The Relationship Between Non -Audit Service and Auditor Independence With Evidence

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Today, funds raised through the share market are one of the main sources of investments in the private sector of a modern economy, and the stakeholders need the company's financial statement for investment. Reliable financial statements form the corner-stone of the capital market system. As public confidence in reliability of financial statement erodes, so will confidence in the integrity of our capital markets. Reliable financial information depends on effective auditor's report. The auditor's report adds value to financial statements through the independent verification it provides (Stone, 2001). Therefore, in this situation the need for independence for auditor becomes necessary (American Institute of Certified Public Accountants, AICPA, 1977) Independence, both historically and philosophically is the foundation of the public accounting profession. And upon its maintenance, it depends on the professions' strength and statute. To be credible, the auditor's opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with the Generally Accepted Accounting Principles (GAAP). Independence is one of the key factors of the auditors. Without independence, the auditor's reports would not be credible and investors which are creditors would have little confidence in them. Independent audits enhance the credibility and reliability of financial statements. *Thus, contributing to effective corporate governance (Defond et al., 2000, Bell et al., 2000) and improving the efficiency of capital markets.*

However, nowadays the force of globalization in accounting and assurance services have also created the multi disciplinary nature of large audit firms' (Brierley and G William 2003). These multi disciplinary firms offer audit and non audit-services (NAS) to audit clients and this has become one of the major concerns regarding the potential auditor independence dilemma (Craswell 1999, Quick and Warming-Rasmussen 2005). Many empirical researches regarding audit independence and NAS have been directed towards identifying the nature and extent of this threat in developed countries (Arlanda 1999, Beattie and Fearnley 2002, Chung and Kallapur 2003, Raghunandan 2003) and in developing countries (Gul and Yap, 1984, Teoh and Lim 1996, Sori et al 2006). Literature has pointed out that the joint provision of audit and non audit services (NAS) could raise the risk of client retention due to economic incentives and the tendency to agree with clients and choices of accounting policies (Beck et al 1988, De Angel, 1981, Frankel et al 2002, Simunic 1984).

In view of this fact, the main concern is the ability of auditors to objectively examine their client's financial statements while at the same time receiving lucrative NAS fee from the same client. Recent accounting scandals and perceived audit failures, such as in Enron, Tyco, and World Com have resulted in criticism of the accounting and auditing professions in the financial press for their alleged role in allowing these situations to evolve. The reality of public concern on this issue is that when company failure exists, there is an immediate outcry of where were the auditors? Along with the question as to whether they were really objective (APB, 1994). Because in the wake of these scandals, many of these companies saw their equity values plummet by billions of dollars. For this matter, provision of NAS by auditors to their audit clients have been regarded by regulators in the US, UK, Australia and various other countries as a threat to auditor independence (Croswell 1999, p. 29). In this paper *the authors (it will be* explained) analyze the importance of independence and then the effect of NAS on auditor independence.

IMPORTANCE OF INDEPENDENCE

The issue of auditor independence in particular, its nature and its determinants, has been the subject of investigation and pronouncements by policy makers and the accountancy profession for several decades. *For example, the U.S. Senate, (1976 and 1985, Metcalf and Dingall committees) AICPA the Cohen (1978), and the Treadway Commission (1987) Public Oversight Board (1986) in the U.S., Canadian Institute of Chartered Accountants (1978). Statement of auditing practice AUP (AARF 1992) in Australia and the auditing practices board (APB 1992, 1994) in the UK (beattie 1999).* Auditor independence is the core of the auditing industry. The independence standard Board (ISB 2000 p. 11) states the goal of auditor independence is to support user reliance on the financial reporting process and to enhance the capital market. Elliott and Jacobson (1998 p. 1) say that "the

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purpose of audit independence is to improve the cost-effectiveness of the capital markets by reducing the likelihood of material bias by auditors that can undermine the quality of the audit and also the objective of audit independence is to improve the reliability of the financial statement. This information risk is reflected in the cost of capital, both of the particular firm and the market in general.

Kinney (1991) agrees that independent standards along with accounting and auditing standards are essential to the value that our capital market system provides for investor protection, corporate governance, and facilitation of capital formation. He explains both, a constraint view and a core value view of independence. According to the constraint view, independence is achieved by externally constraining auditors through rules issued by SEC or the AICPA. According to the core value view, auditors themselves will maintain independence to preserve their market value. Arthur Levitt states that "one generation of accountants passes on the light of independence to the next. That light sustains the profession's life through a culture of integrity, a mission of objectivity and an ethic of responsibility." The auditors are handed a precious legacy, what they do with it will determine the future of this profession. It is a heavy burden but an overwhelming privilege.

