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Audit and non-audit fees and capital market perceptions of auditor independence ☆

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A B S T R A C T

This study provides evidence on whether auditor independence-in-appearance, proxied by earnings response coefficients, is related to the non-audit fee ratio (non-audit to total fees from a client) or client importance (total fees from a client as a percentage of the total revenues of the audit firm). The results from large samples over the period 2001–2006 show, contrary to popular belief and the findings of some prior studies, that there is no evidence of a relation between perceived auditor independence and the non-audit fee ratio. However, perceived auditor independence is negatively associated with client importance, consistent with the economic theory of auditing. Our paper adds to the literature by examining the relative importance of non-audit fee ratios and client importance as determinants of independence-in-appearance.

1. Introduction

Regulators have long been concerned about the potential impact of audit and non-audit fees on auditor independence (SEC, 1979). The Securities and Exchange Commission (SEC) has repeatedly asserted that auditors must be independent in fact and in appearance (SEC, 2000). Independence-in-fact is defined by SEC as the auditor's mental state lacking any bias, while independence-in-appearance is a public perception that the auditor is objective and unaffected by a financial interest in the client (SEC, 2001). Recent papers examining the relationship between audit and non-audit fees and auditor independence tend to provide evidence on independence-in-fact (e.g., DeFond et al., 2002; Frankel et al.,

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2002; Ashbaugh et al., 2003; Chung and Kallapur, 2003; Larcker and Richardson, 2004; Kinney et al., 2004; Srinidhi and Gul, 2007; Lim and Tan, 2008).

The few studies that provide evidence on whether audit and non-audit fees influence independence-in-appearance (Higgs and Skantz, 2006; Krishnan et al., 2005; Francis and Ke, 2006) examine audit fees, non-audit fees, or non-audit fee ratio (non-audit to total fees from a client), but not client importance (fees from a given client to the total revenues of the audit firm). Economic theory suggests that auditors' incentives to compromise their independence depend on client importance and not on non-audit fee ratio (DeAngelo, 1981; Ashbaugh et al., 2003; Chung and Kallapur, 2003). Public attention has nevertheless focused on the non-audit fee ratio as causing perceptions of auditor independence impairment.[1]

In this study, we examine the relationship between audit and non-audit fees and capital market perceptions of auditor independence. Because prior studies do not address whether perceived auditor independence is a function of client importance or non-audit fee ratio, we investigate the relative importance of these two variables in influencing capital market perceptions of independence. The two fee-based metrics are not different measures of the same construct; rather, they are two separate concepts. For a given client, non-audit fee ratio measures the importance of consulting services relative to the total services provided by the external auditor. In contrast, client importance measures the significance of a client relative to the auditor's portfolio of clients.

Our study is important for conceptual and practical reasons. Conceptually, the results would show whether investors perceive independence as a function of non-audit fee ratio although academic studies conclude that client importance, and not non-audit fee ratio, impairs independence. Practically, regulators and audit committees might be misled into preventing non-audit services if the perception of auditor independence impairment is a function of client importance instead of non-audit fee ratio.

Following prior literature (Teoh and Wong, 1993; Hackenbrack and Hogan, 2002; Ghosh and Moon, 2005; Francis and Ke, 2006) we use earnings response coefficients (ERCs) as a measure of investors' perceptions of audit quality.[2] Following much of the prior literature (see Kothari, 2001), we compute ERCs from regressions of annual returns on annual earnings (levels and changes) and from regressions of returns on earnings surprises around quarterly earnings announcements.

Using a large sample of firms with audit and non-audit fee data between 2001 and 2006, and after controlling for the other determinants of ERCs, we find that ERCs are negatively associated with client importance, but there is no evidence of an association between ERCs and non-audit fee ratio. Thus, our results indicate that investors perceive client importance, and not non-audit fee ratio, as compromising auditors' independence. Further, when we decompose client importance into two components, audit fees and non-audit fees from a given client as percentages of the total revenues of the audit firm, we find that only the audit fee component is significantly negatively related to ERCs. Thus, the evidence suggests that investors are concerned about perceived auditor independence when client importance increases because of audit fees, but not because of non-audit fees.

Because size might be correlated with non-audit fee ratio and client importance, we partition the sample by size into three groups and estimate our regression model separately for each size group. We find that ERCs are insignificantly associated with non-audit fee ratio in every size group. On the other hand, the significant negative association between ERCs and client importance holds for middle-sized firms only. One explanation for our results is that auditors' concern for a loss of reputation if independence is impaired in engagements with large clients and less economic dependence in engagements with small clients are perceived as not impairing auditor independence. Another econometric-based explanation for the insignificant results is that there is little variation in non-audit fee ratio or client importance for firms in the large and small size groups compared to firms in the middle size group.

[1] The SEC Proposed Rule: Revision of the Commission's Auditor Independence Requirements (paragraph II (C) 2(a)) http://www.sec.gov/rules/proposed/34-42994.htm cites six sources: (1) Letter from Chairman of POB 1979, (2) SEC Staff Report 1994, (3) Advisory Panel on Auditor Independence (Kirk Panel) 1994, (4) AICPA Special Committee on Financial Reporting (Jenkins Committee) 1994, (5) GAO Report 1996, and (6) Earnscliffe Report 1999, mentioning that non-audit services impair auditor independence in fact or appearance.

[2] Audit quality refers to the probability of detecting and reporting a breach (DeAngelo, 1981). Independence is the probability of reporting a detected breach, and is thus a component of audit quality.