make management decisions or take positions which might impair objections.

In 1966 an AICPA committee began a study of the auditor’s scope of services and issued its report in 1969. The committee found no evidence that NAS impair independence in fact, but found that some users believed that such services created an appearance of lack of independence.

In 1974, the AICPA established an independent commission (the Cohen commission) to study several aspects of accounting professions and published its findings, in 1978. The Cohen commission recommended among other things, that the board of directors (or its audit committee) consider all services provided to the company by the auditor and that the auditors fully inform the board of all such services and their relationship, or lack of them in the audit function.

In 1977 the Metcalf Subcommittee was formed to launch a broad-scale inquiry into the accounting profession, including a review of services furnished by accounting firms. The staff report published its results and concluded that the MAS furnished to audit clients created a conflict of interest. After holding hearings on the staff report the Metcalf subcommittee concluded that only the MAS believed it appropriate to provide to public audit clients certain computer and systems analyses necessary for improving internal central procedures of corporations. The Metcalf subcommittee also concluded that certain types of services such as executive recruitment, marketing analysis, plant layout, product analyses and actuarial services should not be provided to audit clients.

The profession reacted promptly to the Metcalf and Moss subcommittee reports by undertaking a new program of self regulation, including forming the Securities and Exchanges Commissions Practice Section (SECPS) introducing required peer reviews and establishing the public oversight board to oversee the
SECPS, and peer views. The SECPS adopted criteria for scope of services and specified that an auditor may not provide the following services to a public audit client, psychological testing, public opinion polls, and merger and acquisition assistance for a finder’s fee, executive recruitment and actuarial services to insurance companies.

In September 1978, the SEC adopted requirements that certain disclosures related to NAS be made in the annual proxy statements of public companies and released ASR250. The disclosures included the percentage relationship of fees for each NAS to the audit fees, if the fee for NAS compromised more than 3 percent of total fee, that service had to be listed separately and the disclosure also had to reveal whether the board of directors or the committee approved the NAS.

In 1979 The Public Oversight Board (POB) had an extensive study on the disclosure of audit’s fee and NAS fee. The POB studied the history of concerns over scope of services and held public hearings, noting that with one exception, there were few uniform views. The exception was that almost all agreed that providing MAS was perceived by some as creating a situation in which an auditor’s independence is impaired. In its report, the POB reviewed the concerns and also balanced them with the many benefits that appeared to accrue from MAS, even citing a comment letter from a former chief accountant of the SEC. Conversely SEC in response to the POB’s report, released another rule - ASR 264, listing factors for auditors and boards of directors to use, to evaluate the effect of NAS provision on the external auditors’ independence and in 1981 the SEC rescinded ASR No. 264.

In 1982 the SEC repealed ASR No. 250, citing the new SECPs disclosure requirements and having concluded that the disclosure required by ASR No. 250 “was not generally of sufficient utility to investors to justify continuation.

In 1994, in response to a congressional request, the office of the Chief Accountant (OCA) of the SEC, reexamined the existing independence rules and
considered whether any changes were needed. The OCA acknowledged the continuing increase of NAS offerings by firms and undertook to continue to be alert to the development of problems of auditor independence. The POB continued to analyze “extended audit services” such as internal audit outsourcing and to monitor the firm’s expansion of NAS. The POB had concluded that extended audit services need not impair independence if they were properly and carefully structured. The POB suggested that the profession consider whether the code of professional conduct provides adequate framework and guidance for addressing, in a timely manner, the implications of new service lines and organizational structures to provide them on the traditional concepts of independence.

In the 1996 report to Congress, the General Accounting Office (GAO) stated, that it believes that measures that would limit auditor services are outweighed by the value of traditional consulting services, but added that concerns over independence would grow as firms moved to provide new services that go beyond traditional services. The GAO also urged the profession to be attentive to independence concerns in considering new services.

Over the last decade, the independence issue has re-emerged. Auditing firms have increasingly been providing information technology, internal audit, and other management advisory and consulting services to their audit clients. By 1997 this vast increase in NAS, and the increasing financial considerations received by the independent auditor, caused the SEC to again consider the issue of auditor independence.

In January 1999, Standard No. 1 issued by the Independence Standards Board (ISB), and auditors, required, (1) to disclose annually, in writing, all relationships between the auditor and the audit client that may reasonably be thought to bear on independence and (2) to confirm their independence.
In 2000, the SEC issued a disclosure rule, final rule S7-13-00, and mandated firms to specify fees paid to auditors in their proxy statements filed on or after February 5, 2001 (SEC 2000a). This rule requires classifications of payment to auditors into three categories. 1) Audit fee 2) financial information system design and implementation service 3) and all other services including audit-related, internal audit and tax.

The disclosure rule is intended to increase the transparency of auditor’s relationship with their clients and facilitate investigations of impacts of auditor fee on financial reporting quality.

The recent scandal of Enron, involving Arthur Andersen, and other accounting irregularity investigations have brought the accounting and auditing concerns to the attention of Congress and the public as well. On July 30, 2002, President Bush signed the Public Accounting Reform and Investor Protection Act (The Sarbanes Oxley Act) into law. The SOX, which is deemed to be the most significant change to U.S. securities law since 1934 (Koehn and Del Vocchio 2004) is intended to enhance the quality of financial reporting through 1) higher standards for corporate governance 2) executive certification of financial reports and internal controls (3) creating an independent regulatory body for the auditing profession and (4) establishing new civil and criminal remedies for violations of federal securities laws. (Jain and Rezaee, 2004)

In 2003, the SEC modified fee disclosures again, requiring the disclosure of fees for (1) audit services, (2) audit related services, (3) tax services and (4) all other services.

