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Auditor Independence and Audit Quality: A Literature Review

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Abstract

This article presents a comprehensive review of academic research pertaining to auditor independence and audit quality. This literature review is conducted based on published articles during the period 1976-2013 in nine leading journals related to auditing. We organize our review around four main threats to auditor independence, namely, (a) client importance, (b) non-audit services, (c) auditor tenure, and (d) client affiliation with audit firms. For each of the threats, we discuss findings related to the incentives, perceptions, and behaviors of the auditor and the client, as well as the effects of each threat on the actual and perceived quality of audits and financial reports. We conclude that the mixed evidence, together with recent regulatory changes, provides opportunities for future research on auditor independence and audit quality.

Keywords

auditor independence, audit quality, client importance, non-audit services, auditor tenure, client affiliation

Introduction

> Since its creation, the Board has conducted hundreds of inspections of registered public accounting firms each year . . . the Board continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism.
>
> James R. Doty, Chairman, Public Company Accounting Oversight Board, March 28, 2012, testimony before U.S. House Committee on Financial Services

Over the years, regulators have expressed concerns about auditor independence and taken actions to mitigate those concerns. These actions include the passage of the 2002 Sarbanes–Oxley (SOX) Act, which prohibits the auditor from providing most non-audit

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services to its clients; imposing a 1-year cooling-off period for former auditors landing jobs at their clients; and requiring audit partners to rotate every 5 years. Most recently, on December 4, 2013, the Public Company Accounting Oversight Board (PCAOB) conducted an open meeting to reconsider its proposal to improve transparency by requiring the disclosure of the name of the engagement partner.[1] Publicly linking the partner's reputation to the audits which he oversees is believed to improve auditor objectivity and independence.

Auditor independence is important because it has an impact on audit quality.[2] DeAngelo (1981a) suggests that audit quality is defined as the probability that (a) the auditor will uncover a breach and (b) report the breach. If auditors do not remain independent, they will be less likely to report irregularities, thereby impairing audit quality.

As independence is a critical issue for the auditing profession, many studies on this topic have been performed. This article reviews evidence related to auditor independence and audit quality. We organize our review around four main threats to auditor independence, namely, (a) client importance, (b) non-audit services, (c) auditor tenure, and (d) client affiliation with audit firms. Auditors have incentives to yield to client pressure to retain major clients and clients purchasing more profitable non-audit services, possibly resulting in compromised independence. Long auditor–client tenure and client affiliation with audit firms create familiarity that may threaten auditor independence and audit quality.

In this article, we review manuscripts published from 1976 to 2013 and limit our search to nine leading journals related to auditing.[3] Our article contributes to the extant literature in the following aspects. First, we review 1976-2013 manuscripts, thus presenting a comprehensive review of the literature on auditor independence and audit quality. Second, we include studies conducted in a variety of international settings, including the United States, the United Kingdom, Australia, China, Germany, Norway, Spain, among others. In light of increasing global efforts to enhance auditor independence,[4] an updated literature review with an international perspective is warranted. Third, we summarize the literature's findings and offer suggestions for future research around the four major threats to auditor independence, which should be useful to academics interested in auditor independence and audit quality, as well as to regulators, investors, and auditors.

The remainder of the article is organized as follows. ''A Framework for Assessing the Impact of Auditor Independence on Audit Quality'' section discusses the framework for assessing the impact of auditor independence on audit quality. The next four sections, ''Client Importance,'' ''Non-Audit Services,'' ''Auditor Tenure,'' and ''Client Affiliation With Audit Firms,'' cover previous research findings related to client importance, non-audit services, auditor tenure, and client affiliation with audit firms, respectively. ''Concluding Remarks and Suggestions for Future Research'' section concludes the article and suggests directions for future research.