DEFINITION OF AUDITOR INDEPENDENCE

Auditor independence is an important element of the assurance that an audit report provides to its readers with increasing globalization of business and the expansion of the large audit firms into truly multinational enterprises. Also, "the concept of independence has proved, however, to be difficult to be defined precisely" (Antle 1984). Thus, the concept of auditor independence has been argued from many perspectives amongst the professional authorities. Important definitions and views have been presented below:

(1) The SEC (2002) defines independence as "a mental state of objectivity and lack of bias," (2) The AICPA describes auditor independence as an absence of interests that create an unacceptable risk of bias with respect to the quality or context of information that is the subject of an audit engagement (AICPA 1997).(3) Arns et al (1999) defined independence in auditing as taking an unbiased view point in performance of audit tests, the evaluation of the result and issuance of the audit report. Independence includes the qualities of integrity, objectivity and impartiality.

John Carey (1946) explained independence as 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. Independence may be a state of mind or a behavior. According to AUP 32, independence requires freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure.

Mautz et al (1961) defined independence as 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 accountants were not independent of the management of his clients, his opinion would add nothing.

Independence Standard Board (ISB, 2000) gives *freedom* from these pressures and other factors that compromise or can reasonably be expected to compromise an auditor's ability to make unbiased audit decisions. These representative definitions all reflect the importance of objectivity (ability to suppress biases) and integrity (willingness to express an opinion that truthfully reflects the evaluation of what has been discovered during the audit) as the two key aspects of auditor independence (Dunmore and Folk 2001, p. 8)

THE ELEMENTS OF INDEPENDENCE

There is widespread agreement between regulators, accounting practitioners and auditing academics that auditor independence enhances auditor credibility. Historically, the SEC, the ISB and AICPA have partitioned independence into two dimensions: independence in appearance (IIA) and independence in fact (IIF).

The majority of empirical studies on the IIA focused upon identifying the factors which potentially influence independence and assessing their impact upon perceived independence since independence, in fact is unobservable. It is important for an auditor to maintain an unbiased view point in his actions regarding the audit and it is equally important for the auditor to be perceived as independent by the users of financial statements. These two viewpoints are referred to as independence in fact and appearance.

INDEPENDENCE IN APPEARANCE (IIA)

IIA refers to the public or other perceptions of the auditor's independence. Since IIA relies on the perceptions of users of financial statements, thus it is an empirical concept (Dykxhear and Sinning 1981). This notion of independence (IIA) is one of the cornerstones of auditing theory and the sine qua non of auditing practice. The importance of IIA comes from its effects on the value of the firm. Simunic stated that one would expect firm value to be affected by the perceived reliability of financial reports and so the quality of auditing. A loss in value may occur because rational purchasers of the firm's securities will require compensation for any perceived risk of non-truthful reporting. (1984, 684)

Academic research has examined independence in appearance by examining financial statement of users' perceptions of auditor independence where various conditions or services are provided by the auditor. Most of the literature on auditor independence suggests that the credibility of financial statements depends on the perceived independence of the external auditor by the users of financial statements (Levin 1976). Thus auditor independence perceptions do appear to have economic consequences. Firth *(1980)* argues that if the auditor is not seen to be independent, users will have less confidence in the financial statements, and the auditor's opinion on the company's financial statements will be of value. From a regulatory point of view, one violation of IIA occurs when auditors provide material amounts of certain kinds of NAS to audit clients (Pitt and Birenbaum 1977). Hence IIA of activities, relationships and other circumstances which would lead to well informed investors and other users reasonably to conclude that in an unacceptably high risk situation, an auditor lacks independence of mind.