SCOPE OF THE REVIEW

Basically, the review of literature has been analyzed from the viewpoint of studies carried out in foreign countries and in Iran on the effect of non audit services on audit quality.
FOREIGN STUDIES

It is evident that a significant amount of empirical research on the affect of non-audit services on the audit quality, from the viewpoint of the set objectives of the present study, is highly relevant to the present evidence. However, the review of literature focuses on the following issues: (1) non-audit services and auditor independence (2) audit quality and non-audit services (3) non-audit services and size of auditor (4) non-audit services and corporate fraud (5) other researches about non-audit services not mentioned above.

i. Non-audit services and auditor independence

Auditor independence is currently an unresolved issue in the extant literature as to whether a non-audit service affects auditor Independence In Fact (IIF) (Ashbaugh et al., 2003; Defond et al., 2002; Francis and Ke, 2002; Frankel et al., 2002; Geiger and Raghunandan, 2003). A related and equally important issue involves the effects that non-audit services have, on the appearance of independence. The SEC and the American Institute of Certified Public Accountants (AICPA) have long recognized the importance of these two distinct dimensions of auditor independence (Dopuch et al., 2002). Because independence in fact is typically unobservable, users are forced to rely on subjective perceptions of auditor independence (Lowe et al. 1999). Early research investigating the effects of non-audit services on the appearance of independence has yielded mixed results. However, some recent findings suggest that non-audit services may impair user perceptions of independence (e.g. Glezen and Millar, 1985, Lowe and Pany, 1995, 1996; Jenkins and Krawczyk, 2000; Hackenbrack and Elms, 2002; Raghunandan, 2003).

Antle (1984) considers auditor independence to be an auditor’s freedom from management influence as desired by a company’s owner, i.e., the interested party is the current rather than potential owners. According to his economic model, since management controls the auditor’s fees, an auditor is at least as well-off foregoing independence in favor of management, unless a control mechanism is in place. Control mechanisms that might apply to an audit situation, might be
reputation i.e. an auditor will maintain independence to preserve his reputation, or the need to maintain an overall market demand for auditors.

Wines (1994) suggests that auditors receiving NAS fees are less likely to qualify their opinion than auditors who don’t receive such fees, based on his empirical analysis of audit reports issued between 1980 and 1989 by 76 companies publicly listed on the Australian Stock Exchange. He found that auditors of companies with clean opinions received a higher proportion of non-audit fees than did auditors of companies with at least one qualification.

Lowe et al. (1999) in their study, had attempted to assess the impact of outsourcing internal audit on financial statement of user’s perception of auditor independence and related decisions. They sent one thousand questionnaires to the loan officer. The response rate was 17.7 percent. Results indicated no significant differences in perceptions or decisions when the outsourced internal audit performed by another external auditor compared to when this service was performed in house. Conversely, significant differences were found across the various outsourcing groups involving the company’s external auditor and non-outsourced groups. The results also support establishing a requirement to provide a distinct separation of staff within the CPA firm for those performing the outsourced internal audit from those performing the financial statement audit.

Jenkins and Krawezyk (2000) studied a total of 323 investors, non-big five CPA firm professionals and big 5 CPA firm professionals which includes 83 big five and 139 non-big five accounting professionals and 101 investor participants to rate their perceptions of auditor independence, objectivity and integrity for two scenes in which an auditor provides no NAS to one firm and either a nominal amount of NAS (3 percent of total client revenues) or a material amount of NAS (40 percent) to another. They varied the type of NAS provided (actuarial, internal audit outsourcing, and legal services). There were no actual financial statements included in the experimental materials. Although they found investors’ perceptions of independence and decisions on whether to invest, were not affected
by either level of NAS provision, investors (and non-big five professionals) did consider the 40 percent level of NAS to be significant in their investment decisions.

Reynolds and Francis (2001) tested a question on the link between economic dependence and auditor independence. They hypothesize that the incentives to compromise independence depended on client importance (measured as the ratio of fee revenue from a particular client deflated by total fee revenue for the audit firm office), but found no evidence that economic dependence influences audit outcomes. In fact, their evidence shows the opposite effect: abnormal accruals are lower and the likelihood of receiving modified audit opinion is significantly greater when client dependences are greatest. Also they interpret this result as suggestion that litigation risk and reputation concern overwhelm financial dependence.

Gore and Singh (2001) predicted that the provision of NAS by auditors to their clients will impair independence more severely for smaller auditors than for larger auditors. They reported evidence, that client earnings management activity to avoid losses, and earnings decrease, is positively associated with the ratio of non-audit fees to total fees for non-big 5 auditors but not for big 5 auditors. Also the difference in effectiveness of big 5 and non-big 5 auditors in constraining earning management, widens as the non-audit fee ratio increases. These results suggested that, when the provision of NAS is relatively high, smaller auditors are less able to resist aggressive accounting by their clients.

Allen Craswell et al. (2002) investigated whether fee dependence within the audit firms’ offices jeopardizes auditor independence. They focused on audit fee dependence and at the same time they controlled the effect of NAS fee dependence, post 1989 merger. They supposed, if fee dependence affects auditor’s independent judgment, then auditor fee dependence does not affect auditor propensity to issue unqualified audit opinions. The findings are robust to a series of sensitivity analyses including allowing for NAS fee dependence and
identifying setting in when there is heightened pressure on auditors to confront the effects of fee dependence on exercising independent audit judgment.