A Framework for Assessing the Impact of Auditor Independence on Audit Quality

In our framework shown in Figure 1, we offer four dimensions with which to assess the impact of auditor independence on audit quality. These four dimensions, representing four threats to independence, are (a) client importance, (b) non-audit services, (c) auditor tenure, and (d) client affiliation with audit firms. Although these threats would normally reduce independence, they also have some effect on the capabilities of the auditor.[5] Therefore, the

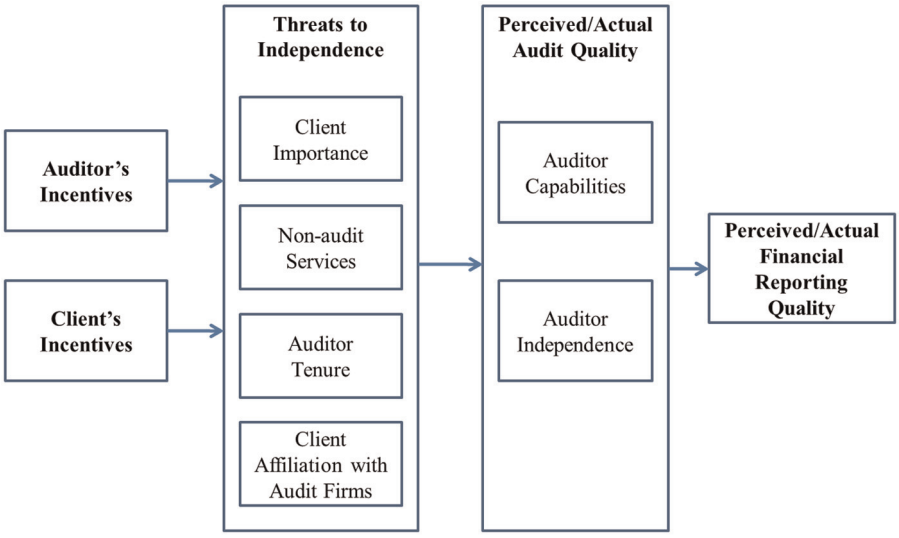

Figure 1. A framework for assessing the impact of auditor independence on audit quality.

impact of the four threats on the quality of audits and financial reports is determined by their net effect on auditor capabilities and auditor independence.

Meanwhile, auditors and clients are likely to have different incentives, resulting in differing perceptions of auditor independence and its effects. For example, auditors are less concerned than non-auditors about the independence problem caused by non-audit services (Beaulieu & Reinstein, 2010). These incentives and perceptions cause the behavior of auditors and clients, as well as the threats to independence, to differ among firms.

In the following literature review, we dedicate one section to each threat. We review the evidence regarding the incentives, perceptions, and behaviors of the auditor and the client, and the effects of each threat on the actual and perceived quality of audit and financial reports.

Client Importance

Auditors are paid by the companies whose financial statements they audit. Economically important clients carry greater weight in an auditor's portfolio. Therefore, an auditor may have a higher incentive to yield to pressure from larger clients, thereby compromising independence.[6] Meanwhile, concerns over litigation and reputation may counter this threat. Therefore, whether audit quality is impaired for important clients is an empirical question. Much research has been conducted on this topic. Studies that use modeling techniques provide strong theoretical grounds for archival and experimental studies. However, empirical evidence is mixed.

Auditors' Incentives, Benefits, and Behaviors

Several articles using theoretical modeling investigate the effect of low-balling on auditor independence and audit quality. DeAngelo (1981b) contends that low-balling is sunk costs and will not impair independence. Lee and Gu (1998) argue that low-balling improves independence. However, Magee and Tseng (1990) indicate that the value of incumbency can negatively affect independence if there is a multi-period disagreement on reporting

policy. Dopuch and King (1996) report experimental evidence that a high degree of low-balling decreases audit quality in non-competitive market settings. However, an archival study by Gul, Fung, and Jaggi (2009) does not find evidence that low-balling results in impaired audit quality.

Despite the fee structure, some modeling articles suggest that litigation risk would decrease the likelihood of auditors acting in favor of the client (e.g., Farmer, Rittenberg, & Trompeter, 1987). In the case of audit failure, an auditor may be subject to legal actions initiated by regulatory agencies or investors, which would harm auditor reputation and potentially cause the auditor to lose fees from other clients (DeAngelo, 1981a). Therefore, high litigation risk serves as an incentive for auditors to remain independent despite economic dependency.

In an early study, Deis and Giroux (1992) document that quality-control review findings increase with the number of clients. Wright and Wright (1997) find that auditors are more likely to waive audit adjustments for larger clients.

