PERCEPTIONS OF AUDITOR INDEPENDENCE: EVIDENCE FROM CPAS', LOAN OFFICERS, AND THE GENERAL PUBLIC

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ABSTRACT

The Sarbanes-Oxley Act of 2002 (SOX) included many components designed to increase auditor independence. Despite these intentions, research finds that many of the included provisions may not have influenced independence as intended. As recent studies focused primarily on independence in fact, not independence in appearance, we surmise that SOX influences the perception of independence. We also suspect that perceptions of users will vary with respect to various aspects of audit quality.

To test our beliefs, we surveyed CPAs, loan officers, and the general public inquiring whether specific components of SOX would increase auditor independence. Members of all three groups indicated that they thought each provision tested would increase independence, but they differed both in the extent they thought the provisions increase independence and in the relative rankings of the different provisions. We also found evidence that the expectation gap is still in existence, with both sophisticated users and the general public having lower perceptions of audit quality as compared to CPA's.

The results of this paper suggest that SOX may increase confidence in the audit process by increasing perceptions of independence. Evidence supporting the continuance of an expectations gap between CPAs and users of financial statements is also present.

INTRODUCTION

The turn of the century signaled not only the start of a new millennium, but also a time of significant change for the accounting profession. For the first time since the formation of the Securities Exchange Commission in 1933, the government exercised its right to legislate audits of public companies. The accounting profession had been self regulated and relied upon the Audit Standards Board, a body of the American Institute of Certified Public Accountants, to enact rules governing audits of both private and public companies. As with other catastrophic events affecting the public, it was necessary for someone to step forward and restore the public trust (Gostick & Telford 2003). Thus we now have the Sarbanes-Oxley Act of 2002 (SOX).

As SOX is a relatively recent phenomenon, many of the details of how to interpret and implement the standards have yet to be put to the test of time. Many of the provisions of SOX focus on auditors maintaining independence with respect to the companies they audit. Several recent archival studies have shown these provisions have no effect on auditors with respect to independence in fact (DeFond & Francis

2005). While auditor independence is essential to an effective audit and the reliability of financial information (Wallman 1996), independence in appearance is just as important. This paper focuses on how the provisions of SOX have impacted independence of appearance based on the perceptions of several key groups: accountants, sophisticated financial statement users (loan officers), and the general public.

To test the perceptions of these groups, a series of questions related to both active provisions of SOX and proposed provisions were presented to the groups. These questions focused on Title I, II, and III of SOX involving the creation of the PCAOB, auditor independence, and corporate governance, respectively. Analysis of these surveys then focuses on which provisions effect users' perceptions and how these perceptions vary among the various groups.

A second aspect of the study also examines how these recent events have influenced the expectation gap and the usefulness of auditing financial statements. Past studies (Hodge 2003; McEnroe & Martens 2001) have shown that the expectation gap still exists, and the perceived reliability of financial statements has gone down over time. Therefore, we examine whether these concerns still exist after the government intervention in regulating the profession by testing perceptions of various dimensions of audit quality (auditor independence, performance, responsibility, and competence as well as financial statement reliability).

This study shows that while the provisions may not have affected auditors' independence in fact, they do effectively influence users' perceptions of independence. All three groups report that they believe the provisions of SOX enhance independence. As such, the provisions of SOX continue to increase users' trust in the accounting profession and the financial statements for which they provide assurance services. We also find that the CPA's have less confidence in the SOX's provisions than the other studied groups, and that they also have more confidence in the quality of financial statement audits they audit as well as their independence with respect to clients.

The remainder of the paper is organized as follows. The next section reviews the existing literature and develops the hypotheses. The third section discusses the method by which the data is collected. The fourth section examines the results of the study. The final section presents a conclusion for the paper, including limitations of the study, and future research.