Frankel et al. (2002) examined audit firm fees and two measures of biased financial reporting discretionary accruals and the likelihood of meeting earned benchmarks to assess effects of NAS on auditor independence. Data was collected from 3,074 proxy statements filed with the SEC between February 5, 2001 and June 15, 2001. They found non audit fees to associate positively with small earning surprises and with the magnitude of discretionary accruals. They interpret this result as evidence that large NAS compromise auditor independence and increase the incidences of biased financial reporting.

Ruddock et al. (2002) examined the relation between provision of NAS by incumbent auditors and earnings conservatism. They expected that big six auditors encourage more conservative financial reporting than non-big six auditors due to the impact of economic losses generally as opposed to just legal and political factors. They also expected that the provision of NAS is less likely to impair the independence of big six auditors due to their bigger size. They used 2,995 firm years observations in Australia while, in 1935 they were audited by six big auditors and 1,060 by non-big six auditors. They found that big six auditee’s earnings are more conservative than non big six auditees. Also provisions of NAS by the big six audit firms have resulted in less independence. Indeed their results show that for the big six auditees earning conservatism increases with the extent of NAS.

Kinney Jr et al. (2004) examined this question that ‘do audit firm fees for NAS provided to an audit client lead to lax enforcement of GAAP?’ The SEC feared to base its concerns on an increased number of restatements of previously audited financial statements during which audit firms’ NAS fees increased at a higher rate than did audit fees. They attempted to identify all interim and annual restatements announced in 1995 through 2000. They identified 713 companies and eliminated 96 companies audited by small non-big 7 firms. They also selected 617
potential restatement registrants and a total of 979 restated quarterly or annual financial statements and a potential 979 fee-years for the restatement sample. They found no consistent evidence of positive difference between audit firm fees for NAS and restatements and they found a positive association between other service fees (tax services) and restatements.

A survey carried out by Brandon et al. (2004), analyzed the effects the magnitude and relative degree of NAS have on the bond rating process. Regression results indicate that the amount of NAS provided by a firm’s external auditors is negatively associated with that of the client’s bond rating. Employing these measures as established proxies for auditor independence and their results provide empirical evidence regarding bond rating analysts’ perceptions of audit independence.

An empirical investigation of the impact of NAS on received auditor independence was made in Denmark by Quick and Rasmussen (2005). Prior empirical research found that shareholders, bank loan officers and journalists perceived a negative effect on auditor independence if NAS are provided and that the perceptions vary between different interest groups. They distributed 927 questionnaires between five groups, and 481 (51.9%) questionnaires were useful. The study ascertained that perceived auditor independence does not increase if MAS is provided by a separate department of the audit firm and also the study showed that the higher the percentage of fees being paid for MAS, higher the risk of independence being impaired. The final finding was that interest groups have different ideas as to what the critical percentage of MAS fees are.

Lai Kam-Wah (2005) examined the passage of the SOX associated with enhanced auditor independence. He believed the passage of the Act would heighten the vigilance of auditors and result in improved auditor independence. He tested that, whether, after the passage of the Act, auditors are more likely to issue modified audit opinions to their clients and also auditors are more likely to constrain the manipulation of discretionary accruals of their clients. The sample
consists of 12,115 firm-year observations. In this sample there are 4,145 /4,286/36,840 observations for the year 2000 (2001/2002). Out of the 3,684, year 2002 observations, 3,241 of them have financial statements that end in August 2002 or after the Act. Results show audit firms are more likely to issue modified audit opinion to their clients and their clients would be associated with lower discretionary accruals than before the Act. He concludes that auditors become more conservative after the Act and the Act improved auditor independence.

Abidin et al. (2006) found a lower perceived auditor independence perceived by a high ratio of non-audit services to audit fees, was also found to be significantly positively associated with auditor change, consistent with companies changing auditors to improve the perception of auditor independence. They believed auditing has an important role in the corporate governance process and they want to know why companies choose particular levels of audit assurance and why given the costs involved, companies, change their auditors. They examined the effect of auditee, auditor and audit characteristics on the likelihood of audit change, including consideration of the link between other governance mechanisms and auditing and role of the NAS. They used a matched-pairs data set of 354 companies taken from the period 1999 to 2003 to estimate ex-post, contemporaneous and ex-ant auditor change models using logistic regression.

Sori et al. (2006) considered the effect of the joint provisions of audit and NAS on auditor independence in Malaysia. This research, based on regulators and shareholders in worldwide capital markets, placed a great concern on the potential threat of joint provision of audit and NAS to the audit client on perceived auditor independence. They used two methods in their research. First, they used the questionnaire for three groups, namely, auditors, loan officers and senior managers of public listed companies. Second, they used a series of interviews with the senior managers of audit firm’s banks and publicly listed companies. The total questionnaires distributed were 800, responded were 88%. 44% and 36% of the questionnaire were returned by auditors, loan officers and senior managers respectively. The majority of the respondents agreed with the statement that
provision of NAS to audit clients by their auditors would threaten independence and the majority of the respondents agreed that auditor independence would not be threatened if the provision of audit and NAS were to be provided by the staff from a separate department and entity.

ii. Audit quality and non audit services

The external audit market is characterized by intense competition generating fee pressure and slow growth (Elliot and Jacobson, 1998). The demand for auditing services arises from a desire to reduce the divergence of interests and information asymmetry between the owners (the principal) and managers (the agent) in principal agent relationship (Jensen and Mckling, 1976). A manager can voluntarily increase the transparency of their actions by hiring independent auditors to monitor their behavior. In addition high quality auditors give great credibility and better quality to financial statements (Khurana and Raman, 2004). Success in this market requires auditors to strive continually to meet clients’ demand by producing and supplying a high-quality audit service. Audit quality describes 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. High quality should be associated with high information quality of financial statements because financial statements audited by high quality auditors should be likely to contain material misstatements. DeAngelo (1981) defined audit quality as an auditor’s ability to detect and report errors and irregularities in financial statements. The ability of auditors to detect irregularities in financial statements depends on their technical capabilities, whereas the ability of auditors to report breaches in financial statements depends on the extent of their independence from their clients.