Most studies examine the association between client importance and independence using the issuance of the audit opinion, including a modified audit opinion (MAO), a qualified audit opinion (QAO), and a going-concern opinion (GCO). Krishnan and Krishnan (1996) document that auditors are less likely to issue QAOs to larger clients when warranted. Similarly, Blay and Geiger (2013) find that higher current and subsequent fees result in a lower likelihood of GCOs.

In Australia, Craswell, Stokes, and Laughton (2002) do not find evidence that independence is compromised for important clients by examining the propensity to issue a QAO. No such evidence is documented in Norway either, where auditors receiving higher fees are not less likely to issue MAOs (Hope & Langli, 2010). This finding is noteworthy as auditors face lower litigation and reputation risk in a sample of private Norwegian firms, relative to the United States.

Meanwhile, regulatory changes may mitigate concerns that auditor independence is compromised for significant clients. C. Li (2009) finds that in the pre-SOX period, there is no link between client importance and the auditor's propensity to issue a GCO. However, in the post-SOX period, this association becomes positive, indicating that larger clients are more likely to receive a GCO. The positive role of regulatory changes in this regard is also documented in a Chinese setting (S. Chen, Sun, & Wu, 2010).

Reynolds and Francis (2001) find that Big 5 auditors are more conservative toward larger clients. Similar findings are reported for non–Big 5 auditors (Hunt & Lulseged, 2007). In contrast, Chi, Douthett, and Lisic (2012) find that Big N partners do not compromise their independence for large clients, whereas non–Big N partners do. The negative effect of client importance on partner independence is also documented by Trompeter (1994) and Carcello, Hermanson, and Huss (2000).

Clients' Incentives, Perceptions, and Behaviors

Much of the research related to economic dependence places a major emphasis on the auditor's part, and very little has been done from the client's perspective.

Financial Reporting Quality

The evidence regarding the effect of client importance on financial reporting quality is mixed. Using accruals to proxy for financial reporting quality, Reynolds and Francis (2001)

find that Big 5 firms are more conservative toward larger clients in offices. Similar findings are documented for non–Big 5 auditors (Hunt & Lulseged, 2007). However, Chung and Kallapur (2003) report no association between client importance and abnormal accruals. In contrast, Sharma, Sharma, and Ananthanarayanan (2011) document that a positive association exists and that an effective audit committee can lessen the economic bond between the auditor and the client.

Two articles investigate the effect of economic dependence on financial reporting quality in the financial services industry and both support the notion that auditors tolerate less earnings management in larger clients (Gaver & Paterson, 2007; Kanagaretnam, Krishnan, & Lobo, 2010).

Users' Perceptions and Behaviors

From the loan officers' perspective, intense competition in the audit service market reduces the likelihood of the auditor resisting client pressure in audit conflicts (Knapp, 1985).

From the investors' perspective, economic dependence on the client is viewed negatively, as reflected in cost of equity (Khurana & Raman, 2006) and the earnings response coefficient (Ghosh, Kallapur, & Moon, 2009). Meanwhile, investor concern over auditor independence could be alleviated by regulatory changes. Hollingsworth and Li (2012) find a decrease in the association between client importance and the cost of equity from the pre- to the post-SOX period.[7]

Summary. There is limited evidence suggesting auditors' reporting decisions are affected by client importance. The notion that Big N auditors are more conservative toward larger clients is generally supported. Regulatory changes help mitigate concerns that auditor independence is compromised for significant clients. The positive role of regulation is evidenced by both actual and perceived audit quality. In particular, an effective audit committee (a provision of SOX) can help lessen the economic bond between the auditor and the client.

Non-Audit Services

The SOX Act of 2002 prohibits an auditor from providing most non-audit services (NAS) to an audit client. The law is motivated by the belief that the resulting economic bond between auditor and client would impair auditor independence, hence compromising audit quality. However, professionals counter-argue that the joint provision of audit and NAS increases auditors' knowledge base and may result in a more efficient and effective audit. Empirical evidence in this area is mixed.[8]

Auditors' Incentives, Perceptions, and Behaviors

Auditors have an economic incentive to provide NAS to their audit clients, as NAS are usually viewed as being more profitable. Dopuch and King (1991) find that restricting the joint provision of audit and NAS may result in auditors choosing NAS over audit. Simunic (1984) contends that the joint provision of audit and NAS may result in knowledge spillovers, thereby reducing engagement risk and increasing audit quality (Beck & Wu, 2006).