LITERATURE REVIEW AND HYPOTHESES

Actual independence and perceived independence are separate constructs. In Accounting Series Release No. 269, the SEC recognized the distinction but also recognized both as being equal in importance (Olazabul & Almer 2001). Several commentators note the existence of both (Sutton 1997; Kinney 1999). Actual independence in fact is a frame of mind that is impossible to measure, so regulations regarding auditor independence tend to focus on the perception of independence (Schuetze 1994). Despite this focus on perception, investors who place value on auditor independence believe that independence in fact is present. Accordingly, they believe independence has a desirable effect upon the quality of audits. Research that tests whether the items believed to impair audit independence and thus audit quality have not always found the commonly expected results.

Since the state of mind of public accountants cannot be known, research on independence in fact compares incentives to not be independent to evidence of audit quality. Research has found an association between non-audit fees and earnings surprises, discretionary accruals, and lower share prices (Frankel, Johnson & Nelson 2002), between the ratio of non-audit fees to audit fees and total accruals (Larcker &

Richardson 2004), and between unspecified non-audit fees and financial statement restatements (Kinney, Palmrose & Scholz 2004). Contrary to these findings, other study's using different research designs or datasets have found non-audit fees or total fees are not associated with earnings surprises, discretionary accruals, importance of client to firm, going concern opinions, financial statement restatements, or auditor assessment of client systems (Reynolds, Deis & Francis 2004; Chung & Kallapur 2003; Geiger & Rama 2003; Defond, Raghumandan & Subramanyam 2002; Ashbaugh, LaFond & Mayhew 2003; Larcker & Richardson 2004; Kinney, Palmrose & Scholz 2004; Raghunandan, Read & Whisenant 2003; Davidson & Emby 1996). The findings between these studies, and sometimes even within the study, are inconsistent as to whether the proxies for auditor independence actually influence audit quality (DeFond & Francis 2005). As such, it cannot be determined without doubt whether the factors associated with non-independence, such as non-audit fees, are actually consistently related to a state of mind that indicates a lack of independence in fact. If independence is a core value or a strategic necessity to public accounting (Kinney 1999), it is in the profession's best interest to remain independent in spite of short-term incentives to act otherwise.

If it is difficult to regulate a state of mind, perception may be influenced through regulation. The perception of independence, as regulated by SOX, could then act to restore confidence in the financial markets after the scandals of 2001. The question for research is then whether changing the relationship between auditor and client influences perceptions of independence, and whether that perception influences investor decisions. However, since initial attempts to answer this question (Schulte 1965; Lavin 1976) research regarding perceptions of independence remains somewhat divided. Some research does not find a change in perception by sophisticated financial statement users in auditor independence based on different levels of management advisory services provided by a public accountant (Pany & Reckers 1988; Pany & Reckers 1987; Knapp 1985; McKinley, Pany & Reckers 1985; Reckers & Stagliano 1981) or that various non-audit functions cause a perception of low independence in less sophisticated users (Jenkins & Krawczyk 2001; Reckers & Stagliano 1981). Other research has found a link between perceptions of independence and non-audit services (Brandon, Crabtree & Maher 2004; Mauldin 2003; Swanger & Chewnin, 2001; Lowe, Geiger & Pany 1999; Lowe & Pany 1995; Gul 1991; Pany & Reckers 1984; Pany & Reckers 1983; Shockley 1981). Most recently, using earnings response coefficients and shareholder ratification votes as proxies for perceptions of auditor independence, Mishrah, Raghunandan & Rama (2005) and Krishnan, Sami & Zhang (2005) both found a negative relationship between non-audit services and auditor independence.

Other avenues of research have examined the effects of employment, partner rotation, and audit client relationships on perceptions of auditor independence. Similar to the earlier research involving other factors influencing auditor independence, these studies (Goodwin & Seow 2002; Koh & Mahathevan 1993; Firth 1981; Imhoff 1978) find no consistent basis for which factors influence perceptions of independence. Additionally, Gaynor, McDaniel & Neal (2006) find that audit committees are less likely to approve nonaudit services due to disclosure requirements, even when the services would improve audit quality. Combined, these studies have examined a number of the provisions in Title I, II, and III of SOX. As results are varied and significant changes have been made in accounting regulations since the majority of these studies, our research aims to find if SOX improves perceptions of independence, for which we have developed two hypotheses.

