

## PART 8

### REVIEW OF AUDITOR INDEPENDENCE STUDIES

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#### INTRODUCTION

8.01 ‘The significance of independence in the work of the independent auditor is so well established that little justification is needed to establish this concept as one of the cornerstones in any structure of auditing theory.’<sup>79</sup> Independence, however, is an imprecise and ambiguous concept, and there is much debate as to the appropriate level of auditor independence and how this should be achieved.

‘The reality of public concern on this issue is that when company failure exists there is an immediate outcry of “Where were the auditors?” and questions as to whether they were truly objective.’<sup>80</sup>

8.02 This Part of the report investigates the concept of auditor independence, its desirability and means of achieving it. It also examines factors that could potentially harm independence. Independence risk, defined as ‘the risk that an auditor’s independence may be compromised or may be perceived to be compromised’<sup>81</sup> and the factors that impact or mitigate this risk, are central to determining appropriate policy on auditor independence.

8.03 Johnstone, Sutton and Warfield<sup>82</sup> develop a framework for considering independence risk. The authors argue that a precondition to the existence of this risk is the presence of certain environmental conditions. At the outset, there must be some incentive to the auditor, whether actual or perceived, and, in addition, there must be an element of judgment-based decision making in the situation. However, independence is a complex field of competing influences, and a reduction in audit quality may not result if other factors are present that moderate or offset the environmental conditions.<sup>83</sup> That is, there exists some set of factors that have the potential to impact or compromise auditor independence, but these factors need to be considered in light of other mechanisms or influences that may enhance auditor independence. The diagram from Johnstone Sutton and Warfield on the next page provides an outline of the framework for considering these competing factors:<sup>84</sup>

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<sup>79</sup> R K Mautz and Hussein Sharaf, *The Philosophy of Auditing*, Monograph No 6 (1961) 204.

<sup>80</sup> Auditing Practices Board (APB), *The Audit Agenda* (1994).

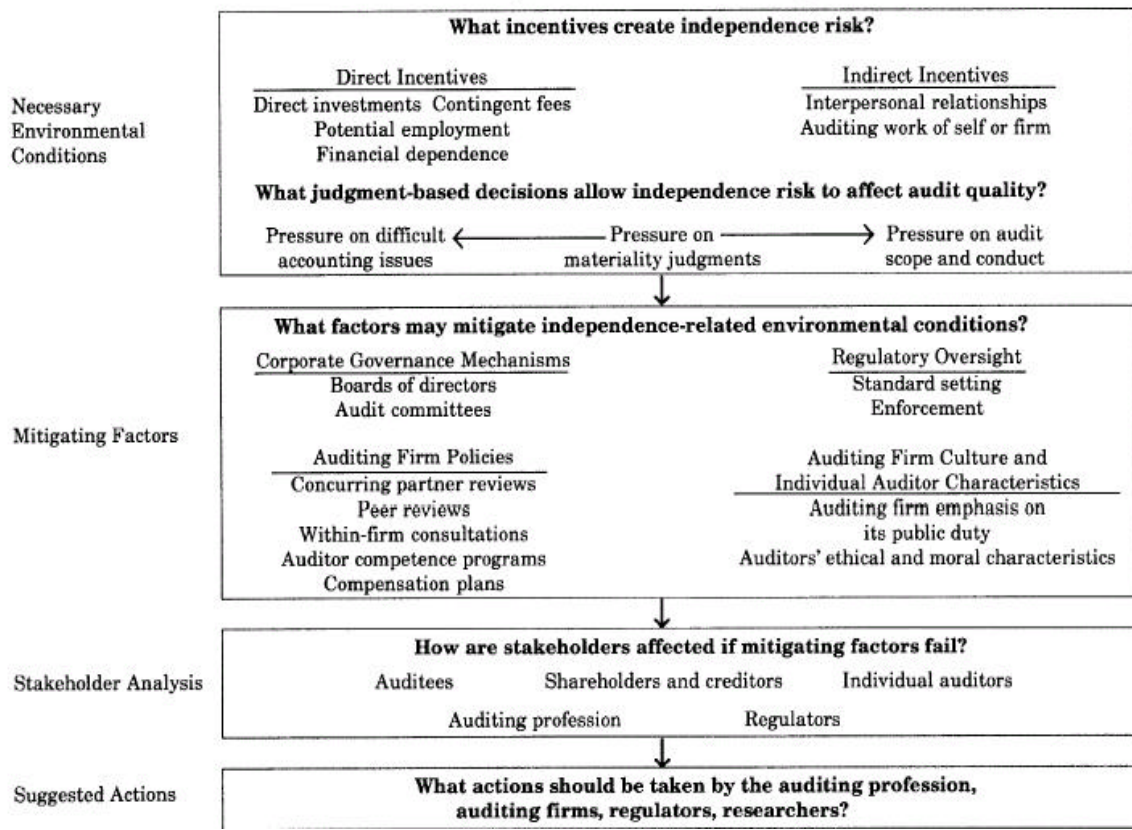
<sup>81</sup> Karla Johnstone, Michael Sutton and Terry Warfield, ‘Antecedents and Consequences of Independence Risk: Framework for Analysis’ (2001) 15(1) *Accounting Horizons* 1.

<sup>82</sup> *Ibid.*

<sup>83</sup> *Ibid.*

<sup>84</sup> *Ibid* 4.

**FIGURE 1**  
**A Framework for Understanding the Antecedents and Consequences of Independence Risk**



\*Source: Karla Johnstone, Michael Sutton and Terry Warfield, 'Antecedents and Consequences of Independence Risk: Framework for Analysis' (2001) 15(1) *Accounting Horizons* 1, 4.

8.04 This Part of the report considers some of the key influences on auditor independence. Section two discusses the definition of independence; section three examines the importance of auditor independence; section four considers the factors that can compromise independence and the empirical evidence relating to those factors; section 5 presents the mechanisms for enhancing independence and related empirical research; and section 6 provides an overview of the alternative approaches to auditor independence found in the literature.

## WHAT IS AUDITOR INDEPENDENCE?

8.05 Auditor independence is a complex concept with many interrelated layers. Although there is no clear definitional accord, there are certainly some common conceptual threads. 'While many definitions of auditor independence exist in the literature, in general the concept implies that the auditor has the ability to act impartially and provide an unbiased report of the client's financial health.'<sup>85</sup> It 'denotes the admirable quality of "not being influenced or controlled by others in matters of opinion or conduct."<sup>86</sup> This section endeavours to outline the key aspects of auditor independence in light of the clear impact of the perspective chosen on policy implications.

<sup>85</sup> Gary Kleinman, Dan Palmon and Asokan Anandarajan, 'Auditor independence: A synthesis of theory and empirical research' (1998) 12 *Research in Accounting Regulation* 3, 4.

<sup>86</sup> John Carey, 'The independence concept revisited' (1985) *Ohio CPA Journal* 5.

“Independence is an abstract concept, and it is difficult to define either generally or in its peculiar application to the public accountant. Essentially it is a state of mind. It is partly synonymous with honesty, integrity, courage, character. It means, in simplest terms, that the certified public accountant will tell the truth as he sees it, and will permit no influence, financial or sentimental, to turn him from that course.”<sup>87</sup>

8.06 Independence may be a state of mind or a behaviour. According to AUP 32, ‘independence requires a freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure.’<sup>88</sup> This suggests that an auditor possessing the requisite *state of mind* will act in the correct fashion. Alternatively, auditor independence may be defined as ‘the conditional probability that, given a breach has been discovered, the auditor will report the breach.’<sup>89</sup> That is, independence is a function of the auditor’s *behaviour*, where behaviour is measured by the likelihood of reporting errors if they are discovered. Other approaches include defining independence as the outcome of reactions to conflicts of interest and the balance of power between the concerned parties, whereby independence is a result of a cost-benefit calculation based on inputs into these struggles.<sup>90</sup>

8.07 All of these approaches to defining independence, although enlightening, have their shortcomings. Independence as a *state of mind* can never be shown. There is no demonstrable way of proving that an auditor possesses it. Further, possession of the right attitude will not automatically lead to the correct behaviour, just as an incorrect attitude will not necessarily result in incorrect behaviour. However, if we were to focus solely on the resultant *behaviour*, we ignore the influences leading to it. Rather than attempting to pigeon hole the concept of independence, it may be more informative to separate independence into its various elements. The next section examines the different aspects of the auditor independence construct.

### The elements of independence

8.08 Many attempts have been made to demark auditor independence into logical and containable categories. Traditional literature has partitioned independence into *independence in fact* and *independence in appearance*.<sup>91</sup> This division emphasises that independence must not only be real, but must also be evident. Writers such as Michael Power<sup>92</sup> have developed further aspects to the term, extending it to the inherent capacity of *auditing* to be independent. Power calls this type of independence *operational independence*, and groups independence in fact and appearance together as *organisational independence*. There are many ways to divide independence, and the examination

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<sup>87</sup> John Carey, *Professional Ethics of Public Accountants* (1946).

<sup>88</sup> Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia, ‘Statement of Auditing Practice AUP 32 “Audit Independence”’ in *Auditing Handbook, Volume 2 of the Accounting and Auditing Handbook* (2001) 955-6.

<sup>89</sup> Linda DeAngelo, ‘Auditor Independence, low balling and disclosure regulation’ (1981) 3(2) *Journal of Accounting and Economics* 113, 116.

<sup>90</sup> Arie Goldman and Benzion Barlev, ‘The Auditor-Firm Conflict of Interests: Its Implications for Independence’ (1974) 49 *Accounting Review* 707 and Donald Nichols and Kenneth Price ‘The Auditor-Firm Conflict: An Analysis Using Concepts of Exchange Theory’ (1976) 51 *Accounting Review* 335.

<sup>91</sup> Mautz and Sharaf describe these two groups as ‘practitioner-independence’ and ‘profession-independence’ respectively, above n 1, 205. Other writers add the dimension of independence in appearance of the *individual auditor* to that of the profession (See eg Michael Power *The Audit Society: Rituals of Verification* (1997) 131-4).

<sup>92</sup> Power, above n 91.

below draws broadly from the seminal work of R K Mautz and Hussein Sharaf<sup>93</sup> and from the more recent exposition by Power.<sup>94</sup>

### ***Independence of the individual auditor***

8.09 Many theorists<sup>95</sup> consider the *real* or *in fact* component of independence of the individual auditor to be a state of mind. However, where independence itself was being described as a state of mind above, in this division the requisite mental attitude is only one element of the overall concept of independence. The appropriate state of mind can be characterised by ‘probity of character and belief in and adherence to an ethical code of behaviour’<sup>96</sup> and necessarily involves moral or ethical factors.

8.10 Mautz and Sharaf divide the real independence of an individual auditor into three dimensions: programming independence, investigative independence and reporting independence. Respectively, these require that the auditor has freedom from ‘interference or friction’ to develop his or her own audit program and to choose the range and nature of audit techniques to be used within it; free and direct access to all legitimate sources including business and other records and co-operation from personnel; and freedom to choose what and how to express through recommendations culminating from the audit.<sup>97</sup>

8.11 Further to independence in fact, the individual auditor must have ‘a public reputation for those attributes of character’<sup>98</sup> and appropriately visible and credible monitoring and sanctions, or, individual independence in *appearance*.

‘Similar to judges, who not only must be just but must seem to be just, these accountants must seem to be independent of their client corporations. This aura of independence is crucial to the accountants’ credibility in the public’s eyes.’<sup>99</sup>

8.12 The relative importance of independence in appearance is a matter of contention. For example, Robert Elliott and Peter Jacobson argue that the ‘appearance of independence should not be the separate coequal of the fact of independence,’ as no immediate public threat is posed by a faltering in perceived independence.<sup>100</sup> However, others have argued that ‘appearance of impropriety is only slightly less dangerous than the impropriety itself.’<sup>101</sup>

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<sup>93</sup> Above n 79.

<sup>94</sup> Above n 91.

<sup>95</sup> See, eg, David Flint, *Philosophy and Principles of Auditing- An Introduction* (1988) 59-61.

<sup>96</sup> *Ibid* 60.

<sup>97</sup> Above n 79, 206-8.

<sup>98</sup> Flint, above n 95.

<sup>99</sup> Tamar Frankel, ‘Accountants’ Independence- the Recent Dilemma’ (2000) *Columbia Business Law Review* 261, 261.

<sup>100</sup> Robert Elliott and Peter Jacobson, ‘Audit Independence: Concept and Application’ (1992) *CPA Journal* 34, 35-37.

<sup>101</sup> Frederick Hurdman, ‘Independence of Auditors’ (1942) *Journal of Accountancy* 60.