INDEPENDENCE IN FACT (IIF)

IIF relates to the notion that the auditors possess an independent mindset when planning and executing audit and that the resulting audit report is unbiased. Dykakoorn and Sinning defined IIF as the auditors' state of mind of his or her ability to make objective and unbiased audit decision (1982). It basically refers to the mental attitude of the auditor in terms of professional objectivity (Gul and Tsui 1991). Thus, IIF is concerned with auditor objectivity (objectivity is defined, in the context of an audit, as the ability to make unbiased audit decision (ISB 2000). IIF means that decisions should be made objectively without influence from other parties or factors. *The second type of independence is that the auditor is perceived to be independent (Stamp and Moonitz 1978) and (Jordan and Johnston 1987) debated IIF deals with intellectual honesty, providing its existence is difficult.* Although IIF is at the core of independence requirement, it is not observable in a timely manner, making it difficult to regulate (Schuetz 1994). In general, prior academic research has examined IIF by examining auditor judgment and decision making variation in the presence or absence of conditions hypothesized to induce auditor bias.

THREATS

Independence risk is defined as "the risk that is threats to auditor independence to the extent they are not mitigated by safeguards, compromise or can reasonably be expected to compromise auditor's ability to make unbiased decisions" (ISB 2000). Threats to auditor independence represent pressures or other factors impairing auditor's objectivity. To be independent, an auditor must be able to overcome the threats that compromise objectivity. Identifying sources of threats help to illuminate their nature and impact on auditor's independence. Threats to auditor independence are sources of potential bias that may compromise or may reasonably be expected to compromise an auditor's ability to make unbiased audit decision. Significance of threat to auditor independence is the extent to which threat increases independence risk. Schultz *Jr, 1966*, pointed out that this attitude could evoke auditor empathy for management, which could compromise independence. The significance of a specific threat depends on many factors including nature of activity, business relationship, financial interests, employment with audit client, managerial or supervisory, personal relationships, provision of NAS and other circumstances creating the threat. Standards of auditor independence should establish a frame work of principles supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures. Theorists generally hypothesize that concurrent provision of NAS to audit clients pose a threat to auditor independence. These arguments are based broadly on notions of economic dependency and mutuality of interest (Graeme Wines, 1994). Relationships that could have an effect on an auditor's independence include personal relationship (such as between family members) financial involvement with the entity (such as by way of investment) provision of other services to the entity (such as undertaking valuations) and dependency on fees from one source. These threats can be generally classified (ISB 2000 (b) paragraph 12) as: (a)Self-interest (b)Self-view threat (c)Advocacy threats (d)Familiarity (or trust) threat and (e) Intimidation threats

a) Self-Interest

Self interest threat arises from auditors acting in their own interests. It includes auditor's emotional, financial or other personal interests. Auditors may favor consciously or subconsciously these self-interests over their interests in performing a quality audit. For example, auditors' relationships with auditees create a financial self-interest because auditees pay the auditors' fees. Auditors also have a financial self-interest if they own stock in an auditee and may have an emotional or financial self-interest if an employment relationship exists between an auditor's spouse and an auditee. To mitigate or to eliminate this threat, it can use safeguard prohibitions against certain financial interests and family relationships between auditors and auditees' restrictions on the percentage of the total firm fees, earned from one auditor and auditing firm disclosures to the audit committee of all services provided to the auditor.

b) Self-View Threat

It is a threat that arises when auditors review their own work or the work done by others in their firms. It may be more difficult to evaluate without bias one's work or that of one's firms than the work of someone else or of some other firms. Therefore, a self-review threat may arise when auditors review judgments and decisions they or others in their firm have made .To mitigate or eliminate this threat, it can use safeguards concurring partner and peer reviews and prohibitions against auditors acting in the capacity of auditor management.

c) Advocacy Threats

These are threats that arise from auditors or others in their firm, promoting or advocating for or against an auditee's position or opinion rather than serving as unbiased attesters of the auditee's financial information. Such threats may be present, for example, if an auditor or others in the auditor's firm promotes an auditee's securities or acting as an advocate for an audit clients' position in dealings with their parties, to mitigate or eliminate, by among other safeguards, mandatory rotation of engagement partners and restrictions on certain employment relationships between auditors' family members and auditees.

d) Familiarity (or trust) Threat

A threat that arises from auditors can be influenced by a close relationship with an auditor. Such a threat is present if auditors are not sufficiently skeptical of an auditee's *serrations* and as a result, too readily accept an auditee's viewpoint because of their familiarity with or trust in the auditee. For example, a familiarity threat may arise when an auditor has a particularly close or long standing personal or professional relationship with an auditee.

e) Intimidation Threats

A threat that arises from auditors being or believing that they are being overtly or covertly coerced by auditees by other interested parties. Such a threat may arise if an auditor or auditing firm is threatened with replacement over a disagreement with an auditee's application of an accounting principle. Intimidation threats may be mitigated or eliminated by among other safeguards concurring partner reviews, internal consultation requirements and an appropriate "tone at the top" in both auditing firms and auditees.