We believe that the Sarbanes-Oxley Act was passed in part to improve confidence in the financial markets of the United States, a belief shared with others (e.g., Jain & Rezaee 2006; Guerra 2004). Because much of the crisis motivating the passage of SOX was related to audit failures, much of SOX relates to improving audit performance, and especially to increasing auditor independence from the client. The specific provisions of SOX regarding independence were enacted because they were perceived to increase auditor independence.

Hypothesis 1: The provisions of the Sarbanes-Oxley Act are perceived to increase auditors' independence from their clients.

We also believe the various groups tested (CPA's, Loan Officers, and the General Public) will vary in their perceived value of the SOX provisions. Although CPA's may feel that certain practices may dilute independence, we believe that they often believe that they are capable of self-regulation of independence and that the accounting profession has intrinsic incentives in maintaining independence (Kinney 1999).

Hypothesis 2: The perceived benefit of the SOX provisions will vary among the CPA's, sophisticated users (e.g., loan officers), and the general public.

In addition to perceptions of the recent SOX provisions, we also test each group's perception of audit quality (auditor independence, performance, responsibility, competence, and financial statement reliability). Past studies (Hodge 2003; McEnroe & Martens 2001) have shown that the expectation gap still exists, and the perceived reliability of financial statements has gone down over time interpretations of unqualified audit reports (McEnroe & Martens 2001), definitions of auditor duties (Porter 1993), and expected levels of assurance (Epstein & Geiger 1994) differ between auditors and investors. We examine whether these concerns still exist after the government intervention in regulating the profession by testing perceptions of various dimensions of the expectations gap between auditors and other stakeholders.

Hypothesis 3: Perceptions of audit quality (auditor independence, performance, responsibility, competence, and financial statement reliability) will vary among CPA's, sophisticated users (e.g., loan officers), and the general public.

METHOD

To test the hypotheses, we designed a survey regarding the provisions of SOX. The survey includes three sections. The first section lists questions regarding perceptions of how provisions of SOX influence auditor independence. The second section lists questions regarding perceptions of audit quality (auditor independence, performance, responsibility, competence, and financial statement reliability). The third section requests demographic information for each of the three groups. The SOX questions are answered on a 0-6 scale, with 0 representing no effect on independence and 6 representing a positive effect on independence for the SOX questions. For the audit quality questions, 0 represents a more negative view of the audit process or less confidence that audits are completed in an independent and competent manner, whereas 6 represents greater confidence in the audit process[i].

Most of the questions are derived directly from Title I, II, and III of SOX. Specifically, Questions 1 and 11 fall within Title I, Questions 2, 3, 5 and 7 fall within Title II, and Questions 8 and 9 fall within Title

III. The fee disclosure provision (Question 4) was mandated by the SEC in 2000 and modified in 2003 (SEC 2000; SEC 2003). We also include two provisions that are under consideration. These provisions were that of audit firm rotation (Question 6) and prohibiting tax services (Question 10). As the PCAOB continues to consider adoption of these provisions (PCAOB 2004), it is important to determine the potential effects of these provisions prior to implementation.

We also included some questions not directly tied to SOX that assess possible differences in opinion regarding the scope and quality of audits. The public interest in the role of public audits in preventing frauds increased as a result of the series of financial statement frauds in 2001. The AICPA released Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* in 2002 (ASB 2002) to provide guidance for auditors to regard fraud in an audit. We ask our survey participants for their opinion regarding the responsibility for finding fraud in an audit. We also ask about the effect that receiving payment from the auditee for both audit and non-audit services may have upon the quality of an audit. Auditors may be biased to avoid conflict with clients to retain fees (Gavious 2007). Finally we ask for perceptions about the quality of audit output, financial statements, as well as the audit process itself and the training of the accountants that perform the audits.