### ***Independence of the profession***

8.13 Perceived independence is not confined to the individual auditor, but must extend to the profession as a whole in order for the audit function to be valuable.<sup>102</sup> The nature of the relationship between auditing and business can cause scepticism, and this public concern needs to be addressed. This necessitates the creation and maintenance of a 'general public trust in the independence and integrity of the audit profession.'<sup>103</sup> The means of achieving this advancement in public image involves 'proscribing observable relations between auditors and clients which, to the community at large, may *appear* to impede the exercise of impartial judgement by auditors,'<sup>104</sup> and having meaningful and credible sanctions and monitoring in place.<sup>105</sup>

### ***Independence of auditing***

8.14 The traditional literature omits this final category of auditor independence, presumably as a result of an initial premise that auditing itself is inherently endowed with impartiality. However, recent works have challenged this notion,<sup>106</sup> and seek to redefine the nature of auditing in a modern society. In defining operational independence, Power<sup>107</sup> draws attention to its two components: *informational* and *epistemic* independence. Informational independence will never be truly achievable, as the auditor must, in spite of attempts at substantiation, rely on some representations made by management through the information supplied. Epistemic independence relates to the source and development of the knowledge base of the auditor. The learning foundations from which the auditor formulates his or her opinion must be unrelated to the auditee.

## **WHY SHOULD AUDITORS BE INDEPENDENT?**

8.15 The importance of independence in the auditing context has become such that the terms 'independent' and 'auditor' can no longer be separated- independence appears to be endogenous to auditing. The inseparability of the concepts has been observed from many academic perspectives,<sup>108</sup> and independence has been described as the 'essence',<sup>109</sup> 'foundation',<sup>110</sup> and 'raison d'être'<sup>111</sup> of auditing, amongst other similar imagery.

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<sup>102</sup> D R Carmichael and R J Swieringa, 'The Compatibility of Auditing Independence and Management Services- An Identification of Issues' (1968) *Accounting Review* 697, 699.

<sup>103</sup> Kim Klarskov Jeppesen, 'Reinventing auditing, redefining consulting and independence' (1998) 7(3) *European Accounting Review* 517, 529.

<sup>104</sup> Peter Wolnizer, *Auditing as Independent Authentication* (1987) 130.

<sup>105</sup> Flint, above n 95.

<sup>106</sup> See, eg, Jeppesen, above n 103.

<sup>107</sup> Above, n 91.

<sup>108</sup> See, eg, a professional perspective in Flint, above n 95 and an economic perspective in Wanda Wallace, *The Economic Role of the Audit in Free and Regulated Markets* (1980).

<sup>109</sup> E Stamp and M Moonitz, *International Auditing Standards* (1978).

<sup>110</sup> O R Whittington and K Pany, *Principles of Auditing* (11<sup>th</sup> ed, 1995).

<sup>111</sup> E Woolf, *Auditing Today* (1979).

‘Independence is an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements which are primarily representations by management. If the accountant were not independent of the management of his clients, his opinion would add nothing.’<sup>112</sup>

8.16 The role of the external auditor is to independently attest as to whether or not the accounts prepared by the client comply with accounting standards and present a ‘true and fair view’ of the financial performance and condition of the firm.<sup>113</sup> ‘If the audit opinion is to provide the desired degree of assurance, the auditor must be able to form and express an opinion without bias.’<sup>114</sup>

‘...[T]he public path in the reliability of a corporation’s financial statements depends upon the public perception of the outside auditor as an independent professional... if investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.’<sup>115</sup>

8.17 Indeed, being a major source of accounting expertise is only one part of the auditor’s function. These days, the accounting knowledge and capabilities of internal financial personnel rival those of auditors.<sup>116</sup> For auditing to exist as a profession, it must add value. ‘If this condition [independence] does not exist, the degree to which the audit opinion can be trusted as an objective statement is limited.’<sup>117</sup> And if the opinion cannot be trusted it adds little value.<sup>118</sup> As the relationship determined by the market to exist between the auditor and the client gets closer, the auditor’s incentives to divulge the truth may decrease, as can the value the market places on the auditor’s opinion.<sup>119</sup> If the capital market did not expect auditors to challenge management on at least some issues, it would value the opinion of the auditor as null. Without independence, ‘auditing simply becomes meaningless.’<sup>120</sup>

### **Integrity of financial markets**

8.18 The requirement to present externally verified financial statements stems from the need to ‘obviate the fear of loss from reliance on inaccurate information, thereby encouraging public

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<sup>112</sup> Robert Kane, Jnr (ed), *CPA Handbook* (1952) Chapter 13, 8 quoted in Mautz and Sharaf, above n 79.

<sup>113</sup> Michael Sutton, ‘Auditor independence: the challenge of fact and appearance’ (1997) 11(1) *Accounting Horizons* 86, 86.

<sup>114</sup> Max Bazerman, Kimberly Morgan and George Loewenstein, ‘The Impossibility of Auditor Independence’ (1997) *Sloan Management Review* 89, 91.

<sup>115</sup> Abraham Briloff, ‘Accountancy and Society: A Covenant Desecrated’ (1990) 1 *Critical Perspectives on Accounting* 5, 29, quoting former United States Supreme Court Chief Justice Burger.

<sup>116</sup> Ralph Saul, ‘What ails the accounting profession?’ (1996) 10(2) *Accounting Horizons* 131, 133.

<sup>117</sup> T A Lee, ‘A Stakeholder Approach to Auditing’ (1998) 9(2) *Critical Perspectives on Accounting* 217, 223.

<sup>118</sup> DeAngelo, above n 89, 116 notes that an audit opinion is not worthless just because an auditor doesn’t always tell the truth.

<sup>119</sup> Linda DeAngelo, *The Auditor-Client Relationship: An Economic Analysis* (1981), 34.

<sup>120</sup> Jeppesen, above n 103.

investments in the Nation's industries.'<sup>121</sup> A lack of confidence in financial markets engenders fear and reluctance to invest, to the detriment of the economy. The accuracy of security prices relies on the provision of and the efficient dissemination of information such that it becomes reflected in security prices,<sup>122</sup> and the pricing of their associated risk.<sup>123</sup> Confidence in the integrity of security prices requires not only the provision of information, but credible attestation as to its truth, fairness and compliance.

'Corporate governance depends upon "gatekeepers" to protect the interests of investors and shareholders by monitoring the behavior of corporate "insiders" and by reporting the financial results of corporate performance in an accurate and unbiased fashion that permits objective valuation of the firm.'<sup>124</sup>

8.19 Without effective watchdogs, 'it is reasonable to believe that market efficiency would be lower, the cost of capital higher, and our structure of corporate governance imperilled.'<sup>125</sup> This gate keeping function is clearly the role required of the auditor for the profession to add value to our markets, but the gatekeeper cannot be effective unless he or she is independent. The gate must be staffed with objectivity and impartiality, or the point of the gatekeeper becomes lost. 'Without accountants to ensure the quality and integrity of financial information, the markets for capital would be far less efficient, the cost of capital would be far higher, and our standard of living would be lower.'<sup>126</sup>

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<sup>121</sup> Walter Schuetze, 'A Mountain or a Molehill?' (1994) 8(1) *Accounting Horizons* 69, 70 quoting from the US Supreme Court in the *Arthur Young* case in 1984.

<sup>122</sup> Eugene Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383.

<sup>123</sup> Marcel Kahan, 'Securities Law and the Social Costs of Inaccurate Stock Prices' (1992) 41 *Duke Law Journal* 977, 979.

<sup>124</sup> John Coffee, Jr. 'The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting,' (Working Paper, Columbia Law School, 2001) 2.

<sup>125</sup> *Ibid.*

<sup>126</sup> Steven Wallman, 'The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change' (1995) 9(3) *Accounting Horizons* 81.

## Reduction of agency costs

8.20 Auditing and the relevance of independence can be analysed drawing from the seminal work by Jensen and Meckling,<sup>127</sup> which models the relationship between a *principal* and an *agent*. Working from one of the basic premises of classical economic theory- that individuals are rational, self-interested utility maximisers- we can describe the auditing problem from the perspective of agency theory. This construct has frequently been used in the literature to model or examine the demand for auditing and the role of independence within this framework.<sup>128</sup>

8.21 Agency theory describes the conflicts that arise as a result of the separation of ownership and control. Managers, who control the firm, are agents of the shareholders (principals), who own it. However, since both parties are rationally self-interested, there is a misalignment of interests, which results in agency costs.<sup>129</sup> It is generally argued that the agent will ultimately bear the agency costs,<sup>130</sup> and therefore has an incentive to reduce them.

8.22 Agency conflicts, and therefore costs, arise because management have the incentive act to maximise their own self-interest, to the detriment and expense of the principal. Further, there is considerable information asymmetry between the agent and the principal. Auditors serve to reduce agency costs by reducing this information asymmetry. It is costly for principals to directly discern the accuracy with which management has prepared the financial reports and represented the financial position of the firm. Independent verification in the form of an audit opinion makes this more observable. However, the resultant reduction in agency costs will not occur unless the audit report is credible in the eyes of the shareholders, and auditor independence is crucial to this credibility.

8.23 A further problem arises from the use of auditors as a 'solution', as it adds another layer of conflict to the existing agency relationship.<sup>131</sup> Auditors, who are also seen as agents, possess the same rational self-interest as the other parties. To the extent that siding with management gives rise to the potential for future economic benefit, an auditor has the incentive to conform to management wishes. However, for the auditor to actually 'cheat' it is also necessary that auditors perceive the

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<sup>127</sup> M C Jensen and W H Meckling, 'Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

<sup>128</sup> See, eg, Rick Antle, 'The Auditor as an Economic Agent' (1982) 20(2) *Journal of Accounting Research* 503; Rick Antle, Auditor Independence (1984) 22(1) *Journal of Accounting Research* 1; Tad Miller, 'Do We Need to Consider the Individual Auditor when Discussing Auditor Independence?' (1992) 5(2) *Accounting, Auditing & Accountability Journal* 74; and Carolyn Levine and Laura Kornish, 'Discipline with Common Agency: The Case of Audit and Non-audit Services' (Working Paper, Duke University, 2000); D S Ng and J Stoeckenius, 'Auditing, Incentives and Truthful Reporting' (1979) Supplement, *Journal of Accounting Research* 1; J Evans, 'Optimal Contracts with Costly Conditional Auditing' (1980) Supplement, *Journal of Accounting Research* 108; F Gjesdal, 'Accounting for Stewardship' (1981) *Journal of Accounting Research* 208. For an economic perspective see, eg, Linda DeAngelo, above n 119; Linda DeAngelo, above n 89.

<sup>129</sup> Jensen and Meckling, above n 127, 308, describe these costs as including monitoring costs, bonding costs and a residual loss.

<sup>130</sup> See, eg, Jensen and Meckling, above n 127; William Beaver, *Financial Reporting: An Accounting Revolution* (2<sup>nd</sup> ed, 1989). This point is not, however, without contention, and generally revolves around the ability of the principal to achieve price protection.

<sup>131</sup> Miller, above n 128, extends the analysis by considering the audit firm itself as a further organisation of *several* economic agents, rather than a *single* economic agent as per DeAngelo, above n 89 and n 119; and Antle, above n 128.

marginal benefits from misrepresentation to exceed the marginal cost,<sup>132</sup> which, amongst other things, may include reputational damage, enforcement action by regulators and legal claims for compensation. Absent this ‘economic interest’, the auditor has no economic incentive to conceal a discovered breach.<sup>133</sup> A truly independent auditor, of course, should be void of this economic interest.

### **Auditing as a public responsibility**

‘A public accountant acknowledges no master but the public, and thus differs from the bookkeeper, whose acts and statements are dictated by his employers. A public accountant’s certificate, though addressed to the president or directors, is virtually made to the public, who are actually or prospectively stockholders. He should have ability, varied experience, and undoubted integrity.’<sup>134</sup>

8.24 Some theorists argue that auditors should act in the interests of external users of financial statements.<sup>135</sup> Many papers<sup>136</sup> take the perspective that these users are auditors’ ‘true’ clients, as opposed to the popular notion that the client is the management or board of directors.

8.25 Other writers take this view even further. Professor Briloff argues that auditors have a covenant with society to perform services which involve ‘signing, delivering or issuing or causing to be signed, delivering or issued,’<sup>137</sup> financial statements, opinions and reports. “Moreover, he contends that the accounting profession owes a unique responsibility to society as a whole to assure full, fair, open and timely disclosure regarding the governance and accountability of the corporate enterprise.”<sup>138</sup> This perspective maintains that auditors owe a special duty to society that prevails over the simple quest for economic profit.

### **WHAT FACTORS CAN COMPROMISE INDEPENDENCE?**

8.26 ‘Everyone would applaud this ideal [of independence], but a cynical world requires more than a mere declaration of intention if it is to stake its money on the accountant’s word.’<sup>139</sup> Whereas it has been established that independence is an essential attribute for an auditor, there is great public scepticism as to the ability of auditors to preserve their independence, absent some mechanism, be it incentive based or regulatory, to bond them to this standard. This disbelief is exacerbated by the existence of a number of factors or influences that have the potential to impair auditor

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<sup>132</sup> DeAngelo, above n 119, 34.

<sup>133</sup> DeAngelo, above n 89, 116-117. Note this conclusion was drawn under the perfect market conditions of zero transactions costs and perfect substitutes.

<sup>134</sup> Andrew Barr, ‘The Independent Accountant and the SEC’ (1959) *Journal of Accountancy* 32 quoting Charles C Reckitt’s definition of public accounting.