NON- AUDIT SERVICES (NAS)

It is found that auditors believe that the auditors' work would be used as a guide for investment, valuation of companies and in predicting bankruptcy. Furthermore, the third party feels that there is a strong relationship between the reliability of auditor's work and the investment decision. Also the auditor's work facilitates the process of economic development through the presentation of reliable information concerning the financial position of the companies (Wahdan et al, 2005). Concerns regarding audits performed by firms also offering non-audit services (NAS) go back to Mautz and Sharaf (1961), who asserted that management advisory and tax services which auditors provide tend to reduce the appearance of audit independence. Globalization in accounting and assurance service has also created the multidisciplinary nature of large audit firms (Brierly and Gwilliam, 2003). These multidisciplinary firms offer audit and non- audit services to audit clients and these have become one of the major concerns regarding the potential auditor independence dilemma (Quick and Rasmussen, 2005). Levitt described auditors who perform significant NAS for audit clients have an additional economic incentive to retain the client-possibly at the risk of deciding difficult issues in the client's favor so as not to present a disagreement with management that might ultimately lead to dismissal. (2000)

The Securities Exchange Commission (SEC) believes that non-audit services impair auditor independence because of the significant revenues generated from these services, and the consulting nature of these services often lead the auditor to identify himself with the interests of the management rather than with those of the public (SEC, 2000). Although there are market-based incentives for auditors to remain independent, there are also forces that potentially threaten auditor independence. Specifically, regulators are concerned about two effects of NAS. One is a fear that non-audit service fees make auditors financially dependent on their clients, and hence less willing to stand up to management pressure for fear of losing their business. The other is that the consulting nature of many non-audit services puts auditors in the managerial role (Defond et al 2002). Significant increases in consulting revenue generated by CPA firms led the SEC to believe that increased economic dependence on these services may potentially impair auditor independence. Hence, in 1978, the SEC adopted disclosure requirements (ASR 250) that required audited firms to disclose NAS fees (as a ratio based on the audit fees). And in September 1981, SEC repealed ASR No. 250 rational for the repeal include insignificant purchases of NAS by audit clients, artificial and detrimental curtailments of NAS because of the disclosures, and investors' seemingly lack of interests on this information (Abbott et al 2003). The concern on NAS negative impacts reemerges as consulting work grew explosively in the 1990s (Antle et al 2002). In 2000, the SEC issued final rule of independence. The rule requires firms to disclose the purposes of all fees paid to the auditor and identifying whether the fee is for *1) audit 2) financial information system design and implementation services 3) others, On July* 30 2002, President Bush signed the public accounting reform and investor protection ACT (the Sarbanes-Oxley Act) into law. According to the Sarbanes-Oxley Act (2002) the following items are non audit services:

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

EVIDENCE

Several studies have investigated effects of NAS on audit quality or financial reporting quality and reached divergent conclusions. Many prior researches suggest that NAS has negative effects on auditor independence. Such work includes analytical studies, markets studies, studies of auditor decision-making and studies of financial statement user perceptions. Each of those areas will be reviewed below:

De Angolo (1981) explains theoretically that as the economic bond between the auditor and client increases, so does the likelihood for the auditor to compromise auditor independence. Dee et al (2002), with a sample of S&P 500 firms demonstrates that firms paying higher proportions of non-audit fees to total fees paid to their auditors have large income-increasing discretionary and total accruals. They proposed that auditors may be more flexible in allowing for income-increasing earning management when fees from NAS account for a high proportion of total fee from a client. Wines (1994) describes that auditors receiving NAS fees are less likely to qualify their opinion than auditors who don't receive such fees. Based on his empirical analysis of audit reports issued between 1980 and 1989 by 76 companies publicly listed on the Austrian stock exchange, he founds that auditor of companies with clean opinions received a higher proportion of non-audit fees than did auditors of companies with at least one qualification. Frankel et al (2001) demonstrates empirically that levels of discretionary accruals are higher for firms whose auditors provided NAS than for firms whose auditors didn't provide such services. These higher levels of accruals suggest a greater potential for earning management. Farnner et al (1987) provides that 70 percent of Big eight partners they interviewed allowed a client's aggressive accounting treatment proposal under high risk of client less but 80 *percent did not under high risk of litigation*, suggesting that both factors influence the objectivity of an auditor's decision. Karnish and Levine (2004) document that when auditors jointly provide non-audit services and audit services, they are more likely to issue favorable audit reports than warranted. The economic bonding between audit firms and their clients would influence auditor independence. *May be that the level of client pressure would increase and the auditor less concerned with the quality of internal control* (Muhammad and Karbhari, 2006).Swanger and Chewning (2001), described the provision of consulting services by the external auditor creates a business relationship with increased fees makes the clients more valuable to the auditor and possibly clouds the auditor's judgment for fear of losing the client. Shockley (1981) seeks whether providing management advisory services (MAS) influences perceptions of auditor independence. He found that CPA firms providing MAS were perceived as having a higher risk services. Mauldin (2003) explains that professional investors perceive that independence is impaired when the auditor provides internal audit services or merger and acquisition services. Pany and Reckers (1984) investigate 67 chartered financial analyses and 46 corporate stockholders and find that independence concerns decrease when NAS are performed by a separate division of the CPA firm rather than by the staff that conducts the audit. Lowe and Pany (1996) survey how financial analysts' perceptions and investment decision are affected by CPA firms' provision of NAS with clients to third parties. Results indicate that the materiality of the business relationship (between the CPA firm and its client) significantly affects the perceptions and investment decisions of financial analysts. Thornton et al (2004) also describes that bankers as well as professional accountants perceive that NAS (unspecified consulting) compromises auditor independence.

CONCLUSION

After several financial scandals and collapses, the bankruptcy of the Enron Corporation in 2002, revealed a key weakness in auditor independence. Independence is one of the key factors of the auditors without which audit reports wouldn't be credible and investors and creditors would have little confidence in them .Independent audit will also enhance the credibility and reliability of financial statements .In short with regard to the research finding in the literature, the provision of NAS to audit clients by auditors will escalate the economic bond between auditors and their clients. However, the authors believe that the main concern is the ability of auditors to objectively examine their client's financial statements and at the same time receive lucrative NAS fees from for the same client. I believe that based on the research findings in literature, the occurrence of scandals, lucrative revenue in NAS and insistence on observance of SEC & SOX regulations**,** if the auditor practices the audit and NAS to their clients, the independence of the auditors will be impaired. Then authors think that much pressure on auditor independence may be due to weaknesses in the structure of corporate governance. In order to increase the auditor independence the following are suggested;

- Activating auditing committees in corporations.
- Defining and clarifying audit and NAS activities in audit services.
- Considering penalties for auditors in case of breaking the auditing regulation.

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2. According to Naik`s analysis as the conclusions of a study by IIM Bangalore Professor Gopal Naik (posted online on Aug 11th 2007. After the ban, the facts: Futures didn`t spike wheat, pulses prices by Ravish Tiwari) “the jump in prices , isn't because of futures trading but because of lower production, lower stocks and soaring international prices of certain commodities”, the reason being if futures trading help farmers to decide which crop to grow, it leads to imbalance in production. It makes the farmer grow the crop that is profitable rather than the crop that is desirable for the nation. It leads to low production and high prices.
3. Another observation is, it takes time to sell the produce since farmer waits till he gets a better price for his crop which in turn creates artificial demand with low supplies due to hoarding, hence the rise in prices.
4. In case the farmer gets a better price after 3 to 4 months also, he cannot wait to take advantage of this price as he has to meet many financial obligations post harvest of the crop.
5. Apart from all these, India being basically an agrarian economy should see to that the country is self sufficient, mainly in food grains. Pulses “the common man's meat” cannot be put to future trading. The country should first have sufficient to meet the internal demand for consumption at fair prices. That is what is needed for the country. One can carry out futures trading on metals, energy, etc., which are not basic necessities to live with. But as far as food grains are concerned, the government should help the farmers to get a better price and facilitate the consumers to get it at an affordable price.

It is appreciated that the government banned futures trading on some pulses protecting the farmers and the consumers and not leaving the market open to speculative trade like futures trading. It is still beneficial if the trading on pulses as such is banned which will benefit the farmers to grow crops according to the nature of the soil and the seasons and not as per futures trading demand.
Hence a total ban on futures trading on pulses is advisable.

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