Similar to the prior behavior studies, we selected subjects from three groups; CPA's, loan officers (sophisticated financial statement users), and the general public. Participants for CPA's and loan officers were randomly selected from commercially available mailing lists, with 250 surveys being sent to each group during the Spring of 2005. After adjusting for bad addresses, approximately 11 percent of the CPA's and 13 percent of the loan officers responded by completing the survey[ii]. For the public participants, email messages were sent to a list of consumers maintained by a data collection agency to solicit responses from the general public. Respondents were directed to a web page to complete the survey. As the actual number of email addresses in the list was maintained by the data collection agency, an exact response rate could not be determined. Demographic information for all participants is provided in Table 1. Of particular interest in the general public group is that they had a higher proportion with a college education than expected and the majority had personal investing experience. Thus their views represent both that of the general public, and that of non-professional investors[iii]. There are no significant differences between the groups except for gender. None of the results found in the survey differ by gender.

Table 1: Demographic information

	CPA	Loan Officers	General Public	Total
Number	28	32	36	96
Age	43.74	45.90	46.47	45.50
Percent Female	29%	13%	36%	26%
Yrs. Experience	20.88	17.63	NA	19.15
College Education	100%	87%	53%	86%
Graduate Degree	25%	16%	25%	24%

RESULTS

Our first objective is to determine whether the SOX provisions increase respondents' perception of auditor independence. A mean response above 0 for each question indicates that respondents, on average, believe the provision increases independence. All of the SOX provisions were perceived by respondents to be associated with greater independence (See Table 2). As such, while the provisions may not have positively improved independence in fact (DeFond & Francis 2005), we find they do significantly improve independence in appearance. However, we suspected that the different groups, although they agreed that the provisions increase independence, may have different opinions about the extent to which each provision increases independence.

Table 2: SOX Independence Question Responses

	CPAs		Loan Officers		General Public	
Questions	Mean	Std. Dev.	Mean	Std. Dev.	Mean	Std. Dev.
1. All accounting firms conducting audits must undergo quality control reviews.	4.39	1.47	4.09	1.47	4.11	1.53
2. Certain non-audit (i.e., consulting) services will be strictly prohibited.	3.33	1.54	4.34	1.68	4.00	1.67
3. Unless approved by the audit committee, companies will be limited on the amount of non-audit services their auditors can provide.	3.46	1.79	4.23	1.69	3.86	1.61
4. Companies are required to disclose audit and non-audit fees paid to auditors.	3.79	1.32	4.03	1.93	4.47	1.54
5. Auditor firms are required to rotate (change) the partner in charge of the audit on a regular basis.	4.11	1.31	4.34	1.62	4.46	1.34
6. Companies are required to rotate (change) their auditors on a regular basis.	2.93	1.94	3.78	2.04	4.33	1.71
7. No key financial officer of the company is to have been employed by the auditors in the year prior to the audit.	3.61	1.64	4.63	1.56	4.44	1.40
8. Audit committees must be comprised of members not employed by the company they are representing.	4.50	1.48	4.16	1.67	4.81	1.31
9. Audit committees are responsible for appointment, compensation, and oversight of the auditors.	4.68	1.25	3.78	1.68	3.94	1.51
10. A company may not receive tax services from their auditor	1.79	1.66	3.13	1.90	3.69	2.10
11. A board appointed by the government rather than the accounting profession establishes audit regulations.	2.11	1.59	1.88	1.76	3.31	1.98

All responses are significantly greater than 0, $p < .001$
Scales from 0 to 6

Our second hypothesis states that question responses differ between groups. We tested this question with two different methods. First, we determined for each question whether the mean response value differed between groups. Second, we looked at the ranking of question answers for each respondent, and compared the mean ranks across the groups to determine if the groups ranked the questions differently, on average.