Palmros (1988) hypothesized that higher levels of assurances are associated with higher audit quality. Measuring audit quality, however, appears to be a difficult task. Therefore market participants rely on various proxies to indicate audit quality. Understanding the factors that are associated with audit quality is a vital concern for investors, policy makers, regulators, the accounting profession,
and the general public alike. A wide variety of prior research projects have proposed alternatives for measuring audit quality. For example, Deis and Giroux (1992) analyze quality control reviews of actual audit engagements and use the results to differentiate audit quality levels in the public sector. The audit quality measure in the Krishna and Schauer (2000) study was based on entity’s compliance with GAAP reporting requirement. Assuming the extent of compliance with GAAP is likely to be directly related to the probability of detecting and reporting material misstatements. Recent research provides empirical evidence that high quality independent audits are used as monitoring and bonding mechanisms to alleviate agency costs. Also audit quality gives to auditor’s greater credibility and better quality to financial statements and are more likely to constrain the opportunistic behavior of management (Francis et al., 1999). As a consequence, high quality auditing services are of particular importance in lending credibility of financial statements and increasing investor confidence.

Houghton et al. (1999) studied the incremental audit production costs associated with issuing a qualified opinion are difficult for public accounting firms to recoup through audit fees alone. They proposed that audit production cost, associated with qualifications may be recouped through NAS fees in addition to audit fees. They also proposed that such recumptions follow a differential timing pattern. The research was based on Australian data and using a sample of 270 companies. They found a significant and positive association between the presence of an audit qualification and significantly higher fees paid. This relationship holds both in the case of an audit qualification contemporaneous with the fee charged and of one occurring in the year preceding the disclosed fees. The effect on audit fees however occurs only on a lagged opinion basis, while the effect on NAS fees occurs only on a concurrent opinion basis.

Lennox (1999) investigated the effect of NAS on audit quality. Lennox suggests that NAS increases auditor’s knowledge on clients as well as the probability of discovering problems. Their empirical data, collected from UK firms, show a significant, though weak, positive relationship between NAS fees
and audit qualifications, a surrogate for audit quality. Lennox attributes the weak association to the presence of both positive and negative effects. The positive effects suggest that NAS increases the probability of problem discovery. However, the negative effects allude increasing likelihood of reductions in auditor independence at the same time.

Kathryn Kadous (2000) studied whether providing higher quality audits increases auditors’ chance of avoiding legal liability. She explained her experiences suggest that the ex post observes consequences of audit failures that can affect the standards of care to which jurors hold auditors. Her results shows when the consequences of audit failure were more severe, participants’ evaluations of the auditor did not depend on the quality of audit provided in the contract. When audit failure led to only moderately negative consequences, auditors who provided higher quality audits reserved more favorable evaluations. She suggests that providing higher quality audits will not necessarily protect auditors from legal liability when the consequences of audit failure are severe.

Antle et al. (2002) found a negative association between non-audit fees and discretionary accruals and they conclude that NAS has a positive effect on audit quality, as measured by the amount of discretionary accruals. This study points out that the economics of scope can have information effects similar to that of knowledge spillovers. One service has a favorable effect on the other. Their empirical data showed a negative association between non-audit fees and discretionary accruals, which support this conclusion. They used audit and non-audit fee data from the U.K. for 1994-2000.

Jain et al. (2005) examined the issue of whether audit quality contracted by issuers at the time of going public is associated with post-IPO survival. They found that audit quality is significantly related to post-IPO time to failure, both, in isolation and the presence of other covariates that influence firm survival. Survival analysis methodology is applied to estimate the probability of post-IPO times to failure as a function of audit quality. Also the association between audit quality and post-IPO survival is strong when investment bank prestige is slow. Their
samples of 3836 IPO firms are compiled for the period 1980-1996 from securities data corporations.

Naharioh Jaffar et al. (2005) investigated the potential factors that influence the quality of auditors from the perceptions of three selected parties in auditing: partners of audit firms, audit committees and investment analysts. Their results show that four major factors that may influence the audit quality are: auditor’s knowledge in accounting and auditing standards, auditor should be able to inform the client about any development in accounting and financial reporting, auditor must follow ethical standards and auditor’s knowledge about the industry. The populations used in their survey of companies listed on the Kuala Lumpur Stock Exchange. 100 samples are taken from each category of respondents. Approximately 12 percent, 10 percent, and 13 percent, of the respective audit partners, audit committees and investment analysts, responded.

A survey carried out by Nagy (2005), examined the effect of mandatory auditor change on audit quality in the unique environment created by the failure of Arthur Andersen. The ‘demise’ of Arthur Andersen does not truly replicate a mandatory relation regime but it does provide a rich setting to examine one aspect of such a regime- that the effect a forced auditor change has on the level of audit quality. Results show that for smaller companies the level of audit quality improved for companies forced to switch from Arthur Andersen and that the negative relation between short auditor tenure and audit quality was effectively mitigated over the period of Arthur Andersen’s demise.