<sup>135</sup> See, eg, Bazerman, Morgan and Loewenstein, above n 114, 90.

<sup>136</sup> See, eg, Goldman and Barlev, above n 90, and Steven Zeff, ‘Does the CPA Belong to a Profession?’ (1987) *Accounting Horizons* 65.

<sup>137</sup> Briloff, above n 115, 5.

<sup>138</sup> Brendan O’Connell, ‘An analysis of Key Issues arising from Professor A. J. Briloff’s Paper entitled, “Garbage In/Garbage Out: A Critique of Fraudulent Financial Reporting: 1987-1997 (The COSO Report, 1999) The SEC Accounting Regulatory Process (AAERs)”’ (2001) 12(2) *Critical Perspectives on Accounting* 167, 178.

<sup>139</sup> Carey, above n 87.

independence. Indeed, Bazerman, Morgan and Loewenstein<sup>140</sup> argue that given the close working relationship between auditors and clients and the fact that auditors are paid by their clients, it is psychologically impossible for an auditor to be free from bias. Numerous factors of concern have been noted in the literature for many years:

‘...[A] member would not be considered independent with respect to any enterprise if he or any of his partners during the period of the professional engagement or at any time of expressing his opinion had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise or was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee.’<sup>141</sup>

8.27 There is a substantial amount of academic literature, which examines, either empirically or analytically, the impact of these many factors on auditor independence. Kleinman, Palmon and Anandarajan<sup>142</sup> categorise the empirical research in this field as being either perceptual or archival. Perceptual research arises from the inherent difficulties in measuring the relevant variables directly. Therefore, these variables are investigated in terms of the perception of various user groups as to their impact. Whilst such research provides valuable insights, especially in the realm of independence in appearance, it should be viewed with caution due to the shortcomings of such a research methodology.<sup>143</sup> Many of the variables examined in this vein stem from a model by Randolph Shockley.<sup>144</sup>

8.28 Archival research, on the other hand, endeavours to discover and measure relationships between these variables, or close proxies, where they are available. For example, archival research may try to ascertain the relationship between the level of management advisory services provided by the audit firm and the tenure of that firm with the client.<sup>145</sup>

8.29 The factors examined in this section which may adversely affect auditor independence include:

- (a) the scope of services provided by the audit firm;
- (b) the audit fee, and, in particular, the practice of low balling; and
- (c) employment relationships.

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<sup>140</sup> Above, n 114.

<sup>141</sup> Carey, above n 86, 186-7.

<sup>142</sup> Above n 85, 9-27.

<sup>143</sup> Kleinman, Palmon and Anandarajan, above n , 9 discuss a study by Orren which warns perceptions are ‘notoriously inaccurate’.

<sup>144</sup> Randolph Shockley, ‘Perceptions of Audit Independence: A Conceptual Model’ (1982) *Journal of Accounting, Auditing and Finance* 126.

<sup>145</sup> A study of this type was undertaken in P J Beck, T J Frecka and I Soloman, ‘An Empirical Analysis of the Relationship Between MAS Involvement and Auditor Tenure: Implications for Auditor Independence’ (1988) *7 Journal of Accounting Literature* 65.

## Scope of services

8.30 There 'is an inherent scepticism about how close the relationship between the auditor and the management of the audit client can be without creating, in fact or in perception, a mutuality of interest that could impair the auditor's independence.'<sup>146</sup> As the scope of the services performed for the client by the audit firm broadens, the relationship between management and auditor becomes more proximate. The literature has debated the impact of the provision of non-audit services ('NAS'), and, in particular, at great length a common form, management advisory services ('MAS') on auditor independence.

'Of fundamental importance in understanding the conflict of interest that arises from the provision of non-audit services to audit clients is the fact that in so doing the audit firm is really serving two different sets of clients: management in the case of 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 the audit.'<sup>147</sup>

8.31 Theorists generally hypothesise that the concurrent provision of NAS to audit clients poses a threat to auditor independence. These arguments are based broadly on notions of 'economic dependency and mutuality of interest.'<sup>148</sup> As the relative importance of NAS increase, a loss of impartiality may ensue from the client dependency that results. Further, the frame of mind required for NAS provision requires more promotion than objectivity. Schulte<sup>149</sup> pointed out that this attitude could evoke auditor empathy for management, which could compromise independence.

8.32 However, advocates of NAS point out the benefits of dual service provision. 'The provision of non-audit services by auditors to their audit clients reduces total costs, increases technical competence and motivates more intense competition.'<sup>150</sup> These benefits take form in the significant economies of scope,<sup>151</sup> and thus cost savings, that can arise in these situations. Advocates of NAS further contend that the provision of such services does not necessarily impair auditor independence, and can, in fact, enhance professional judgment through the increased familiarity the auditor will have with the client, especially in relation to areas such as intangible assets, and through the efficient use of experts.<sup>152</sup>

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<sup>146</sup> Sutton, above n 113.

<sup>147</sup> Levine and Kornish, above n 128, 5 quoting the Panel on Audit Effectiveness.

<sup>148</sup> Graeme Wines, 'Auditor Independence, Audit Qualifications and the Provision of Non-Audit Services: A Note' (1994) *Accounting and Finance* 75, 76.

<sup>149</sup> A Schulte Jr, 'Management Services: A Challenge to Auditor Independence?' (1966) *Accounting Review* 721.

<sup>150</sup> Benito Arrunada, 'The Provision of Non-audit Services by Auditors: Let the Market Evolve and Decide' (1999) 19(4) *International Review of Law and Economics* 513.

<sup>151</sup> J J Gaver and K M Gaver, 'Simultaneous Estimation of the Demand and Supply of Differentiated Audits' (1995) 5(1) *Review of Quantitative Finance and Accounting* 55 point out the difficulties in measuring these production efficiencies.

<sup>152</sup> *Ibid.*

8.33 Joint service provision has a documented popularity with audit firms and client management. Antle and Demski<sup>153</sup> note the enduring interest in joint service provision from auditors and client firms. To illustrate, Wines documented an increase in average NAS remuneration to audit firms in his sample from \$64,500 in 1980 to \$617,800 in 1989.<sup>154</sup> Palmrose<sup>155</sup> found 75% of a sample of 298 companies purchased other services from their audit firm. Indeed, it has been argued that in the absence of restrictions, audit firms 'have an incentive to strive for competitive advantage by developing concentrations of multiple-service expertise.'<sup>156</sup> Where all categories of services are provided, a position where value is shared between the auditor and the client in the most advantageous fashion can be attained. The benefit borne of economies of scope and increased client awareness can, it is argued, reduce the costs of the audit firm, and, in turn, the fees charged to the client for service provision.<sup>157</sup> This can be complimented by a greater meeting of client needs.

8.34 The 'value adding' opportunities for the audit firm increase with joint-service provision. Over time, the nature of the audit function has changed in recognition of this. Although many writers<sup>158</sup> have previously defined consulting services by carving out audit services, Jeppesen argues that auditing has been 'reinvented', eroding this separation. In today's 'value-added' culture, a 'successful commodity must take into account the needs of the customer.'<sup>159</sup> Indeed, it has been argued, controversially, that the nature of auditing has now changed to such an extent that the possibility of auditor independence is precluded. 'The *auditor* can no longer be independent because *auditing* is no longer an independent discipline.'<sup>160</sup>

8.35 The association between audit fee and NAS is important due its potential to impact auditor independence. The bond between management and auditor has been analytically documented to increase with the provision of NAS.<sup>161</sup> Where services are provided concurrently, economies of scope will result in cost savings that may be distributed between the audit firm and the client. Where knowledge is transferred between audit and non-audit staff, the production efficiencies attained, if retained by the audit firm, can increase the relative bargaining power of the client and thereby threaten auditor independence. This arises because where the audit firm retains the cost savings, the reliance of the audit firm on the client increases, as these cost savings represent

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<sup>153</sup> R Antle and J Demski 'Contracting Frictions, Regulation and the Structure of CPA Firms' (1991) 29(Supplement) *Journal of Accounting Research* 1.

<sup>154</sup> Above, n 148, 78.

<sup>155</sup> Z Palmrose, 'The Effect of Non-Audit Services on the Pricing of Audit Services: Further Evidence' (1986) *Journal of Accounting Research* 405.

<sup>156</sup> Alain Mikol and Peter Standish 'Audit Independence and Nonaudit Services: A Comparative Study in Differing British and French Perspectives' (1998) 7(3) *European Accounting Review* 541.

<sup>157</sup> *Ibid* 548-550.

<sup>158</sup> See, eg, Mautz and Sharaf, above n 79.

<sup>159</sup> Above n 103.

<sup>160</sup> *Ibid*.

<sup>161</sup> See, eg, P J Beck, T J Frecka and I Solomon, 'A Model of the Market for MAS and Audit Services: Knowledge Spillovers and Auditor-Auditee Bonding' (1988) 7 *Journal of Accounting Literature* 50; D Simunic, 'Auditing, Consulting and Auditor Independence' (1984) *Journal of Accounting Research* 679.

increased future economic interest in the client. This, according to Davis, Ricchiute and Trompeter, creates 'incentives for the auditor to resolve disputes in the client's favour.'<sup>162</sup>

8.36 On the whole, however, the results of studies on the impact of NAS provision on auditor independence are diverse. Wines<sup>163</sup> studied financial statements to investigate the existence of any relationship between their content and the level of NAS provision. Using a ten-year sample of 76 companies, the author found a potential for the appearance of damaged auditor independence where there was high NAS provision. This inference derived from the finding that companies not receiving a qualified opinion during the sample period were associated with higher NAS provision, which could suggest the appearance of compromised independence. The results of Wines were consistent with earlier studies by Simunic<sup>164</sup> and Palmrose.<sup>165</sup> This vein of research stemmed from concerns relating to auditors prioritising their own economic benefit over independence.<sup>166</sup>

8.37 Using a sample of 263 'Big Eight' clients from 1976 to 1977, Simunic<sup>167</sup> investigated the pricing effects of knowledge spillovers to determine whether cost savings arising from economies of scope in NAS provision were retained by the auditor or passed on to the audit client. The author found that not only were the production efficiencies not passed on to the client in the form of lower fees, but that joint service clients actually paid increased fees relative to audit-only clients. Palmrose<sup>168</sup> examined the issue further by separating NAS into several categories such as tax and management advisory services. Findings in this study supported the positive relationship between NAS and audit fee documented by Simunic. Abdel-Khalik,<sup>169</sup> however, argued that the result of these studies was counter-intuitive. Using a survey methodology, the author concluded that the provision of NAS did not impact audit fee.

8.38 The studies providing support for a positive relationship between audit fees and NAS provision raise concerns due to the analytical results<sup>170</sup> discussed above that predict where the benefits of cost savings are retained by the auditor, the auditor becomes more dependent on the client, posing a threat to independence. Results from Davis, Ricchiute and Trompeter,<sup>171</sup> however, attribute the fee increase to an increase in audit effort. Parkash and Venable<sup>172</sup> ascribe the

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<sup>162</sup> Larry Davis, David Ricchiute and Greg Trompeter, 'Audit Effort, Audit Fees, and the Provision of Nonaudit Services to Audit Clients,' (1993) 68(1) *Accounting Review* 135.

<sup>163</sup> Above n 148.

<sup>164</sup> D A Simunic, 'Auditing, Consulting and Auditor Independence' (1984) *Journal of Accounting Research* 679.

<sup>165</sup> Palmrose, above n 155.

<sup>166</sup> See, eg, P Barnes and H D Huan, 'The Auditor's Going-Concern Decision: Some UK Evidence Concerning Independence and Competence' (1993) 20(2) *Journal of Business Finance & Accounting* 213.

<sup>167</sup> Above n 164.

<sup>168</sup> Above n 155.

<sup>169</sup> A R Abdel-Khalik, 'The Jointness of Audit Fees and Demand for MAS: A Self-Selection Analysis' (1990) *Contemporary Accounting Research* 295.

<sup>170</sup> See eg, Beck, Frecka and Solomon, above n 161.

<sup>171</sup> Davis, Ricchiute and Trompeter, above n 162.

<sup>172</sup> Mohinder Parkash, and Carol Venable, 'Auditee Incentives for Auditor Independence: The Case of Nonaudit Services' (1993) 68(1) *Accounting Review* 113.

inconsistencies between these studies to methodological faults such as survey response bias and inconsistent NAS definition.

8.39 In light of the above inconsistencies, Barkess and Simnett<sup>173</sup> tested the relationship between audit fees and the provision of NAS. A large Australian sample, from 1986 to 1990, was employed in their study. In each year, between 371 and 466 of the Top 500 listed companies were drawn into the sample, with a total of 2,094 observations. Using regression analysis, the authors rejected the null hypothesis of no relationship between audit fees and the provision of NAS predicted by Abdel-Khalik,<sup>174</sup> and found results consistent with the earlier studies by Simunic and Palmrose.