Some studies find a positive association between audit fees and either the provision or magnitude of NAS (e.g., Palmrose, 1986; Simunic, 1984), other studies suggest no relation

(e.g., Davis, Ricchiute, & Trompeter, 1993; Whisenant, Sankaraguruswamy, & Raghunandan, 2003). Chan, Chen, Janakiraman, and Radhakrishnan (2012) report the existence of benefits from the joint offering of audit and NAS when audit and NAS fees are jointly determined.

However, archival studies generally do not provide direct, actual evidence of knowledge spillovers, which is difficult to obtain and may require the examination of audit work papers. An experimental study by Joe and Vandervelde (2007) provides some insights on this topic. They document evidence of knowledge transfer when the same auditor performs both audit and NAS, except when the auditor has access to NAS work papers.

Archival studies focusing on auditors' behaviors use the propensity to issue a GCO to examine whether NAS impair independence. Findings are mostly consistent with the non-existence of such evidence (e.g., Callaghan, Parkash, & Singhal, 2009; DeFond, Raghunandan, & Subramanyam, 2002; Geiger & Rama, 2003). However, Lim and Tan (2008) find that the likelihood of a GCO is higher when NAS acquired from industry specialists increase. Similarly, Robinson (2008) reports a positive relation between tax service fees and the likelihood of correctly issuing a GCO prior to the bankruptcy, suggesting the potential benefits of providing tax services to audit clients.

Clients' Incentives, Perceptions, and Behaviors

Clients of external auditors have incentives to also purchase NAS from them, due to cost savings and higher quality service (Public Oversight Board, 1979). Nevertheless, not all clients prefer to obtain NAS from their external auditors. Companies need independent audits to reduce agency costs. Clients with high agency costs may be less willing to obtain NAS from their auditors because doing so may result in reduction in perceived independence and audit quality (Parkash & Venable, 1993). Firth (1997) confirms that firms with higher agency costs purchase fewer NAS from their external auditors.

Regulation matters when it comes to NAS purchases. After the U.S. Securities and Exchange Commission (SEC) mandated fee disclosures, NAS purchases become negatively associated with firms seeking financing, and the propensity for NAS purchases decreases among larger firms (Abbott, Parker, & Peters, 2011).

In addition, studies in this area have examined different parties within the client firm, including shareholders, directors, and audit committees. Most of the literature on shareholders investigates the association between the magnitude of NAS and shareholder approval of auditors. In an early study, Glezen and Millar (1985) document no relation. However, Raghunandan (2003) reports that NAS are positively related to the proportion of shareholders not voting for auditor ratification. Mishra, Raghunandan, and Rama (2005) argue that such voting may also depend on the type of NAS. They find that the audit-related fees are viewed favorably by shareholders, whereas tax and other service fees are viewed unfavorably.

Pany and Reckers (1983) find that directors are less likely to approve NAS when the magnitude of NAS is high. Regarding the audit committee, researchers find that firms with an effective one purchase fewer NAS (Abbott, Parker, Peters, & Raghunandan, 2003) and outsource less internal auditing activities to the external auditor (Abbott, Parker, Peters, & Rama, 2007). Gaynor, McDaniel, and Neal (2006) provide experimental evidence that audit committees are less likely to recommend the joint provision of both types of services if the fee disclosure is required, confirmed by an empirical study (Abbott et al., 2011).

Financial Reporting Quality

Many studies use accruals as a surrogate for financial reporting quality. Some find that higher NAS fees are associated with lower accrual quality (e.g., Frankel, Johnson, & Nelson, 2002; Srinidhi & Gul, 2007). Other studies suggest no relation (e.g., Ashbaugh, LaFond, & Mayhew, 2003; Chung & Kallapur, 2003; Mitra, 2007). The last group documents the benefits arising from providing NAS: more predictable future cash flows and lower information risk (Nam & Ronen, 2012), shorter audit report lags (Knechel & Sharma, 2012), and improved earnings quality (Koh, Rajgopal, & Srinivasan, 2013).