A MANOVA test was used to determine whether the overall results differed between the groups, using the groups as the independent factor and the responses to each of the questions as the dependent variables. The MANOVA tests whether the group responses differ across all the questions together. The MANOVA ($F = 3.29$, $p < .001$) indicates that the responses are different between groups, supporting the second hypothesis. We then used ANOVA to find which questions' responses differed between groups (See Table 3). The ANOVA results indicate that differences exist between the group responses in six of the questions. For each of those six questions we conducted a t-test between the mean responses of each of the three groups for each question, as shown in Table 3. The table suggests that both loan officers and the general public differ more from CPAs than from each other. Comparing the CPAs against a combined group of loan officers and general public using MANOVA found a significant difference ($F=4.05$, $p < .001$); comparing loan officers to the general public also finds significant differences ($F=2.63$, $p<.01$). For each question in which the CPA responses are significantly different than the other groups' responses, the CPA response mean is less confident that the SOX provision will improve independence. The lone exception is Question 9, concerning supervision of the audit function by audit committees.

Table 3: Group Differences – ANOVA and t-tests

			T-Scores					
Question	ANOVA F		CPAs vs. Loan Officers		CPAs vs. Public		Loan vs. Public	
1	0.38		ns		ns		ns	
2	2.84	*	2.39	**	ns		ns	
3	1.49		ns		ns		ns	
4	1.49		ns		ns		ns	
5	0.47		ns		ns		ns	
6	4.35	**	ns		3.08	***	ns	
7	3.73	**	2.46	**	2.12	**	ns	
8	1.62		ns		ns		ns	
9	3.00	**	2.32	**	2.08	**	ns	
10	8.06	***	2.89	***	3.95	***	ns	
11	6.18	***	ns		2.61	**	3.13	***

ns: Not significant
*$p< .10$
**$p<.05$
***$p<.01$
Scale ranges from 0 to 6

We also tested if different groups ranked the questions differently. For example, the CPA group gave question 2 a significantly lower score than the loan officer group. But the CPA's tended to give lower responses to all the questions. So how did the CPA's rank question 2 relative to the other questions as compared to the other groups? To determine whether the groups ranked the questions differently, we gave each question a ranking based on each individual's response. The question which received a respondent's highest score was ranked with a 1, and the question that the respondent scored lowest received a rank of 11. For each question, we compared the groups' rankings (Table 4). MANOVA results indicate that the groups ranked the questions differently ($F=3.4$, $p<.001$). The ANOVA results and t-tests for each question shown in Table 4 illustrate a pair of observations. First, as expected from comparing the absolute score differences, CPA opinions vary more from loan officer and general public responses than loan officers and the general public differ from each other. Second, CPAs rate only the influence of reporting to the audit committee significantly higher than the other two groups. The loan officers and the general public tend to rate provisions that limit auditor behavior higher than CPAs rate those provisions, including two provisions not required by SOX: limiting tax services and requiring regular rotation of audit firms. CPAs have relatively less confidence that restrictions on the public accounting industry will increase independence than other parties, and their concerns appear to be reflected in the provisions actually included in the legislation.

Table 4: Mean Ordering of Questions by Group - Question Ranking

Question	CPA	Loan Officers	General Public	ANOVA F
1. All accounting firms conducting audits must undergo quality control reviews.	3.25	4.22	4.31	1.23
2. Certain non-audit (i.e., consulting) services will be strictly prohibited.	5.26	3.34 #	5.31	3.95 **
3. Unless approved by the audit committee, companies will be limited on the amount of non-audit services their auditors can provide.	4.79	4.00 #,^	5.83	2.80 *
4. Companies are required to disclose audit and non-audit fees paid to auditors.	4.90	4.09	3.33	2.01
5. Auditor firms are required to rotate (change) the partner in charge of the audit on a regular basis.	3.82	3.47	3.49	0.15
6. Companies are required to rotate (change) their auditors on a regular basis.	5.86	4.53	3.31 #	4.71 **
7. No key financial officer of the company is to have been employed by the auditors in the year prior to the audit.	5.14	2.56 #	3.64 #	6.13 ***
8. Audit committees must be comprised of members not employed by the company they are representing.	2.68	3.81	2.58	2.24
9. Audit committees are responsible for appointment, compensation, and oversight of the auditors.	2.57	5.06 #	5.22 #	7.51 ***
10. A company may not receive tax services from their	8.07	6.22 #	4.83 #	6.68 ***