8.40 The existence of a positive relationship between NAS fees and audit fees has also been documented in the UK.<sup>175</sup> Using a random process to select a sample of the 1,083 UK quoted companies named in the 1992 *Quality of Markets: Companies Book*, Ezzamel, Gwilliam and Holland<sup>176</sup> constructed a final sample of 314 companies. At the outset, the authors note that in the 1992-1993 period, up to 87% of total audit fees could be traced to NAS provision. Further, consistent with many of the US and Australian studies, a positive relationship between fees for NAS and audit service provision was found.

8.41 Another stream of research has looked to explain pricing issues in terms of the existence or non-existence of audit fee premia. Competitiveness is a documented feature of the market for audit services,<sup>177</sup> and in such an environment, these premia can be interpreted as returns to quality-differentiated features offered by an audit firm.<sup>178</sup> Craswell, Francis and Taylor<sup>179</sup> examined brand name reputation and industry specialization as two possible sources of fee premia. Using auditor remuneration data for 1,484 publicly listed Australian companies during 1987, the authors found evidence of both sources in audit fees. On the other hand, Craswell and Peiris<sup>180</sup> did not find evidence of a service-quality premium, where this represents the management's internal opinion as to the value added by the audit.<sup>181</sup> The sample used, however, only covered 111 Australian companies.

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<sup>173</sup> Lynn Barkess and Roger Simnett, 'The Provision of Other Services by Auditors: Independence and Pricing Issues' (1994) 24(94) *Accounting and Business Research* 99.

<sup>174</sup> Above n 169.

<sup>175</sup> M Ezzamel, D R Gwilliam and K M Holland, 'Some Empirical Evidence from Publicly Quoted UK Companies on the Relationship Between the Pricing of Audit and Non-Audit Services' (1996) 27(1) *Accounting and Business Research* 3.

<sup>176</sup> *Ibid.*

<sup>177</sup> See, eg, Allen Craswell, Jere Francis and Stephen Taylor, 'Auditor Brand Name Reputations and Industry Specializations' (1995) 20 *Journal of Accounting and Economics* 297, 312-313.

<sup>178</sup> *Ibid.*

<sup>179</sup> *Ibid.*

<sup>180</sup> Allen Craswell and David Peiris, 'Pricing Service Quality in Audit Engagements' (Working Paper, University of Sydney, 1999).

<sup>181</sup> *Ibid* 3.

8.42 A recent study by Frankel, Johnson and Nelson<sup>182</sup> provides empirical evidence on the effect of NAS provision on auditor independence and whether the market values fee disclosure. The authors collected fee information from 4,000 proxies filed with the SEC between February and June 2001, after the introduction of the new US disclosure requirements. A significant negative market reaction was found with respect to firms with the highest unexpected NAS fees. Looking at earnings management, the authors document that companies with higher levels of NAS provided by their audit firms are more likely to meet or beat earnings benchmarks. The authors conclude that the provision of NAS can threaten auditor independence. However, although the number of observations was large, the small sample period of four months may limit the ability to generalize these results.

8.43 The study by Barkess and Simnett<sup>183</sup> investigated questions beyond the pricing matters discussed above. In relation to independence issues, the authors included an examination of the association between the provision of NAS and the issuance of qualified audit reports. The *t*-tests for the relationship between the amount of NAS provided by the audit firm and the type of audit report (ie, qualified or unqualified) were insignificant, indicating that there is no relationship between audit qualification and the level of NAS provided by the incumbent auditor. A final experiment tested the hypothesis that the stability of audit tenure increases with the provision of NAS.<sup>184</sup> A binary variable measuring 0 or 1 depending on whether the client had changed audit firms within the period was used. For the tests, the sample was restricted to those 194 companies that were represented in the database for each of the five sample years. On this level, no relationship between the stability of auditor tenure and NAS provision was found.

8.44 The association between NAS provision and other events of interest has also attracted research. DeBerg, Kaplan and Pany<sup>185</sup> studied the effects of NAS provision on the auditor-client relationship. Using an archival approach, the authors collected an experimental group and a control group sample and tested research questions to determine the relationship between NAS provision and client propensity to change auditors. Further, in the event of a change, the level of NAS service provision purchased from the new auditor was also investigated. The authors relied on disclosures mandated by ASR No 250.<sup>186</sup> Under this provision, the SEC required, amongst other things, disclosure of NAS fees as a percentage of total audit fees, but not as an absolute value. Decisions to change auditors and NAS provision were found to be unrelated, mitigating concerns that audit firms may attempt, potentially to the detriment of independence, to retain high NAS clients. Immediately following an auditor change, clients were found to purchase a lower proportion of NAS from the new auditor. The authors suggest that this could be driven by a desire to reduce total professional fees, or by reticence to involve the auditor in NAS provision until a relationship is established.<sup>187</sup>

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<sup>182</sup> Richard Frankel, Marilyn Johnson and Karen Nelson, 'Auditor Independence and Earnings Quality' (Working Paper, Stanford University, 2001).

<sup>183</sup> Above n 173.

<sup>184</sup> Where stability increases with the provision of NAS, a threat to independence might result.

<sup>185</sup> Curtis DeBerg, Steven Kaplan and Kurt Pany, 'An Examination of Some Relationships Between Non-Audit Services and Auditor Change' (1991) *Accounting Horizons* 17.

<sup>186</sup> This rule was only in effect between September 30, 1978 and February 1982.

<sup>187</sup> DeBerg, Kaplan and Pany, above n 185, 28.

8.45 Craswell<sup>188</sup> tested the link between NAS provision and the nature of the audit opinion. Using a logit model to analyse Australian data for 1984, 1987 and 1994, the author concluded that the results indicate that NAS provision may not pose a threat to auditor independence. This inference derived from the finding that the decision to qualify an audit opinion is unrelated to NAS provision.

8.46 Many other studies have examined the perceptions of external parties to gauge the impact of NAS provision on auditor independence.<sup>189</sup> For example, Pany and Reckers<sup>190</sup> related auditor independence to the type of NAS and the existence of any separation between the consultancy and audit arms by examining the perceptions of shareholders and financial analysts. Perceived threats to independence were found to vary with the type of NAS, and to decrease with separation of functions. These results were, however, countered by those of Glezen and Millar,<sup>191</sup> which indicated that NAS provision did not threaten the appearance of auditor independence.

8.47 Lowe and Pany<sup>192</sup> extended the perceptual research to determine how NAS provision *with* the client differed from NAS provision *for* the client. That is, in situations where the audit firm teams with an auditee to provide consultancy services for a mutual client. The authors considered a number of types of services provided in this fashion in order to provide results enabling comparison. 2,100 questionnaires were mailed to financial analysts, as representatives of a key group of financial statement users, resulting in 304 useable responses. The subjects were asked to evaluate an investment decision based on information given in a case study format. Results indicated that the type of relationship used to provide services with a client did not impact perceptions of auditor independence, investment decisions or the reliability of financial statements. These results were consistent with an earlier study by Lowe and Pany,<sup>193</sup> which examined the perceptions of loan officers.

8.48 In the more recent study, the authors analysed three possible levels of relationship. Firstly, where there was no relationship, secondly, where there was an immaterial relationship, and, finally, where a material relationship with the client existed. Perceptions of independence and reliability were found to be greater where the relationship fell into either of the first two groups, that is, where the relationship was non-existent or immaterial, as compared to where the relationship was material. However, no discernible difference was found between perceptions where there was no relationship and where the relationship was immaterial, indicating that the existence of an immaterial business

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<sup>188</sup> Allen Craswell, 'Does the Provision of Non-Audit Services Impair Auditor Independence?' (1999) 3 *International Journal of Auditing* 29.

<sup>189</sup> See, eg Abraham Briloff, 'Old Myths and New Realities in Accountancy' (1966) *Accounting Review* 48; R V Hartley and T L Ross, 'MAS and Audit Independence: An Image Problem' (1972) *Journal of Accountancy* 42; Kurt Pany and Philip Reckers, 'Non-Audit Services and Auditor Independence: A Continuing Problem' (1984) 3(2) *Auditing: A Journal of Practice and Theory* 89; D J Lowe and Kurt Pany, 'CPA Performance of Consulting Engagements with Audit Clients: Effects on Financial Statement Users' Perception and Decisions' (1995) 14(2) *Auditing: A Journal of Practice and Theory* 35.

<sup>190</sup> Above n 189.

<sup>191</sup> G Glenzen and J A Millar, 'An Empirical Investigation of Stockholder Reaction to Disclosures Required by ASR No 250' (1985) 23 *Journal of Accounting Research* 859. This study compared auditor approval voting by stockholders before and after the SEC issued ASR No 250.

<sup>192</sup> D Jordan Lowe and Kurt Pany, 'An Examination of the Effects of Type of Engagement, Materiality and Structure on CPA Consulting Engagements with Audit Clients' (1996) 10(4) *Accounting Horizons* 32.

<sup>193</sup> Above n 189.

relationship may not impact perceptions of auditor independence. Staff separation in performing these functions was found to have a significant effect on user perceptions.

8.49 Perceptual studies, however, are often subject to academic criticism. Response rates are notoriously low,<sup>194</sup> leading to potential non-response bias. Further, the theoretical setting lacks many elements and pressures of reality. Following psychological literature, Gul<sup>195</sup> further contended that the results of perceptual studies can be driven by the characteristics of the subjects.

8.50 Arrunada contends that the decision whether to source NAS from an audit firm, and if so, how much, should be a matter governed by freedom of contract between the audit firm and management,<sup>196</sup> both of whom are informed market participants. Limitations on joint-service supply restrict management and auditors from arriving at the economically 'optimal' mix of service provision. Mikol and Standish<sup>197</sup> note that where restrictions on NAS provision are imposed, the probable result from the perspective of both the manager and the auditor is a reduction in utility. However, the managers, in negotiating contracts for NAS provision, are agents of the shareholders, who, due to information asymmetries, are not necessarily as 'informed' as managers. As described in Section 3.2 above, this separation of ownership and control can lead to agency conflicts, and incentives for managers to maximise their own self-interest at the expense of shareholders. Mikol and Standish highlight the agency conflicts that may arise over 'measures affecting audit quality, objectivity and value.'<sup>198</sup> This arises because each party, seeking to self-maximise, may prefer different levels of these attributes in an audit process. Shareholders, for example, may require a higher level of objectivity than management, due to the difficulty in direct observation of the truth of management statements. Given the existence of these conflicts, any welfare reduction suffered by managers and auditors where services are restricted may not extend to shareholders, who, in fact, may benefit from limitation.

8.51 The mixed results found in the literature makes it difficult to draw firm conclusions from these sources regarding the provision of NAS to audit clients. The disaccord amongst theoretical proponents carries through into the empirical results. Some theorists use this lack of conclusive evidence to conclude that the 'available empirical evidence does not support the contention that auditor independence is harmed by providing such services, even to audit clients.'<sup>199</sup> Others conclude that heed should be taken of the evidence that does imply impairment to auditor independence. Carmichael and Swieringa point out that 'to say that the performance of management services and independent auditing for the same client is incompatible is not the same as saying that the auditor has lost his independence.'<sup>200</sup> That is to say, although the *potentiality* for impairment of independence exists, this does not necessarily imply that it can, or will, occur.

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<sup>194</sup> See, for example, Lowe and Pany, above n 192, which had a response rate of 14.5%. In another example, the response rate in J M Lacey, 'Auditor/Client Joint Investments and Independence' (1990) 4 *Research in Accounting Regulation* 129 was 11%.

<sup>195</sup> Ferdinand Gul, 'Qualified Audit Reports, Field Dependence Cognitive Style, and their Effects on Decision Making' (1990) *Accounting and Finance* 15.

<sup>196</sup> Above, n 150.

<sup>197</sup> *Ibid.*

<sup>198</sup> Above n 156.

<sup>199</sup> Arrunada, above n 150.

<sup>200</sup> Above n 102.

8.52 However, regardless of the eventuality of an actual impairment to independence in fact, damage to independence in appearance has been documented.<sup>201</sup> And, given the development of the importance of this element of independence above, this should be cause at least for some notice. As noted by Wines, ‘it is the signal to financial statement users and others which is of paramount importance.’<sup>202</sup>

### Audit fee

8.53 As noted in Section 3.2 above, where an auditor has an ‘economic interest’ in a client, he or she may have incentives for misrepresentation. DeAngelo has identified the start-up costs of an audit as one situation that can create the ‘economic interest’ necessary to impair auditor independence.<sup>203</sup> These initial costs may arise as a result of the initial lack of familiarity with the client and the necessity to verify details such as beginning balances and the particulars of certain assets, including fixed assets.<sup>204</sup> However, given the advantage the auditor will gain through performing this initial audit, and assuming the auditor has some bargaining power, he or she can increase fees beyond total costs in future audits.<sup>205</sup> With this knowledge, an auditor may ‘low ball’<sup>206</sup> as a competitive response.