Several studies provide evidence on factors affecting the relation between NAS and accruals. Larcker and Richardson (2004) find that a negative association between total fees and accruals is most severe for weak governance firms. Gul, Jaggi, and Krishnan (2007) report that NAS are positively related to accruals when auditor tenure is short and client size is small.

Apart from accruals, researchers also use restatement as a surrogate for low financial reporting quality. Kinney, Palmrose, and Scholz (2004) report evidence of (a) positive association between audit fees, audit-related fees, and unspecified non-audit fees and restatement and (b) negative association between tax service fees and restatement. The positive role of auditor-provided non-audit tax services (NATS) is confirmed by Seetharaman, Sun, and Wang (2011), who document a negative association between NATS and tax-related restatements.

Ferguson, Seow, and Young (2004) use both restatement and the likelihood of being targeted by regulatory investigations in the United Kingdom as proxies. They find that NAS lead to low financial reporting quality. Similarly, Markelevich and Rosner (2013) document that NAS fees are positively related to the likelihood of being sanctioned by the SEC for fraud.

Users' Perceptions and Behaviors

Financial statement users may perceive economic dependence induced by NAS as reducing auditor's objectivity and, hence, reducing the quality of financial reports (Kinney et al., 2004). Lavin (1976) finds that payroll services are perceived by loan directors as reducing auditor's objectivity. Shockley (1981) finds that auditors' provision of management advisory service is perceived by bankers and financial analysts as a threat to auditor independence. Lowe, Geiger, and Pany (1999) find that auditors' involvement in internal audit-related management functions has an adverse impact on loan officers' perception and the final loan approval.

Researchers have also studied the effect of NAS on users' behavior. For the equity market, some find no association between the magnitude of NAS and abnormal returns (Ashbaugh et al., 2003; Chaney & Philipich, 2002). However, most evidence is consistent with the negative market reaction to a high level of NAS in various cases: (a) the fee disclosure date (Frankel et al., 2002), (b) quarterly earnings announcement (Francis & Ke, 2006), (c) key events leading up to the passage of SOX (Jain & Rezaee, 2006; Zhang, 2007), (d) Arthur Andersen's clients around the indictment period (Krishnamurthy, Zhou, & Zhou, 2006), and (e) the disclosure of NAS regulation violations (Eilifsen & Knivsflå, 2013). Regarding the earnings response coefficient (ERC), some studies report a negative association between NAS and the ERC (Higgs & Skantz, 2006; Krishnan, Sami, & Zhang, 2005). However, Ghosh et al. (2009) do not find any association. In contrast,

Lim and Tan (2008) document that the ERC increases with the level of NAS acquired from industry specialists.

As for the debt market, the literature indicates that NAS have an adverse impact on either bond ratings (Brandon, Crabtree, & Maher, 2004) or cost of debt (Dhaliwal, Gleason, Heitzman, & Melendrez, 2008).

In the context of audit litigation, Schmidt (2012) investigates the impact of NAS on perceived auditor independence and finds that (a) higher NAS fees lead to an increased likelihood that a restatement results in litigation, and (b) the litigation is more likely to result in auditor settlement and a larger settlement amount if plaintiff attorneys argue that independence was hindered due to economic dependence, in particular, due to NAS fees.

Summary. Most studies find no evidence that NAS impair actual audit quality, based on examining auditors' reporting decisions and the quality of accruals. However, some studies document that NAS increase the likelihood of regulatory investigation and that publicly disclosing NAS fees reduces NAS purchases. This is consistent with the findings of most perception-related studies that financial statement users and juries deem NAS a threat to auditor independence and audit quality. Nonetheless, the empirical evidence regarding actual audit quality suggests otherwise, in particular, tax-related NAS actually improve audit quality.

Auditor Tenure

There are two opposing views on the effects of auditor tenure on audit quality. One states that as the auditor–client relationship lengthens, the auditor may develop a close relationship with the client and become more likely to act in favor of management, thus reducing audit quality. This view supports mandatory audit partner rotation. The other view is that as auditor tenure lengthens, auditors increase their understanding of their clients' business and develop their expertise during the audit, resulting in higher audit quality. The literature on auditor tenure has generally concluded that long auditor tenure does not impair audit quality.