Table 4: Mean Ordering of Questions by Group - Question Ranking				
Question	CPA	Loan Officers	General Public	ANOVA F
auditor				
11. A board appointed by the government rather than the accounting profession establishes audit regulations.	7.86	9.00 ^	6.44	4.96 ***

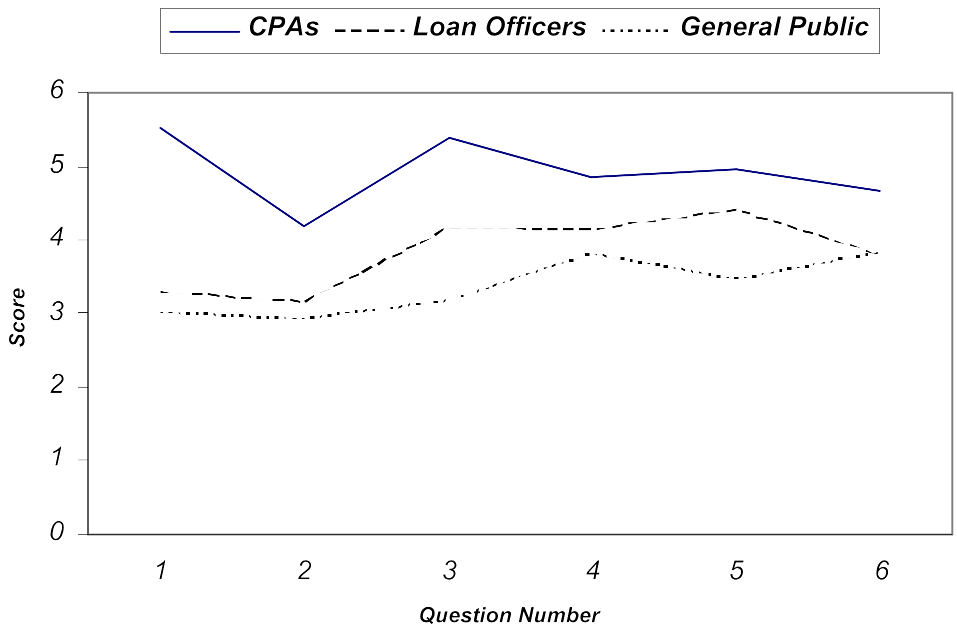
If all participants had given their highest score to a question, that question would have an ordering score of 1.
* p< .10
** p<.05
*** p<.01
# Difference from CPA, p < .05
^ For Loan Officers, difference from General Public p<.05

We also tested several perceptions concerning the adequacy of audit quality. Measures used include overall auditor independence, performance, responsibility, competence, and financial statement reliability. Mean responses are reported in Table 5. Comparisons of group means are illustrated in Figure 1. As with the questions about the independence provisions of SOX, we found a division between groups supporting Hypothesis 3 based on the MANOVA results (F=2.61, p<.05). As further illustrated by the ANOVA results and t-tests in Table 5, the CPA's have greater confidence in the audit process and believe that the audit process is less-biased and that audits are well-conducted than non-CPA's believe in every measure of audit quality. In two questions the general public also displays greater confidence in the audit process than the loan officers. Therefore, the expectation gap between CPA's and users of financial statements continues to exist even after the additional guidance and exposure provided by SOX.