8.54 This practice of low balling, and its impact on auditor independence, has caused considerable contention in the literature. Some theorists argue that the practice, of itself, impairs independence.<sup>207</sup> Others, such as DeAngelo<sup>208</sup> argue that while the concept is related to the existence of future economic interest, the practice itself does not damage independence. Finally, some theorists contend that it is, in fact, beneficial to the public.<sup>209</sup>

8.55 The *Cohen Report*,<sup>210</sup> in denouncing low balling, likened the resulting situation to giving management a bail bond which could be used to induce docility in the auditor through threats of replacement. Lee and Gu<sup>211</sup> criticise this argument in that it implies that the auditor is only the agent

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<sup>201</sup> See, eg, P L Titard, ‘Independence and MAS- Opinions of Financial Statement Users’ (1971) *Journal of Accountancy* 47; Randolph Shockley, ‘Perceptions of Audit Independence: An Empirical Analysis’ (1982) 56(4) *Accounting Review* 785.

<sup>202</sup> Above n 148, 77.

<sup>203</sup> Above n 119, 35-38.

<sup>204</sup> A Arens and James Loebbecke, *Auditing, an Integrated Approach* (1976).

<sup>205</sup> DeAngelo, above n 119, 36.

<sup>206</sup> ‘Low balling’ is a term used to describe the practice of introductory pricing whereby an auditor is willing to price the initial engagement below total costs in the knowledge that they can increase their fee above total costs in future periods. One reason for concern is that introductory pricing can be indicative of a predatory pricing strategy. See, eg, P Areeda and D F Turner, ‘Predatory Pricing and Related Practices Under Section 2 of the Sherman Act’ (1975) 88 *Harvard Law Review* 697 in relation to predatory strategies in auditing.

<sup>207</sup> See, eg, Commission on Auditors’ Responsibilities, *Report, Conclusions and Recommendations* (1978) (‘*Cohen Report*’).

<sup>208</sup> Above, n 89.

<sup>209</sup> See, eg, Arrunada, above n 150.

<sup>210</sup> Above n 207.

<sup>211</sup> Chi-Wen Jevons Lee and Zhaoyang Gu, ‘Low Balling, Legal Liability and Auditor Independence’ (1998) 73(4) *Accounting Review* 533, 535.

of management,<sup>212</sup> and not of the owners. Further, it disregards the existence of legal liability. They develop a multi-agent moral hazard model,<sup>213</sup> under which hiring and firing the auditor is the responsibility of the owners/shareholders, and find that low balling enhances independence. Their model shows that low balling ‘creates the same kind of disincentive for unscrupulous auditor behaviour as does auditors’ legal liability, but it does so for less cost.’<sup>214</sup>

8.56 However, this result is largely contingent on the assumption that the power to hire and fire rests with shareholders. As the authors themselves are cognisant,<sup>215</sup> this is not entirely consistent with the institutional reality. If this assumption is reversed and the power is handed to management, low balling is found to be deleterious to auditor independence, consistent with the *Cohen Report*.<sup>216</sup> The authors note<sup>217</sup> that the reality ‘lies somewhere between these extremes: the owners or their representatives are actively involved and the managers also have limited power to hire and fire the auditors.’<sup>218</sup> They conclude that to the extent the actuality lies at least in this middle ground, and therefore the power is not entirely with management, low balling, as demonstrated by their model, can enhance the monitoring process and lead to improved independence.

8.57 DeAngelo<sup>219</sup> argues that low balling does not impair independence as the price reduction is a sunk cost in future periods. The competitive advantages of the incumbent auditor described above are identified by DeAngelo as assets specialised to the specific client and the auditor. The creation of these assets has implications for the future relationship between the parties, as where they exist, termination by one party will be costly to the other. With this knowledge, both the auditor and the client can procure gains (higher fees and acquiescence on some matters respectively) through the *threat* of termination. DeAngelo terms this situation a ‘bilateral monopoly’.<sup>220</sup> Where these potential gains to incumbency are coupled with a competitive initial audit market, low balling may result.

8.58 DeAngelo uses the analytical model developed in the study to examine regulation intended to enhance independence through augmenting the disclosure requirements when an auditor is changed.<sup>221</sup> The author contends that the *Cohen Report*<sup>222</sup> is ‘over simplistic’. She claims that

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<sup>212</sup> Cf Antle, above n 128.

<sup>213</sup> Moral hazard may arise in this multi-agent situation because the auditor, as the monitoring agent, may have the incentive to conceal or misrepresent information about the manager, the monitored agent, in exchange for a ‘side payment’: Lee and Gu, above n 211, 533.

<sup>214</sup> Lee and Gu, above n 211, 534.

<sup>215</sup> *Ibid* 535.

<sup>216</sup> Above, n 207.

<sup>217</sup> Lee and Gu, above n 211, 550-551.

<sup>218</sup> *Ibid*.

<sup>219</sup> Above n 89, 115.

<sup>220</sup> *Ibid* 118.

<sup>221</sup> DeAngelo examines the US initiatives from the 1970s, ASR-165 and ASR-250. Where there has been a change of auditor, ASR-165 requires disclosure of significant disagreements within the last two financial years and their effect if material, the auditor resignation and new appointment, and a response by the former auditor. ASR-250 relates to the fee relationship, and requires the services provided to be disclosed, along with the percentage non-audit fees represents in relation to audit fees and any non-negotiable audit fee limits: DeAngelo, above n 89, 124.

although it is correct that the effectiveness of client threats decreases with increased external scrutiny, such as disclosure of significant disagreements between the auditor and client, the report fails to acknowledge that the optimal level of independence is also reduced due to the increase in future economic interest from the client that will occur, all else held constant. This increase in future ‘rents’ occurs because such legislation increases the costs of changing auditors. DeAngelo extends this line of reasoning to suggest that the net effect of such rules is therefore inconclusive, and, further, as the initial bidding for these increased future profits increases, more low balling will occur. The author concludes that regulation restricting low balling, such as the initiatives considered in her paper, must either result from a mistaken belief that decreasing introductory pricing enhances independence, or it is a veiled attempt to preserve monopoly profits for auditors.<sup>223</sup>

8.59 Benito Arrunada agrees that a lack of understanding of low balling has led to several incorrect regulatory initiatives,<sup>224</sup> and claims that ‘such rules are self defeating...in terms of both independence and competition.’<sup>225</sup> He reiterates the resultant increase in ‘quasi-rents’ and notes the negative impact on competition arising from the increased costs of changing auditors. He also concludes that the push to restrict low balling may have arisen through the desire to preserve ‘monopolistic rents than with the alleged objective of preserving independence.’

8.60 Magee and Tseng<sup>226</sup> extend the work of DeAngelo by taking into account the level of agreement between auditors in the market as to the acceptability of a client’s choice of accounting policy, before considering independence. This will depend, to some extent, on the level of discretion available within generally accepted accounting principles (GAAP). They find that although low balling will occur whether or not there is agreement between auditors as to the appropriate choice of policy, independence will only be damaged where there is auditor disagreement.

8.61 The model proposed by Magee and Tseng was tested by Calegari, Schatzberg and Sevik.<sup>227</sup> The authors note that the Magee and Tseng model did not predict cooperation between management and auditor for mutual gain. Using an experimental design creating eight markets representing agreement, and eight for disagreement they tested the predicted effect of auditor agreement. Next, they partitioned the sample into a control and treatment group and tested the price-independence prediction. In this experiment, they provided an incentive to cooperate through imposing only a low penalty on an auditor who impaired his or her independence. The findings in the control group and half of the treatment group are consistent with the model predictions and imply that auditor independence is greater where there is agreement as to appropriate policy, and that a high penalty need not be imposed to prevent damage to independence. However, in the other half of the treatment group, evidence of cooperative strategies is evinced, and, under further tests, that auditors may damage independence even where there is inter-auditor accord. Where the penalty for impaired

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<sup>222</sup> Above n 207.

<sup>223</sup> Above n 89, 125.

<sup>224</sup> Arrunada, above n 150, 5, uses the example of the EU Green Paper item 4.11 in Official Journal of the European Communities, *Green Paper on the Role, the Position and the Liability of the Statutory Auditor within the European Union* (96/C 321/01) (1996).

<sup>225</sup> *Ibid.*

<sup>226</sup> R Magee and N Tseng, ‘Audit Pricing and Independence’ (1990) *Accounting Review* 315.

<sup>227</sup> Michael Calegari, Jeffrey Schatzberg and Galen Sevik, ‘Experimental Evidence of Differential Auditor Pricing and Reporting Strategies’ (1998) 73(2) *Accounting Review* 255.

independence is increased, findings indicate that auditors remain independent, suggesting penalties may be required to bond auditors to independence.

8.62 Dye's<sup>228</sup> model, contrary to that of DeAngelo<sup>229</sup> above, predicts that where audit pricing is disclosed, low balling will not occur. The author contends that the driver of DeAngelo's results is the underlying assumption that the auditor controls fees for periods subsequent to the initial audit. Dye tests the effect of this auditor-client power relationship on pricing and independence. He concludes that low balling results from non-transparent audit fees rather than contracting costs as determined by DeAngelo.

8.63 Craswell and Francis<sup>230</sup> document studies that found significant low balling in the United States under non-disclosure conditions.<sup>231</sup> That is, where audit fees were not normally publicly disclosed in the United States at the time the studies were undertaken.<sup>232</sup> Furthering these results by investigating a similar sample of Australian companies under disclosure conditions, the authors found little evidence of low balling. These results are consistent with Dye as opposed to DeAngelo. However, where the auditor change was from non-Big eight to Big Eight (as it then was), low balling was documented. Craswell and Francis posit the notion of experience goods<sup>233</sup> to explain this phenomenon.

8.64 Butterworth and Houghton<sup>234</sup> also investigated the presence of low balling in the Australian market. The authors tested for low balling using a regression model of audit fees on a sample of Western Australian companies. Although they found that the initial audit fee was lower than subsequent billings, this difference was insignificant, leading to the rejection of the proposition that new auditors charge less than incumbents.

### **Employment relationships**

8.65 The threat posed to auditor independence by former employees of audit firms gaining employment with clients is an issue that has 'been discussed by the SEC and the profession for years, as the frequency of partners and other senior professionals leaving their firms to join audit clients has increased.'<sup>235</sup> From a client's perspective, there are many advantages to hiring a former

<sup>228</sup> R Dye, 'Informationally Motivated Auditor Replacement' (1991) 14 *Journal of Accounting and Economics* 347.

<sup>229</sup> Above n 89.

<sup>230</sup> Allen Craswell and Jere Francis, 'Pricing Initial Audit Engagements: A Test of Competing Theories' (1999) 74(2) *Accounting Review* 201.

<sup>231</sup> See, eg, M Etteredge and R Greenberg, 'Determinants of Fee Cutting on Initial Audit Engagements' (1990) 28 *Journal of Accounting Research* 198.

<sup>232</sup> The two principal studies considered in the paper, Etteredge and Greenberg, above n 231, and D Simon and J Francis, 'The Effects of Auditor Changes on Audit Fees: Tests of Price Cutting and Price Recovery' (1988) 63 *Accounting Review* 255, used samples covering the early to mid-1980s. The lack of audit fee disclosure in this era can be contrasted to the position since the adoption by the Securities and Exchange Commission of new audit rules in November 2000.

<sup>233</sup> Experience goods exist where higher priced and quality goods are sold at a low introductory price to induce consumers to 'experience' them such that uncertainty as to quality can be settled: Craswell and Francis, above n 230, 203.

<sup>234</sup> S Butterworth and K A Houghton, 'Auditor Switching: The Pricing of Audit Services' (1995) 22(3) *Journal of Business Finance and Accounting* 323.

<sup>235</sup> Independence Standards Board (ISB), *Annual Report* (1998).

auditor. Auditors in the large firms are commonly distinguished graduates from the best schools,<sup>236</sup> and possess other appealing attributes including breadth of experience<sup>237</sup> and exposure to varied and complex financial transactions.<sup>238</sup> Further, the 'former auditor is intimately familiar with the client's business strategy, financial reporting processes, and industry peculiarities.'<sup>239</sup> Indeed, a recent study by Behn *et al.*,<sup>240</sup> observed that among Fortune 1000 companies, 33% of financial controllers had prior experience with the current audit firm.

8.66 Auditor employment with client firms raises a number of issues with respect to independence. At the outset, there is a question as to the ability of remaining auditors to be independent and exercise proper due diligence when dealing with the ex-colleague,<sup>241</sup> especially where that ex-colleague held a senior position within the audit firm. This may arise through a reticence to query the former colleague.<sup>242</sup> This is exacerbated by the inside knowledge the former auditor will hold with respect to the practices of the audit firm.<sup>243</sup> Knowing exactly what the auditors are looking for and the strategy they are likely to follow can facilitate concealment. Further, in the period preceding employment with the client, the auditor may attempt to ingratiate him or herself with the client through taking a more lenient approach to the client's compliance with the relevant accounting standards.<sup>244</sup>

8.67 On the whole, empirical studies have supported the concerns raised above with regards to the damage to real or perceived independence caused by auditor employment with clients. The literature is not as saturated with empirical research as was the case for NAS, but several studies have examined the issue, primarily on a perceptual level. In an early study, Imhoff<sup>245</sup> used a questionnaire approach to gauge the perceptions of users of financial statements, represented by (i) bankers and financial analysts, and (ii) CPAs, where an auditor gained employment in a client firm. The hypothetical situations posed to the respondents explored two dimensions: firstly, the nature of the role of the auditor while auditing the client, and whether this was supervisory or not, and secondly, the time lag between the audit engagement and accepting the appointment within the client firm. Results indicated that as the length of time to employment increased or where the nature of the auditor's role was non-supervisory, less of a threat was posed to independence. In all cases examined, the group of bankers and financial analysts perceived a higher threat to independence than the CPA group, with the greatest difference being where an employment offer was accepted within six months of an audit supervisor working as an auditor of the client firm (68% of users queried independence compared to 40% of CPAs).