Bae et al. (2007) studied that mandatory audit firm retention affects audit quality in Korea. Some countries e.g. Brazil, India, Korea, and some European Union members have a similar statutory law on auditor tenure. They wanted to know the essence of debates on auditor tenure regulation and whether regulation helps improve audit quality. The sample was selected from all non-financial firms listed in the Korean Stock Exchange and from financial database prepared by the financial analysis system of the Korean investor service, including over the years
1993 to 2001. They found that the (retention) firms subject to the mandatory and for retention law of Korea significantly, reduce accrual discretion under the law and that they were more likely to have received modified opinions relative for the retention years. Also those results are consistent with the view that mandatory auditor retention improves audit quality.

iii. Non audit services and size of auditing firm

Auditor size is one of the most common proxies for audit quality. Auditor size can be measured as the audit fees that are charged to clients, the total number of clients, total client assets or sales, which are continuous measures and Big vs. non-Big auditors, which is a dichotomous measure. The foremost argument associating auditor size and audit quality was developed by DeAngelo (1981). Her theories on audit quality and auditor size have been supported by numerous studies (e.g., Palmor, 1986), and have become accepted paradigms in accounting research. DeAngelo argues that large audit firms supply higher quality audits than do small audit firms. DeAngelo (1981) argues that large auditors (as measured by the number of clients) have more client-specific quasi-rents that serve as collateral against losses that are incurred through the discovery of a lower quality audit than was promised. This collateral motivates large auditors to behave less opportunistically and thus supply a perceived higher quality audit and display a higher level of independence. She argues that the size of audit firms is positively associated with audit quality. Many researches have used auditor size as a measure of audit quality (Johnson and Lys, 1990; DeFond et al., 2000). Many audit quality studies indicate that, when accounting firm size is used as the indicator of audit quality, higher quality is associated with less information asymmetry and higher information quality, for example, using discretionary accruals as the measure for earning management. Becker et al. (1998) found that audit quality is negatively related to income-increasing discretionary accruals. This indicates that high quality is associated with low information asymmetry.

Some studies have used audit fees as quality measures. For example, Copley (1991) found that using audit fees as the audit quality measures have
greater power than Big 8 vs., non-Big 8 dichotomies in explaining variation levels of local government disclosures. Many studies indicated that big accounting firms represent high audit quality, because client sales revenues should be highly correlated with client-specific quasi-rents and greater client sales signify a large auditor size (Johnson and Lys 1990, DeFond 1992).

Some studies indicated that the total assets of clients as a surrogate of quasi-rents, and employ a dummy variable of top ten to indicate whether an auditor is a top ten auditor (large auditor) according to total assets of its clients (Gul et al., 2003; DeFond et al., 2000).

A survey carried out by Tahinkish and Nicolaou (2003) examined four variables which perceived effects of the size of the audit firm, provision of MAS, competition between audit firms and auditor’s tenure on the risk that independence of the certified auditor may become impaired. They focused on view points of three groups: a) the certified auditors b) the financial analysts and c) the bank executives in loan decisions. The questionnaires were mailed to all 315 certified auditors and 70 usable responses (23%) were received. For the bank executive loan officers, 180 were mailed and 45 usable responses (25%) were received. For the financial analysts, 106 were mailed, 29 usable responses (27%) were received. Their results showed that the groups of certified auditors and financial analysts expressed the opinion that small audit firms, when operating in highly competitive environments, provide MAS as well as tenure with a given client of more than three years, perceived as having a higher risk of losing independence while the group of bank executives in loan decisions considered that high competition and provision of MAS have an effect on the risk, that the independence of the certified auditor might become impaired.

Kim and Firth (2003) studied the effect of firm size on corporate earning management. They found that small firms engage in more earnings management than large or medium sized firms to avoid reporting losses. On the other hand, large and medium sized firms exhibit more aggressive earning management to
avoid reporting earning decreases than small sized firms. They believed the size of a firm is related to the internal control system and large companies may have more sophisticated internal central systems and more competent internal auditors, as compared to smaller companies. They reduce the likelihood of manipulating earnings by management because large CPA firms tend to have more experienced auditors that in turn could help prevent earnings misrepresentation. This research, with sample, includes all companies where financial statement data are available from compustat database, for 18-years from 1983 to 2000.

A survey carried out by Niemi Lukka (2004), examined the relation between auditor size and audit prices by using the data on hourly billing rates and the auditor characteristics from 103 small Finnish audit firms. In a competitive market, audit prices can vary if the clients believe that the quality of audit varies. Previous research links auditor independence, a key element of audit quality, to auditor size and consequently suggests a positive association between audit quality and auditor size. By using the dichotomy approach (Big five/non-big five) numerous studies in many countries have found that the largest audit firms with international reputations earn fee premiums due to their perceived higher quality. He found positive association between audit size and audit pricing. The results show that both- size and technical capability- have a positive impact on auditor remuneration, implying that product differentiation also takes place among these small audit firms.

Ainul Islam et al. (2005) tested econometric analysis (using panel data methods) of data on securities traded on the Dhaka Stock Exchange, Bangladesh, over the period 1995-99, indicated that audit quality may not necessarily increase with audit size. However, choice of a large auditor does seem to alleviate any negative impact of NAS on the confidence of investors. Auditing by a big firm itself doesn’t appear to make audited earnings more informative in explaining returns to company shares. Generally, investors seem to have a lower confidence in the information content of earnings when a relatively large amount of NAS are obtained from the same auditor, but the loss of confidence is mitigated when the
firm auditing the earning, is big. Their results show that companies requiring a relatively large amount of NAS from their auditors should find it worthwhile to hire a big audit firm, albeit with a fee premium. Also, companies declaring negative earnings do not appear to suffer any detriment to their share returns as the link between earnings and returns is significantly weakened when announced earnings are negative.