Table 5: Audit Quality Responses			
Questions	CPA Mean	Loan Officer Mean	Public Mean
1. Auditors have the primary responsibility to prevent fraudulent financial reporting.	1.48 *^#	3.72 *	4.00 *
2. Auditors can perform an independent audit when the audit client pays them for non-audit services.	4.19 *^#	3.16	2.92
3. Auditors can give an independent audit if the audit client pays them for that audit.	5.41 *^#	4.16 *#	3.17 ^
4. Most audits are performed well.	4.85 *^#	4.13 *	3.81 *
5. Most financial statements are not materially misstated.	4.96 *^#	4.41 *#	3.47 ^
6. Auditors are properly trained.	4.67 *^#	3.78 *	3.83 *

* p<.05 difference from midpoint of 3
^ p < .05 difference from loan officers
# p <.05 difference from general public
0 = Strongly disagree 6 = Strongly Agree

Figure 1
Graph of Audit Quality Question Responses



Question 1 reverse scored on graph.
High scores indicate a favorable opinion of audits
Response scale from 0 to 6

SUMMARY

Our primary findings are that the Sarbanes-Oxley provisions increase the perception that auditors will be independent from their clients, that auditor's perceptions of the efficacy of the provisions of SOX differ from the perceptions of both sophisticated users of financial statements and the general public, and that an expectations gap regarding audit responsibilities and quality exists between auditors and other groups.

We found that all of the provisions of the Sarbanes-Oxley Act about which we requested information were perceived as improving auditor independence. This was true for auditors, loan officers, and the general public. All three groups rated government regulation of auditing standards as having minimal influence on auditor independence. The CPA responses differed significantly from the non-CPA responses in other questions.

All groups of respondents believe that the SOX provisions enhance independence, but the extent differs, with auditors generally being less confident than other respondents. The order in which the respondents rate the provisions also differs between groups. Non-CPA's are more likely to believe that restrictions on auditors will have a greater influence on independence than CPAs**.** These results are consistent with the most recent studies involving perceptions of auditor independence (Mishrah, Raghunandan & Rama 2005; Krishnan, Sami & Zhang 2005).

We also find that there is still a significant expectation gap between CPA's and users of financial statements. While it can be argued that the accounting profession did not need to be 'fixed', the continued existence of this gap can be considered support that the public finds SOX as a corrective process for the profession, rather than a formalization of existing policies and procedures.

As we only surveyed a small percentage of the population, there is the possibility of bias being present. Additionally, as respondents were asked to directly report their views, demand effects could be present. Should the various provisions be tested in an experimental study, results could vary. Furthermore, as our results are limited to the respondent's perceptions of the provisions, respondents actual decisions in matters regarding the provisions could vary.

Further research may need to be conducted to determine the long-term effects of the Sarbanes-Oxley Act. For example, has confidence in auditor independence and in financial statement reliability increased as public companies comply with the provisions of the Act? As the provisions in SOX are a relatively new initiative, will the impact shown in this study mitigate over time? As SOX seems to primarily influence independence in appearance, and not independence in fact, will the provisions be effective once the shock of recent scandals fades in time?

ENDNOTES

[i] Pilot testing found some minor difference between the 0-6 scale and a thirteen point scale ranging from-6 to 6 scale with -6 stated as having a detrimental effect on independence rather than no effect. Means significantly differed between the small scale and the larger scale on questions 3, 7, 8, and 11. Questions 3 and 10 were not significantly different than 0. Although some of the specific results differ, we feel that the interpretation of the results is the same using the small or the large scale.

[ii] As with any study relying on survey data, this study is subject to response bias. Additionally, the response rate is subject to difficulties in getting professions to respond due to increasing demands on their time. For a more complete assessment of these difficulties, refer to Schipper (1991).

[iii] The occupations listed of those responding to the general public group were viewed to verify no one in this group was employed as a CPA or Loan Officer.

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