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<sup>236</sup> Mark Beasley, Joseph Carcello and Dana Hermanson, 'Should you offer a job to your external auditor?' (2000) 11(4) *Journal of Corporate Accounting & Finance* 35, 35.

<sup>237</sup> Eugene Imhoff, Jr, 'Employment Effects on Auditor Independence' (1978) 53(4) *Accounting Review* 869.

<sup>238</sup> Beasley, Carcello and Hermanson, above n 236, 36.

<sup>239</sup> *Ibid.*

<sup>240</sup> Bruce Behn, Joseph Carcello, Dana Hermanson and Roger Hermanson, 'Client Satisfaction and Big 6 Audit Fees' (1999) 16(4) *Contemporary Accounting Research* 587.

<sup>241</sup> Imhoff, above n 237, 870.

<sup>242</sup> Beasley, Carcello and Hermanson, above n 236, 37.

<sup>243</sup> *Ibid.*

<sup>244</sup> Beasley, Carcello and Hermanson, above n 236, 36. See also Imhoff, above n 237, 870.

<sup>245</sup> Above, n 237.

8.68 The next major study was completed by Michael Firth in 1981.<sup>246</sup> In his paper, he explored the influence of certain facets of the auditor-client relationship on the lending decision of bankers. A questionnaire approach was used, sending financial statements with audit reports to 1700 members of the Institute of Bankers and receiving a 74% response rate. Attached to the information was a note on the auditor-client relationship, covering nine different situations.<sup>247</sup> Results on the relationship where a former audit firm partner was now the financial director of the client indicated that bankers were concerned that independence could be compromised in this situation, evidenced by an intention to grant a smaller loan. These results were supported by Schleifer and Shockley.<sup>248</sup>

8.69 Koh and Mahathevan<sup>249</sup> used a different experimental design for their examination of the employment relationship. Following a between-subjects methodology as opposed to a within-subjects methodology,<sup>250</sup> the authors add to the previous study by Imhoff<sup>251</sup> by adding the two additional factors of the type of opinion issued by the auditor prior to leaving the audit firm, and the position of the former auditor within the client. Using a case study questionnaire, managers' perceptions were analysed in relation to the last audit performed by the ex-auditor and subsequent audits performed after the ex-auditor took up the position within the client. In relation to the nature of the ex-auditor's role, two key findings on perceptions on the threat to independence arose. Firstly, perceptions were found to increase where the auditor's previous role in the audit firm was supervisory, and secondly, where the current role in the client involves preparation of financial statements. With regards to the time lag before appointment, perceptions of threats to independence were found to increase as the time between the last audit and appointment within the client decreased.

8.70 The above studies should be viewed in light of their limitations.<sup>252</sup> Of primary concern is their reliance on perceptions, which will not necessarily be translated into actions. Further, a survey-style approach necessarily creates an artificial situation that may not contain all the

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<sup>246</sup> Michael Firth, 'Auditor-Client Relationships and their Impact on Bankers' Perceived Lending Decisions' (1981) 11 *Accounting and Business Research* 179.

<sup>247</sup> These relationships were (1) an independent relationship; (2) the accounting firm receives 15% of gross fees from the client; (3) audit partner has been in sole charge of a large audit; (4) the financial director was previously a partner for 10 years with the audit firm; (5) the partner in charge owns 1000 shares (out of one million) in the client; (6) a partner in the audit firm who is not involved in the audit is the trustee of a trust that owns 10% of the client firm; (7) a partner in the audit firm managed a building owned by the client; (8) the audit firm provided other services including preparation of financial statements; and (9) the audit firm provides the client MAS from a separate consultancy arm, Firth, above n 246, 181.

<sup>248</sup> Linda Schleifer and Randolph Shockley, 'Policies to Promote Auditor Independence; More Evidence on the Perception Gap' (1990) *Journal of Applied Business Research* 10.

<sup>249</sup> Hian Chye Koh and Premila Mahathevan, 'The Effects of Client Employment on Auditor Independence' (1993) 25 *British Accounting Review* 227.

<sup>250</sup> A between-subjects methodology requires subjects to respond to only one level of manipulated variables, whereas a within-subject methodology solicits a response to more than one level: Kurt Pany and Philip Reckers, 'Within - Vs. Between-Subjects Experimental Designs: A Study of Demand Effects' (1987) 7(1) *Auditing: A Journal of Practice & Theory* 39, 39. The results in this study, which examined the provision of MAS, indicated that the experimental design might affect the results obtained.

<sup>251</sup> Above, n 237.

<sup>252</sup> Firth, above n 246, 184 is cognisant of these limitations.

information or conditions that would be required in a real case. Finally, the impact of non-response bias on the validity of results should be considered in any survey-style experimental design.<sup>253</sup>

8.71 The issue of client employment was further developed by Parlin and Bartlett<sup>254</sup> through the consideration of real independence, as opposed to independence in appearance. In the study, the auditor-subjects were asked to determine an initial estimate of materiality. Each auditor was provided with background information, which, amongst other things, advised as to whether or not the controller of the company was a recent ex-auditor of the audit firm. The findings, which established a larger materiality estimate was made where the controller was a former auditor, were consistent with ex-auditor employment having an adverse effect on independence.

8.72 Beasley, Carcello and Hermanson<sup>255</sup> discuss a study of instances of fraudulent reporting they were commissioned to undertake by the Committee of Sponsoring Organizations of the Treadway Commission. In this report, the authors found some connection between client employment of ex-auditors and financial fraud. In a final sample of 44 fraud-related SEC enforcement actions, the current CFO had joined the client immediately post leaving the audit firm in five, or 11 percent of cases. The authors discussed an anecdote where Livent, a producer of Broadway shows hired an ex-auditor from their audit firm, Deloitte, and quoted the following passage from an article in the *National Post* (January 19, 1999) to highlight the concerns that arise from employing an ex-auditor:

‘Having a top officer who knew how Deloitte [the external audit firm] worked, and what its auditors were looking for, no doubt made it easier for the company to keep auditors from finding evidence of any fraud. She [the new CFO] also had credibility with former colleagues when questions arose, which may have been used to reassure them if something suspicious was noticed.’

8.73 The above studies indicate that employment of an ex-auditor with a client poses a threat to auditor independence, to a degree varying depending on the particulars of the situation. These results have policy implications. Imhoff<sup>256</sup> raised the concern, however, that prohibitions against auditors considering taking up employment with a client during the term of an audit would be ineffective due to hesitance on the part of other auditors in the team to disclose the situation.

8.74 A recent article by Kaplan and Whitecotton<sup>257</sup> found results consistent with these concerns. The authors examined the reporting intentions of other auditors where an audit team member had been offered employment with the client firm, and, contrary to ethics rulings, was considering that offer without withdrawing from the audit commitment. Extending a model by Schultz, Johnson, Morris and Dyrnes,<sup>258</sup> the authors predict that where an auditor appreciates that a ‘questionable’ act has transpired, the likelihood that the act will be reported will be related to three factors. Firstly, the

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<sup>253</sup> F N Kerlinger, *Foundations of Behavioural Research* (1973) examines the effects of non-response bias.

<sup>254</sup> J C Parlin and R W Bartlett, ‘Prior Employment and Independence in Fact’ (1994) 13 (1&2) *Business & Professional Ethics Journal* 185.

<sup>255</sup> Above, n 236, 38-41.

<sup>256</sup> Above, n 237.

<sup>257</sup> Steven Kaplan and Stacey Whitecotton, ‘An Examination of Auditors’ Reporting Intentions When Another Auditor is Offered Client Employment (2001) 20(1) *Auditing: A Journal of Practice & Theory* 45.

<sup>258</sup> J J Schultz Jr, D A Johnson, D Morris and S Dyrnes, ‘An Investigation of the Reporting of Questionable Acts in an International Setting’ (1993) 31(Supplement) *Journal of Accounting Research* 75.

gravity of the act in question, secondly, the level of reporting responsibility the particular individual believes they are subject to, which may be related to their position or personal factors, and, finally, the costs they feel they will incur at a personal level as a result of reporting the act.

8.75 Seventy-five audit seniors from a large international firm were asked to participate in the study, resulting in 73 useable responses. Each subject was asked to provide an anonymous response to a case study. They were provided with information concerning the client company, and informed that the audit manager had been involved in three previous audits of the particular company, and was liked by the company. The auditors were then told that the manager had been offered employment with the client company but had not removed himself from the engagement. The auditors were also given information on both the ethics ruling and the potential for the situation to impair independence. The reporting obligations of other auditors observing the behaviour were not explained to the subjects, who were then asked to provide responses to several variables. These included a scaled response of the likelihood they or others would report the behaviour, the seriousness of the act, their responsibility to report and the costs of doing so. They further included 'manipulated' variables relating to the character of the CEO of the client company and the audit manager.

8.76 Results established that the auditors considered the personal costs of reporting were quite high, but that the gravity of the act was only moderate, as was their responsibility to report. The measured likelihood of reporting the incident was low for both the auditor personally, and for the perceived position of other auditors, indicating that auditors are not likely to report this type of behaviour in colleagues.

8.77 The authors point out that '[t]his result is somewhat paradoxical since a primary role of the auditor is to seek out and report the questionable behavior of clients.'<sup>259</sup> They propose that the issue be tackled by audit firms encouraging reporting through two methods. Initially, by working to strengthen perceptions of personal responsibility within the firm, and, next, by reinforcing the notion that reporting this type of situation will be at little cost to the employee.

### **Other factors**

8.78 The above discussion covers several of the major areas for concern in relation to auditor independence. There are further factors that have been argued in the academic literature to impact independence. These include length of auditor tenure, financial interests in auditees, ambiguity of accounting rules and opinion shopping by auditees.

#### ***Length of auditor tenure***

8.79 Theorists have hypothesised that as tenure increases, so too do perceptions that the auditor may be more accommodating to the client.<sup>260</sup> This may arise for many reasons,<sup>261</sup> but Mautz and Sharaf warn that the 'greatest threat to...independence is a slow, gradual, almost casual erosion of [the auditor's] honest disinterestedness'.<sup>262</sup> Teoh and Lim<sup>263</sup> and Beck, Frecka and Solomon<sup>264</sup>

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<sup>259</sup> *Ibid* 61.

<sup>260</sup> See, eg, Shockley, above n 201.

<sup>261</sup> Shockley cites 'complacency, lack of innovation, less rigorous audit procedures, and a learned confidence in the client' as key dangers arising as tenure increases: above n 201, 789. Following DeAngelo, above n 119, another explanation could be the desire not to lose future economic interest in the client.

<sup>262</sup> Above n 79, 208.

considered the relevance of the length of auditor tenure to independence. The latter authors provide some evidence that when certain MAS services are provided by the auditor, tenure increases, whilst the variability of tenure decreases.<sup>265</sup>

8.80 Shockley tested the hypothesis that perceptions of impaired auditor independence increase when the period of tenure surpasses five years. The author used a sample comprising firstly certified public accountants (CPAs), and then bank loan officers and financial analysts to represent creditors and investors respectively, two key groups of financial report users. The subjects completed a questionnaire, which required them to rate the risk to independence under a number of scenarios. This information was then analysed using analysis of variance (ANOVA). The effect of tenure overall was not found to be significant, but for the sub-group of bank loan officers, increased tenure was perceived to impair independence. A study by Knapp<sup>266</sup> also found that groups of CPAs and financial analysts did not consider auditor tenure a threat to independence.

8.81 Wright<sup>267</sup> used a laboratory setting to investigate the relationship between factors including tenure and the type of audit report that would be issued where material uncertainties existed. The type of report was found to be related to the length of the auditor-client relationship, but not to a significant level. Barkess and Simnett<sup>268</sup> examined the relevance of the stability of auditor tenure, and whether this increased with the provision of NAS. However, no relationship between the stability of auditor tenure and NAS provision was found.

8.82 Carey and Simnett<sup>269</sup> investigated audit partner tenure and the potential impact this might have on audit quality. Using a sample of Australian listed companies during the period from 1987 to 1993, the authors tested the relationship between tenure and the probability of audit qualification. Findings suggested a negative association between the two variables, implying a potential threat to independence with increased tenure. However, the tests relied on audit qualification as a proxy for quality, and this may be influenced by numerous other factors.<sup>270</sup>

### ***Financial interest in auditees***

8.83 Financial interest in the auditee has been considered by Pany and Reckers<sup>271</sup> and Lindsay, Rennie, Murphy and Silvester,<sup>272</sup> although such interests are widely prohibited. Pany and Reckers,

<sup>263</sup> H Y Teoh and C C Lim, 'An Empirical Study of the Effects of Audit Committees, Disclosure of Non-Audit Fees, and Other Issues on Auditor Independence: Malaysian Evidence' (1996) 5(2) *Journal of Accounting, Auditing and Taxation* 231.