Chien and Chen (2005) studied the current NAS by auditors after the Enron bankruptcy in Taiwan. Their samples were 767 accounting firms in Taiwan which were divided in terms of size. There were 128 (84.2%) small firms, 19 (12.5%) medium firms and 5 (3.3%) large ones, and for supply and demand of NAS among the 153 effective return samples. 149 (97%) firms provided tax advisory service; MAS provided by 121 (79%) firms, 99 (64.7%) firms providing finance and investment advisory services and 32 (20.9%) firms provided information technology advisory services. They found that a higher CPA to employee ratio amounting firms will have better non-audit performance and organization size is positively related to non audit performance, while the independence of the accounting firms shows negative effect on non audit performance.

Sori et al. (2006) examined the impact of auditor reputation (size of audit firm) on auditor independence. They investigated five issues which includes: 1) that big 4 auditors are expected to better able to resist management pressure in conflicting situations 2) are more effective in detecting activities that will affect the client companies continuity 3) are more risk averse in respect of damage to their reputation from events such as public scandals 4) are more risk averse of litigation arising from fraud and are more independent compared to smaller sized auditors. They used questionnaires to seek a broad view of auditors also on officers and senior managers and interviews with senior managers of audit firms and banks of public listed companies on the issues of audit committee and auditor independence. They sent out 800 questionnaires. The response received was about 36 percent of them and total numbers of people interviewed were 47. They found that big 4 auditors are-better able to resist management pressure in conflicting
situations, are more effective at detecting activities that will affect clients company continuity, are more risk averse and thus more disinclined to be associated with public scandals, are more risk averse with regard to litigation arising from fraud and are more independent than non big 4 auditors.

Geiger and Rama, (2006) suggest in their studies that the big 4 audit firms are of higher quality than non-big 4 firms. They examined two types of going concern reporting errors (i.e., type 1 errors- modified opinions rendered to subsequently viable clients and type 2 errors-unmodified opinions rendered to subsequently bankrupt clients) over an eleven year period. Also, they examined reporting errors rate differences between the national second tier firms and regional local third tier firms. They collected samples of 1042 companies that receive first time going concern modified reports over the 1990-2000 period and 710 bankruptcy companies over the 1991-2001 period. They found that both, type one and type two error rates for big 4 audit firms, are significantly lower, compared to non- big 4 firms. They also found no significant difference between the national second tier and regional local third tier audit firms with respect to either type of reporting error.

Chuntao et al. (2007) examined the continuous relationship between audit firm size and audit quality, in China. The general hypothesis on the relationship is that audit services offered by larger audit firms tend to be of higher quality than those offered by smaller firms. They investigated two subjects, one the relationship between audit firm size and audit quality and second, the relationship between audit firm size and audit fee. They studied all firms listed (excluding 24 firms that are listed only by the B-share market) on the Shanghai and Shenzhen Stock Exchanges from 2001 to 2003 and they had a total of 3,396 firm year observations. They found that larger firms are more likely to issue modified opinions than smaller firms and large firms tend to command significantly higher audit fees.
Francis and Yu (2007) hypothesized that large practice offices of big four accounting firms have more expertise and less fee dependence on individual clients than smaller offices. They believed auditors in larger offices are more likely to detect and report material problems in client financial statements, resulting in higher quality audits. This assumption is tested for a sample of 6,568 US firm year observations for the period 2003 to 2005, audited by 285 unique big 4 offices ranging in size from offices with a single SEC registrant to offices auditing hundreds of SEC clients. Results show large offices providing higher quality audits and large accounting firms have incentives to provide uniform quality across their practice officers particularly in the post-SOX era with rigorous PCAOB inspections. Their results suggest there are frictions in the ability of firms to accomplish this through their existing knowledge-sharing practices and quality control procedures.

iv. Non audit services and corporate fraud

In general, auditors are responsible for exercising due care, which includes professional skepticism and auditor judgment in adhering to professional standards. This due care lead to detection of fraud and the reporting of material misstatements. Material misstatements include the over statement of income or assets, the under statement of expenses or liabilities and fictitious transactions. Fictitious transactions include falsification by the client of accounting transactions. Also, we know that some firms commit accounting frauds and that these frauds distort financial statements and move price away from the fundamental value of the firm, if market participants are misled. Consistent with this pattern of events, there is evidence that stock prices decrease when accounting frauds are revealed (Dechow et al. 1996; Feroz et al., 1991).

Feroze et al. (1991) found that over 50 percent of the reporting violations in their sample of SEC enforcement actions involve premature revenue recognition and the over statement of receivables.
Bonner et al. (1998) argued that the disproportionate attention that is given by the media to fictitious events makes people believe that these types of fraud occur more frequently than they actually do. Auditors are more likely to be held responsible for detecting and reporting material misstatement fraud than disclosure fraud from the regulator’s perspective.

Rosner (2003) found that the financial statements of bankrupt firms reflect significantly greater material income-increasing earning management in pre-bankruptcy years than the statements of non bankruptcy firms.

Farber (2004) investigated association between the credibility of the financial reporting system and quality of governance mechanisms. He seeks to fill this gap by investigating the association between the revelation of financial reporting fraud and subsequent improvement in the quality of corporate governance mechanisms. The corresponding economic consequences of such improvement regulators, perhaps in response to the recent flurry of highly publicized financial reporting frauds (e.g. Enron, WorldCom) are considered to strengthen the quality of corporate governance. The fraud sample consists of publicly held companies cited in the United States and SEC accounting and auditing enforcement releases (AAERs) during the period 1982-2000, for violating SEC rule 10(b)-5. He restricts his analysis to frauds that were detected through 1997 to allow for a three year period after fraud detection of selected 87 companies. He found a positive association between fraud detection and subsequent improvements in the quality of the board of directors and audit committee activity and also positive association between the magnitudes of the increase in outside director percentage and buys and holds abnormal returns for the three year period after fraud detection.

Carcello et al. (2004) examined the relation between audit firm tenure and fraudulent financial reporting. The GAO suggests that mandatory audit firm rotation may be necessary if the Sox requirements do not lead to an improvement in audit quality. They determined samples from the accounting and auditing
enforcement releases issued by the SEC between 1990 and 2001 alleging violation of section 10 (b)-5. They found that fraudulent financial reporting is more likely to occur in the first of the auditor client relationship. The results indicate that financial fraud is more likely in the early years of the auditor client relation and suggest that long auditor tenure is not problematic. They failed to find any evidence that fraudulent financial reporting is more likely given the long auditor tenure.

A Survey carried out by Coram and Moroney (2006) assessed the importance of the internal audit function in detecting fraud within organizations. They tried to know the link between both the existence and the type (in sourced versus outsourced) of internal audit functions and the propensity to detect fraud. They used a unique self-reported measure of fraud, primarily relating to the misappropriation of assets, for the first time. They collected internal audit data through a questionnaire mailed across Australia and New Zealand. They sent questionnaires- 2,180 for the organizations (67.5%), 324 replied. Their results showed that organizations with an internal audit function are more likely to detect and report fraud than those that do not. Also, it showed that having some in-sourcing is more effective in detecting and reporting fraud than completely outsourcing the internal audit functions. They suggested that internal audit adds value through improving the control and monitoring environment within organizations to detect fraud.

Holm and Seehausen (2007) considered contributing to an understanding of the intricate relationship between audit regulation and developments in audit practice for the purpose of understanding current responsibilities of the auditor in relation to fraud. They classified actual cases, where the responsibilities of auditors have been established by the court system and/or by the auditors own professional organizations in Denmark. The data set includes all publicized cases raised against Danish auditors within the time period of 1999 to 2006, i.e. 72 unique fraud cases in total. The information provided in the cases provides a basis for identifying the actual responsibilities pertaining to fraud, during the audit. They found that the historical analysis is that the responsibilities of the
auditor, in relation to fraud, should be interpreted not as a group of its own, but in line with the development of what constitutes a good audit in general.

vi. Other researches about non-audit services not mentioned above

Deberg et al. (1991) examined the relative level of NAS purchased by a group of companies that changed auditors, compared to companies that did not change auditors. They believed that one of the factors that will affect the economic bonds between the auditor and company is NAS. This may occur for various reasons. To the CPA firm, NAS is profitable and the firm may be motivated to maintain clients who purchase such services. They used matched pairs design to investigate empirically the relationship between auditor change and consumption of NAS. The results of the research show no evidence of an association between decisions to changing auditors and NAS. That no significant difference were found between the level of total recurring or non recurring NAS purchased by a set of companies changed auditors and a matched set of companies that did not change auditors and also the results do not provide any evidence that the reported level of NAS, as a percentage of audit fees helps identify companies likely to change auditors.

Houghton A. et al. (2001) tested model auditors who provided non-audit services (APNAS) fees arguing that there are three component parts to the supply of, and demand for, those services 1) the ex ante need for NAS 2) the auditor’ particular skill in supplying such services to audit clients, and 3) the willingness to appoint the auditor to undertake these NAS. It is this third factor that reflects the unusual characteristics of this particular market and the sensitivity of the joint supply of audit and non-audit services. Using a sample of most of the “Top 500” listed Australian companies in 1997, results showed that the ex ante need for NAS are significant in explaining auditor provided NAS (APNAS). The existence of the auditors as a specialist supplier of APNAS also significantly explains fees. The third determinant, “the willingness to appoint” shows that political costs (involving auditees’ membership of certain industries), stockholder dispersion and certain corporate governance practices are all significantly related to APNAS fees.
That is, the “willingness to appoint” variables significantly affect the level of APNAS purchased.

Frankel et al. (2002) examined the association between the provision of non-audit services and earnings quality. Because of concerns regarding the effect of non-audit services on financial reporting credibility, the Securities and Exchange Commission recently issued revised auditor independence rules requiring firms to disclose in their annual proxy statement, the amount of fees paid to auditors for audit and non-audit services. Their results are consistent with the argument that the provision of NAS strengthens an auditor’s economic bond with the client and that investors price this effect. They collected samples of 3074 firms from the proxy statement field between February 5, 2001 and June 15, 2001. They submitted evidence that firms purchasing more NAS from their auditor are more likely to just meet or beat analysts’ forecasts and report larger absolute discretionary accruals. They found that the purchase of NAS is not associated with meeting other benchmarks and also found that the unexpected component of the non-audit to total fee ratio is negatively associated with stock returns on the filing date.

Geiger and Rama (2003) investigated the association between the magnitude of audit and NAS and audit report modification decisions for financially stressed manufacturing companies. They identified samples in two groups, first a group of firms that received a going concern modified audit opinion which includes 66 companies and then they received a non going concern modified audit opinion which also includes 66 companies. They also identified companies with fiscal year ends between September 30, 2000 and February 28, 2001 from the September 2001 version of the compact disclosure data base. The results indicated a significant positive association between audit fee and the likelihood of receiving going concern modified audit opinions and found the same positive association of audit fees with opinions. They also found no significant relationship between the ratios of NAS fees to audit fees and reporting decisions.
overall, they found no evidence of a significant adverse effect of NA fees on auditor reporting judgments for our sample of distressed companies.