<sup>264</sup> Beck, Frecka and Soloman, above n 145.

<sup>265</sup> *Ibid.*

<sup>266</sup> Michael Knapp, 'Factors that Audit Committee Members Use as Surrogates for Audit Quality' (1991) 62(3) *Accounting Review* 578.

<sup>267</sup> A Wright, 'The Impact of CPA Firm Size on Auditor Disclosure Preferences' (1983) *Accounting Review* 621.

<sup>268</sup> Above n 173.

<sup>269</sup> Peter Carey and Roger Simnett, 'Audit Partner Tenure: Implications for Audit Quality and Mandatory Rotation Policy' (Working Paper, Monash University, 2001).

<sup>270</sup> Indeed, the authors are currently revising the paper, including changing the proxy for quality to the level of discretionary accruals.

<sup>271</sup> Kurt Pany and Philip Reckers, 'The Effects of Gifts, Discounts and Client Size on Perceived Auditor Independence' (1980) 55(1) *Accounting Review* 50.

for example, considered the impact of gifts and purchase discount arrangements on perceptions of auditor independence. The authors obtained a random sample of shareholders who had recently purchased a block of shares, and asked the subjects to evaluate the ability of an auditor to withstand client pressure. Gifts and purchase discount arrangements were found to significantly impact perceptions of independence.<sup>273</sup>

8.84 Firth<sup>274</sup> examined the perceptions of bankers in relation to financial interests<sup>275</sup> including where a partner owns 1000 out of a total one million shares on issue. Using a random sample of 1700 members of the Institute of Bankers in the United Kingdom, the author found that the responses were widely varied. 10% of respondents believed that where such an interest was held, loan prospects were, in fact, enhanced.<sup>276</sup> However, the average response was in line with the wider view, which fears a threat to independence.

### *Ambiguity of accounting rules*

8.85 Research has also been directed at the complexity of rules and the level of discretion available in generally accepted accounting principles (GAAP). These studies generally indicate that as the level of ambiguity increases, so to does the risk of impairment to auditor independence.<sup>277</sup> In the context of a tax audit, Klepper, Mazur and Nagin<sup>278</sup> submit a model that indicates that involvement of an expert will encourage compliance where there is no ambiguity, but will have the opposite effect where discretion exists. Where discretion exists, it is difficult to draw a direct conclusion that the auditor acted as a result of compromised independence, as their decision fell within the 'accepted' framework. When there is no ambiguity, auditors are likely to remain independent for fear of the detriment to their reputation if they did not report the truthful value.<sup>279</sup> In the auditor context, Magee and Tseng<sup>280</sup> find that low balling will occur whether or not there is ambiguity in the appropriate accounting policy choice, but that independence will only be damaged if there is disagreement amongst auditors in relation to the appropriate accounting treatment. Testing the model offered by the previous authors, Calegari, Schatzberg and Sevik<sup>281</sup> found that independence might be impaired in some cases even where there is agreement between auditors. These results build on the model by Magee and Tseng by incorporating a dimension allowing for cooperative strategies between management and auditor. The authors suggest that under some

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<sup>272</sup> D Lindsay, M Rennie, G Murphy and H Silvester, 'Independence of External Auditors: A Canadian Perspective' (1987) 1 *Advances in International Accounting* 169.

<sup>273</sup> Pany and Reckers, above n 271.

<sup>274</sup> Above n 246.

<sup>275</sup> Other interests were also examined, see above n 247.

<sup>276</sup> Firth posits that this may be because bankers interpret the holding of shares by the auditor as an inside 'expression of confidence' in the company, *ibid* 187.

<sup>277</sup> See, eg, S Klepper, M Mazur and D Nagin, 'Expert Intermediaries and Legal Compliance: The Case of Tax Preparers' (1991) 34(1) *Journal of Law and Economics* 205.

<sup>278</sup> *Ibid*.

<sup>279</sup> Brian Mayhew, Jeffrey Schatzberg and Galen Sevcik, 'The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Independence' (Working Paper, University of Wisconsin at Madison, 2000).

<sup>280</sup> Above n 226.

<sup>281</sup> Above n 227.

conditions penalties might need to be imposed to deter auditors from compromising their independence.

### *Opinion shopping by auditees*

8.86 Finally, opinion shopping by clients, whereby an auditor change may follow a qualified audit report, is another area for concern. In this respect, Bell and Tabor note that the fact ‘that auditors do not qualify every client experiencing financial difficulty...indicates that qualifying is not costless.’<sup>282</sup> Several studies have found that an increased likelihood to switch auditors is associated with receipt of a qualified opinion.<sup>283</sup> However, in many of these cases, the new auditor was found to also provide a qualified opinion.<sup>284</sup> In addition, conservatism amongst auditors has been documented.<sup>285</sup> Conservatism refers broadly to following a less accommodating approach to accounting policy choice and measurement. Further, the results of Jeter and Shaw<sup>286</sup> suggest, contrary to speculation that auditors may try to entice clients through accommodating their wishes, that where solicitation of audit clients is permitted, more qualified opinions are issued than where solicitation is disallowed. Beattie and Fearnley<sup>287</sup> documented a statistically significant relationship between unsolicited approaches by audit firms and either a subsequent competitive tender or a contemplation of auditor change. This could indicate that even if clients attempt to opinion shop, auditors will not be led to compromise their independence as a result.

8.87 Butterworth and Houghton<sup>288</sup> considered opinion shopping as an alternative explanation for the anecdotal evidence of fee-cutting. Opinion shopping would indicate that competition between auditors is driven by the nature of the audit opinion rather than price. However, with insignificant results, the authors concluded that this phenomenon was not a driving factor of the results.

8.88 A common research formulation for studying opinion shopping attempts to relate audit opinions to audit fees. These papers are generally premised upon the argument that audit fees may influence or impact the opinion issued by the auditor. Houghton and Jubb,<sup>289</sup> on the other hand, investigate the converse of this theme. That is, they study the influence of the audit opinion on audit fees. In particular, the authors argue that a qualified opinion is associated with higher production costs and that these costs may be recovered through an increase in fees. However, given the relative

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<sup>282</sup> P Bell and P Tabor, ‘Empirical Analysis of Audit Uncertainty Qualifications’ (1991) 29 *Journal of Accounting Research* 350, 367.

<sup>283</sup> See, eg, D Jeter and P E Shaw, ‘Solicitation and Auditor Reporting Decisions’ (1995) 70 *Accounting Review* 293; J Krishnan, ‘Auditor Switching and Conservatism’ (1994) 69(1) *Accounting Review* 200.

<sup>284</sup> Cf A T Craswell, ‘The Association Between Qualified Opinions and Auditor Switches’ (1988) *Accounting and Business Research* 23, which found that unqualified opinions were issued by the new auditor.

<sup>285</sup> J Krishnan and R G Stephens, ‘Evidence on Opinion Shopping from Audit Opinion Conservatism’ (1995) 14(3) *Journal of Accounting and Public Policy* 179.

<sup>286</sup> Above n 283.

<sup>287</sup> Vivien Beattie and Stella Fearnley, ‘Audit Market Competition: Auditor Changes and the Impact of Tendering’ (1998) 30 *British Accounting Review* 261.

<sup>288</sup> Above n 234.

<sup>289</sup> K A Houghton and C A Jubb, ‘The Cost of Audit Qualifications: The Role of Non-Audit Services’ (1999) 8(2) *Journal of International Accounting, Auditing and Taxation* 215.

inflexibility of audit fees alone,<sup>290</sup> NAS fees may also be employed in the recapture of these costs. Consistent with the constraints imposed on audit fees, they posit that increased NAS fees will be observable concurrently with the qualified opinion, but that the increase in audit fees will be subject to a lag.

8.89 The theories used to develop this hypothesis are based upon the idea that qualified opinions are associated with higher audit risk. Quoting Dopuch, Holthausen and Leftwich,<sup>291</sup> and, amongst others, Simunic and Stein,<sup>292</sup> Houghton and Jubb<sup>293</sup> link this higher risk to uncertainty often being associated with auditees likely to receive qualified opinions, and increased litigation risk for the auditors of these clients.<sup>294</sup> The argument that qualified opinions attract higher fees, then, stems from the idea<sup>295</sup> that auditors who take on high-risk clients will require compensation for assuming the additional risk. Further, they note that a qualified opinion will usually require more hours to complete the audit, and that audit fees are likely to reflect hours used.

8.90 The authors investigated the annual reports of 270 companies for the years 1987 and 1988. After controlling for factors such as size and complexity, their findings suggest a significant positive relationship between qualified opinions and increased fees (both audit and NAS) in the year of the opinion and the following year. However, the 270 companies in the sample were dominated by mining companies in the limited area of Western Australia, which could impact the ability to generalise the results.

8.91 On the whole, the results of the opinion shopping papers highlight the concerns raised by opinion shopping by auditees, but also mitigate them to some extent. Although auditor 'switching' has been documented to occur following qualification,<sup>296</sup> the literature, as discussed above, demonstrates a number of possible explanations for this phenomenon.

## WHAT FACTORS CAN ENHANCE INDEPENDENCE?

8.92 Section 4 identified several threats to auditor independence. This section identifies several mechanisms that have been documented to have a positive effect on auditor independence. They include:

- (a) moral or ethical factors;
- (b) reputation of the auditor; and

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<sup>290</sup> The authors assert that two factors that may lead to inflexibility in audit fees are audit fee tendering and fixed audit fee billing: *ibid* 216.

<sup>291</sup> N Dopuch, R W Holthausen & R W Leftwich, 'Predicting Audit Qualifications with Financial and Market Variables' (1987) 52(3) *Accounting Review* 431.

<sup>292</sup> Dan Simunic and M T Stein, 'The Impact of Litigation Risk on Audit Pricing: A Review of the Economics and the Evidence' (1996) 15 (Supplement) *Auditing: A Journal of Theory and Practice* 119.

<sup>293</sup> Above n 289.

<sup>294</sup> The authors note that financial distress increases chances for errors, motivation for management manipulation, auditor/client dispute, the probability of non-routine management changes and lags in the timeliness of filing auditor change announcements: above n 289, 217.

<sup>295</sup> Simunic and Stein, above n 292.

<sup>296</sup> See eg Jeter and Shaw, above n 283.

- (c) legal liability.

### Moral or ethical factors

8.93 The following passage from the April 1933 Hearings (US Congress, Senate Committee on Banking and Currency, 58) is widely quoted with respect to the public accountant requiring some overseeing ethical dimension:

**Senator Barkley:** You audit the controller?  
**Mr Carter:** Yes, the public accountant audits the controller's account.  
**Senator Barkley:** Who audits you?  
**Mr Carter:** Our conscience.

8.94 Some theorists argue, contrary to classical economic theory, that economic rationality or self-interest may be tempered by a broader social purpose. Hausman and McPherson<sup>297</sup> note that 'the morality of economic agents influences their behavior and hence influences economic outcomes.' In a recent study by Barry Cushing, a new approach was taken by incorporating a moral cost into the utility function of the auditor.<sup>298</sup> Maury emphasises that the 'ethical decisions that accountants make about their independence and objectivity need to be more than just compliance decisions, they need to be based on a very strong sense of public integrity'.<sup>299</sup> Some studies have found that the degree of ethical behaviour demonstrated by an auditor is significantly related to the culture of the audit firm.<sup>300</sup>

8.95 An experimental study presented by Falk, Lynn, Mestelman and Shehata<sup>301</sup> attempted to extend the current literature by assessing the prior beliefs and expectations of the auditor as a part of a laboratory experiment on independence. They concluded that 'amoral, self-interested profit maximizing behavior does not generally characterize the subjects in this experiment.' Such results suggest that an auditor's ethics or conscience may override profit maximisation motives in certain circumstances. However, using an ethical decision process model they outlined, Lampe and Finn<sup>302</sup> concluded that the Code of Conduct developed by the American Institute of Certified Public Accountants (AICPA) was generally inadequate to stimulate ethical behaviour. This conclusion was drawn from a comparison of their decision process model for auditors and the AICPA Code decision model.

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<sup>297</sup> D M Hausman and M S McPherson, 'Taking Economics Seriously: Economics and Contemporary Moral Philosophy' (1993) 31(2) *Journal of Economic Literature* 671.

<sup>298</sup> See, eg, Barry Cushing, 'Economic Analysis of Accountants' Ethical Standards: The Case of Audit Opinion Shopping' (1999) 18 *Journal of Accounting and Public Policy* 339.

<sup>299</sup> Mary Maury, 'A Circle of Influence: Are all the Stakeholders Included?' (2000) 23(1) *Journal of Business Ethics* 117.

<sup>300</sup> See, eg, L A Poneman and A Glazer, 'Accounting Education and Ethical Development: The Influence of Liberal Learning on Students and Alumni in Accounting Practice' (1990) 5(2) *Issues in Accounting Education* 195.