Kam-wah Lai (2005) examined whether the passage of the Sarbanes-Oxley Act in July 2002 is associated with enhanced auditor independence. Their sample consists of 12,115 firm-year observations. In this sample there are 4,145, 4,286, 3,684 respectively for 2000, 2001, 2002, out of the 3,686 year 2002 observations, 3,241 of them have financial statements in August 2002 or thereafter (i.e., after the Act). They found that after the passage of the Act, audit firms were more likely to issue modified audit opinion to their clients and their clients are associated with lower discretionary accruals than before the Act. Additional tests show that after the Act, auditees are less (more) likely to have higher positive (lower negative) discretionary accruals. Thus, auditors become more conservative after the Act. Their results show that the passage of the Sarbanes-Oxley Act is associated with improved auditor independence.

Seok Wee Jeong et al. (2005) investigated the relationship among audit fees, mandatory auditor assignment and the joint provision of NAS and audit services in Korea. They found that assigned auditors charge significantly higher audit fees than freely selected auditors. Also, they found that the joint provision of NAS and audit services does intensify the relation between auditor assignment and audit fees. This research based on a sample of 2,025 firms/years over a period from 1999 to 2002 are consistent with the idea that assigned auditors charge higher fees than competitively selected auditors and that the joint provision of audit and NAS does not alleviate the effect of auditor assignment on audit fees even though the results are relatively weak. Their results raise the possibility that the auditor-assignment system may improve auditor independence and audit quality.

Asare and Cohen (2005) studied the effect of NAS on client risks, acceptance and staffing decisions while there is concern over the effect of NAS on independence in fact and appearance but the empirical evidence is equivocal.
There is the public policy question of whether the provision of such services might improve audit quality by allowing the auditor to gain greater insight into the client’s operation.

They found that a higher level of risk decreased the likelihood of acceptance and this relation did not vary with the potential to provide NAS. They also found that more experienced auditors were assigned to the prospective client whose management had lower integrity.

Gleason and Mills (2006) examined whether auditor’s providing tax services compromise with auditor independence. The constraints imposed by the SEC, the Sox and the Public Corporation Accounting Overview Board (PCAOB) have substantially reduced auditor provided tax services. They used data from three primary sources, SandP audit fee data (2000-2003), SandP compustat financial statement data fiscal year (1994-2003) large and mid size business tax return data (return years 1994-2003) and we used the sample of the 7,337 corporation year. Their results indicated that when corporations do not use auditor provided tax services, tax expense is positively related to the tax deficiency the IRS proposes when it completes its examination of the tax return. Conversely, when corporations use auditor provided tax services they do not average record additional tax expenses for the tax deficiency and they concluded that the auditor’s independence is not impaired.

Ghosh et al. (2006) provide evidence on determinants of auditor independence-in-appearance using earnings response coefficients (ERCs) as a proxy for investor perceptions of earnings, and therefore audit, quality. Their sample consist of 8,940 firm-years over the 2000-2002 period, a sample of 8,940 firm-years over the (2000-2002) period and they found that the non-audit fee ratio (ration of non-audit to total fees from given client) is negative with earnings response coefficients (ERCs). However, client importance (the ratio of fees from a given client to the total revenues of the audit firm) also is negatively associated with ERCs. Results of this research show they are robust to the inclusion of fixed
firm effects to control for correlated omitted variables and on the statistical insignificance of the non-audit fee ratio as a determinant of ERCs also hold within size groups.

A survey carried out in New Zealand by Sharma (2006). He investigated the association between audit lag, a surrogate for audit efficiency and NAS and audit firm tenure. He supposed the auditor provide NAS field’s knowledge spillover that manifests in a more efficient audit and that effect erodes following the ban on NAS imposed by the SOX. Also, he hypothesized that as the auditor client engagement lengthens, the auditor deepens client’s specific knowledge and expert are which manifests in a more efficient audit. His sample was 5393 firm years’ observations across fiscal years 2000 to 2003. He found significant negative association between NAS fees and audit lag between audit firm tenure and audit lag and between NAS fees and audit lag erodes in the post SOX period.

IRANIAN STUDIES

Unlike extensive studies being conducted in foreign countries, the empirical research on NAS in Iran has been very limited. We have just one empirical research about NAS. Hence, the following empirical evidence on NAS in Iran has been presented here.

A survey carried out by Nikbakhat and Mhrabani in 2003, investigated the effect of NAS and fees of NAS on auditor independence. Their samples were: four groups-investors, bankers, auditors and financial managers. They selected fifty companies from the Tehran Stock Market. They sent questionnaires for their samples. Their results show that NAS and fees of NAS had no effect on auditor independence.

SUMMARY

The issue of auditor independence remains important, and the increased levels of non-audit services (NAS) provided by audit firms to their clients continue to be of concern. For these reasons SEC, using the newly mandated audit fee proxy disclosures and SOX proposing are considering the elimination of
external auditor provision of many or all NAS. Although knowledge and independence perceptions were significant in explaining financial statement reliability perceptions, their effect disappeared when audit quality was included in the regression.

Future research could investigate the potential benefit of even more disclosures of specific non-audit services, and the ability of these disclosures to mitigate the decrements in perceived auditor independence, audit quality, financial statement reliability, and investment attractiveness.

Several studies have investigated effects of NAS on audit quality or financial reporting quality, and reached divergent conclusions. Many writers maintain that NAS impair objectivity, even though the joint supply of audit and NAS improves efficiency. Others, however, argue that there exists no association between NAS and audit quality. In general, the findings of prior studies on impacts of NAS on audit quality are negative, positive, or no effects.