<sup>301</sup> Haim Falk, Bernadette Lynn, Stuart Mestelman, and Mohamed Shehata, 'Auditor Independence, Self-Interested Behavior and Ethics: Some Experimental Evidence' (1999) 18(4/5) *Journal of Accounting and Public Policy* 395.

<sup>302</sup> J C Lampe and D W Finn, 'A Model of Auditors' Ethical Decision Processes' (1992) 11(Supplement) *Auditing: A Journal of Practice and Theory* 33.

## Reputation

8.96 The role of reputation as a deterrent to compromising independence has been widely acknowledged. DeAngelo, for example, notes that even where the incentive to ‘cheat’ exists, if costs such as those to the reputation of the auditor outweigh the benefits of misrepresentation, ‘cheating’ will not occur.<sup>303</sup> This discouragement derives from the notion that the value of an audit hinges on the reputation or ‘brand name’ of the audit firm<sup>304</sup> as well as the individual auditor. Were this to be impaired, the value of the audit would suffer. As outlined in section three, if the market does not believe the auditor has some incentive to tell the truth, market participants will consider the audit meaningless.

8.97 Mayhew, Schatzberg and Sevcik<sup>305</sup> used an experimental design to study the role of reputation in conjunction with the level of certainty regarding the appropriate accounting treatment. They found that reputation did provide an incentive to maintain independence, but only where the accounting market was certain. That is, where GAAP was unambiguous as to the proper accounting treatment. Where uncertainty existed, inferences drawn by the markets were noisy, weakening the role of reputation as a deterrent and providing incentives to compromise independence.

8.98 Mayhew, Schatzberg and Sevcik highlight that there may be a role for reputation to enhance independence, but this role may not provide a perfect set of incentives.<sup>306</sup> Coffee<sup>307</sup> notes the danger that where a firm with a well established reputation might be deterred, this disincentive does not necessarily extend to all of the individuals within the firm. Further, Flint<sup>308</sup> notes that this conflict extends to auditors taking a ‘free ride’ on the reputation of the profession as a whole, but notes that all auditors have a collective interest in preserving the reputation of auditing if the utility of the profession is to continue.

8.99 A further concern is that although theorists may emphasise the deterrent aspect of reputation, the profession may not embrace the concept entirely for the same purpose of ensuring independence. Coffee notes that although ‘academia still largely views the gatekeeper as a reputational intermediary, the industry increasingly perceives the paradigmatic gatekeeper (the auditor) as a portal for entry into the client.’<sup>309</sup>

## Legal liability

8.100 The threat of legal liability for the auditor can provide a strong disincentive to misbehaviour. Although legal liability has been analysed from many perspectives,<sup>310</sup> of interest here is the

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<sup>303</sup> Above n 119, 34.

<sup>304</sup> Miller, above n 128, 76.

<sup>305</sup> Brian Mayhew, Jeffrey Schatzberg and Galen Sevcik, ‘The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Independence’ (Working Paper, University of Wisconsin at Madison, 2000).

<sup>306</sup> *Ibid.*

<sup>307</sup> Above n 124, 11.

<sup>308</sup> Above n 95, 62.

<sup>309</sup> John Coffee, Jr. ‘The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting,’ (Working Paper, Columbia Law School, 2001) 57.

<sup>310</sup> See, eg, factors leading to litigation in K E St Pierre and J Anderson, ‘An Analysis of the Factors Associated with Lawsuits Against Public Accountants’ (1984) *Accounting Review* 242; and the relationship between audit firms,

influence and effect of liability on audit firms. Davis and Simon,<sup>311</sup> for example, found that where litigation is disclosed, a loss of reputation resulting in a reduction of new client fees ensues. A 1984 study found that breaches of independence have not been a major cause of litigation against auditors.<sup>312</sup> The level of legal risk auditors are exposed to, however, has been criticised as having exploded,<sup>313</sup> which is not without its social cost.<sup>314</sup>

8.101 Acemoglu and Gietzmann<sup>315</sup> develop an analytical model to investigate the role of legal liability as a commitment mechanism for auditors. They conclude that if legal liability is set either too high or too low, the audit market will collapse. Where liability is too low, the value of the audit evaporates as the credibility of auditor independence is reduced. If liability is too high, the cost of an audit will increase to an insupportable level as auditors incorporate the cost of insurance into their fees.

8.102 Most of the research suggests there is a role for legal liability in encouraging auditor independence, but that imposing too high a level will either cause the audit market to collapse or impose excessive costs. The difficulty in assessing what is the appropriate level of legal liability implies that litigation needs to be supported by other incentive mechanisms to maintain auditor independence.

### Other factors

8.103 Many other factors and initiatives have been investigated in relation to their impact on auditor independence. The size of the audit firm, for example, is considered to affect auditor incentives. As size increases, the importance of each client, and therefore auditor dependence, decreases. Research indicates that perceptions of auditor independence increase with the size of the audit firm.<sup>316</sup> In addition, even where fee dependence exists, Craswell, Laughton and Stokes<sup>317</sup> provide evidence that this does not impact the propensity of an auditor to issue a qualified opinion.

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business failures and fraud in Z Palmrose, 'Litigation and Independent Auditors: The Role of Business Failures and Management Fraud' (1987) *Auditing: A Journal of Practice and Theory* 90.

<sup>311</sup> L R Davis and D T Simon, 'The Impact of SEC Disciplinary Actions on Audit Fees' (1992) 11(1) *Auditing: A Journal of Practice and Theory* 58.

<sup>312</sup> K E St Pierre, 'Independence and Auditor Sanctions' (1984) 7(3) *Journal of Accounting, Auditing and Finance* 257, found that only 7 out of 334 actions against auditors included compromised independence as a cause.

<sup>313</sup> R Mednick and JJ Peck, 'Proportionality: A Much Needed Solution to the Accountants' Legal Liability Crisis' (1994) 23(3) *Valparaiso University Law Review* 867.

<sup>314</sup> J W Hill, M B Metzger and J G Werment, 'The Spectre of Disproportionate Auditor Liability in the Savings and Loan Crisis' (1994) 5(2) *Critical Perspectives on Accounting* 133.

<sup>315</sup> Daron Acemoglu and Miles Gietzmann, 'Auditor Independence, Incomplete Contracts and the Role of Legal Liability' (1997) 6(3) *European Accounting Review* 355.

<sup>316</sup> See, eg, Knapp, above n 266.

<sup>317</sup> Allen Craswell, Janet Laughton and Donald Stokes, 'Auditor Independence and Fee Dependence' (Working Paper, University of Sydney, 2000).

8.104 Other systems, such as second partner review, are argued to improve independence. Tucker and Matsumera<sup>318</sup> developed and tested a model of second partner review. The authors found that in general these reviews reduced bias and improved independence, but that this could be compromised by the effect of incentive schemes. Incentives were incorporated into the model as economic pressures to bias judgments. Auditors may also be compulsorily rotated, but this imposes costs.<sup>319</sup> These costs may include lower audit quality from lessened client expertise and the financial costs of the new partner gaining client familiarity.<sup>320</sup>

8.105 Establishing audit committees is argued to reinforce independence. To be effective, these committees should have powers including making recommendations regarding the external auditor; scope of the external audit and appropriate fee review; liaising with internal auditors, including making recommendations necessary to enhance internal control; reviewing financial statements, reports, external auditor communications and accounting policy selection; and oversight of special investigations.<sup>321</sup>

### WHAT ARE THE ALTERNATIVE APPROACHES?

8.106 It is evident from the discussion above that although the importance of auditor independence is clear, ‘the incentives...are not always adequate to the task.’<sup>322</sup> This raises substantial concern, because as ‘the independence of the gatekeeper is thus eroded, externalities are likely to follow: the cost of capital may rise slightly, market efficiency should suffer, and corporate governance will be increasingly distorted by inaccurate informational inputs.’<sup>323</sup> Auditor independence in its purest form, however, is a theoretical construct.

‘Audit independence requires not only freedom of investigation and freedom in reporting, but also the absolute independence of the auditor in the sense of absence of previous or present involvement in the subject of audit, absence of interest in the outcome or its consequences, and absence of bias or susceptibility to influence by considerations extraneous to the matter at issue.... Absolute independence is, however, a theoretical concept. It is an ideal to be strived for; but the actuality is compromise. Auditors cannot be made completely socially aseptic...’<sup>324</sup>

8.107 This leads to the issues of what level of auditor independence should be required, and how it should be achieved. There are many perspectives, ranging from strict regulation to a ‘laissez faire’ approach, using market forces as a control mechanism. Further, there is an issue of whose

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<sup>318</sup> E M Matsumera and R R Tucker, ‘Second Partner Review: An Analytical Model’ (1995) *Journal of Accounting, Auditing and Finance* 173; R R Tucker and E M Matsumera, ‘Second Partner Review: An Experimental Economics Investigation’ (1997) 16(1) *Auditing: A Journal of Practice and Theory* 79.

<sup>319</sup> Vincent O’Reilly, Patrick McDonnell, Barry Winograd, James Gerson and Henry Jaenicke, *Montgomery’s Auditing* (12<sup>th</sup> ed, 1998), 3.42.

<sup>320</sup> Carey and Simnett, above n 269.

<sup>321</sup> *Ibid.*

<sup>322</sup> Coffee, above n 124.

<sup>323</sup> *Ibid.*

<sup>324</sup> David Flint, ‘Social and ethical issues in auditing’ in A Hopworth, M Bromwich and J Shaw (eds), *Auditing Research: Issues and Opportunities* (1982).

perspectives need to be accounted for in determining the appropriate solution. Maury<sup>325</sup> argues that the perspectives of all stakeholders, including ‘investors, suppliers, creditors, employees, customers, professional organizations, and government authorities’ should be considered. ‘It would be hoped that the highest ethical standards will be identified and practiced to meet the needs of decision makers and all stakeholders to move the accounting profession into the next millennium as the repository of consumer trust.’<sup>326</sup> Others argue that the auditor is simply the agent of the owners.

8.108 Complete prohibition of NAS provision is argued to negatively impact competition and quality, and may suffer from enforcement difficulties.<sup>327</sup> Under strict regulation, audit firms may split different functions into separate, but centrally controlled, entities to thwart the prohibition. Arrunada argues that market forces should be combined with an enhanced incentive system for self-regulation. The goal of these structures should be ‘to allow audit firms, self-regulatory bodies and audit clients to discover through competitive market interaction both the efficient mix of services and the corresponding quality safeguards, adjusting for the costs and benefits of each possibility.’<sup>328</sup> Rules should only be used to encourage competition and to improve market incentives. He contends that ‘regulators... lack both the required knowledge and the right incentives to define the efficient framework.’ Regulators are neither clients nor producers, and may be swayed by external interest groups to legislate a sub-optimal solution to the auditor independence problem.<sup>329</sup> The author concludes that regulation aimed at causing auditors to maintain a diversified client base such that the correct incentives are stimulated could aid the pursuit of auditor independence.

8.109 Levine and Kornish<sup>330</sup> also emphasise the costs of prohibitive regulation. They note that strict restrictions may destroy production efficiencies, and may even cause a talent deficiency in the human capital attracted by audit firms. The authors argue that a less regulated approach can achieve the desired level of independence, and at less cost. They provide a ‘starfish’ analogy to illustrate the problems faced by restrictions. When the leg of a professional service firm is severed, another grows back in its place. This implies that where one type of service provision, such as MAS, is restricted, it will be replaced with another, such as global risk management.

8.110 Self-regulation is often supported on a cost-benefit basis. It is offered by some proponents as a solution of itself, and by others as a supplement to other mechanisms such as legal liability and regulation. Self-regulation exploits the inherent incentives of competitors to monitor each other. Some studies on the ethical dimension of auditing would suggest that Codes of Conduct would provide a sufficient bond to auditor independence.<sup>331</sup> However, sometimes these incentives are overborne by the incentive to collude.<sup>332</sup> Therefore, some authors conclude that regulation is a necessary cost.

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<sup>325</sup> Above n 299.

<sup>326</sup> *Ibid.*

<sup>327</sup> Arrunada, above n 150, 12.

<sup>328</sup> *Ibid* 13.

<sup>329</sup> *Ibid.*

<sup>330</sup> Above n 128.

<sup>331</sup> See, eg, Lamp and Finn, above, n 302.

<sup>332</sup> Coffee, above n 124, 59.

8.111 The findings of DeFond, Wong and Li<sup>333</sup> in a Chinese context suggest that regulation alone is 'insufficient to create financial markets that foster independence.'<sup>334</sup> It is important that all of the incentive structures for ensuring auditor independence are given due consideration. There are important roles for systems such as extra reviews, audit committees and legal liability. An environment conducive to the ethical standards underpinning independence needs to be fostered at the educational and firm levels. In summary, because of the incentives that exist to compromise independence, a range of structures, be they imposed through self or mandatory regulation, are needed to maintain the standard of independence required to preserve the integrity of the financial markets.

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<sup>333</sup> Mark DeFond, T J Wong and Shuhua Li, 'The impact of improved auditor independence on audit market concentration in China' (2000) 28(3) *Journal of Accounting & Economics* 269.

<sup>334</sup> *Ibid.*

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