Auditors' Incentives, Perceptions, and Behaviors

Findings of auditor tenure research on the auditor's part have been mixed. Some studies suggest no relation between tenure and auditor's perception or behavior. In an early study on auditor's perception, Shockley (1981) report that auditors do not regard tenure exceeding 5 years as reducing independence. Knechel and Vanstraelen (2007) find that longer tenure neither increases nor decreases the likelihood of GCOs for companies that subsequently went bankrupt.

Other researchers produce conflicting findings on the association between tenure and auditor's behavior. Deis and Giroux (1992) report that quality-control findings decrease as auditor tenure lengthens. Carey and Simnett (2006) confirm that, in Australia, long partner tenure is associated with lower likelihood of GCOs. However, a U.S. study on GCOs suggests that audit failures are more likely in the early years of the auditor–client relationship (Geiger & Raghunandan, 2002).

Bamber and Iyer (2007) point out that the incentive of the individual audit partner may conflict with that of the audit firm. They find that long partner tenure increases the likelihood of the auditor acquiescing to the client's preferences and that audit firm tenure is

associated with the decreased likelihood of auditor concessions. Taken together, these results imply that, unlike an audit partner, an audit firm has stronger reputation incentives to remain independent.

In relation to auditor tenure, researchers have also explored the impact of partner rotation on auditor effort and audit quality. Bedard and Johnstone (2010) provide empirical evidence that planned engagement effort increases following partner rotation. Using interviews and surveys, Daugherty, Dickins, Hatfield, and Higgs (2012) suggest that mandatory partner rotation generally increases the likelihood of relocation while partners would rather pick up a new industry than relocate. Importantly, partners perceive that audit quality suffers from retraining, which suggests that accelerated partner rotation may have an unintended negative impact on audit quality.

Regarding firm rotation, an experimental study by Wang and Tuttle (2009) suggests that under mandatory firm rotation, negotiation results are closer to the preference of the auditor than that of the client. In the case of Spain, Ruiz-Barbadillo, Gómez-Aguilar, and Carrera (2009) find no empirical evidence that mandatory audit firm rotation is associated with a higher likelihood of issuing GCOs.

Clients' Incentives, Perceptions, and Behaviors

There is limited evidence on the client's part. The existing evidence suggests, that clients perceive long auditor tenure positively. In an early survey study, Knapp (1991) finds that the audit committee perceives auditors with tenure of between 5 and 20 years as being more likely to discover material errors than those with shorter tenure. Meanwhile, longer tenure benefits the auditor, as evidenced by increased tax services purchases (Omer, Bedard, & Falsetta, 2006), and the client, as reflected in higher frequency of just meeting earnings benchmarks in Australia (Carey & Simnett, 2006).

Financial Reporting Quality

Most empirical findings are consistent with longer auditor tenure not resulting in lower financial reporting quality. The majority of studies use accruals as a surrogate for financial reporting quality. Myers, Myers, and Omer (2003) and C. Chen, Lin, and Lin (2008) report a positive relation between auditor tenure and earnings quality. Carey and Simnett (2006) find no association in Australia.

Researchers also note that client size matters when it comes to the relation between auditor tenure and financial reporting quality. Manry, Mock, and Turner (2008) find that tenure is not associated with financial reporting quality for large clients, while a negative association exists for small clients, which supports the notion that auditors tolerate less earnings management in larger clients. This notion is confirmed by D. Li (2010), who finds that the positive association between audit firm tenure and conservatism exists for large clients, but not for small clients.

Some studies report results consistent with the notion that auditors need time to develop their understanding of clients' business, so the quality of financial reports may be lower in the early years of engagement. Johnson, Khurana, and Reynolds (2002) report that the quality of financial reports is lower for companies with short-tenure (vs. medium-tenure) audit firms and that the long tenure is not associated with lower quality. Similarly, Carcello and Nagy (2004) find that firms are more likely to receive Accounting and Auditing Enforcement Releases (AAERs) in the early years of the auditor–client relationship, but

there is no evidence of higher propensity to receive AAERs for long tenure.[9] Jenkins and Velury (2008) suggest that accounting conservatism increases between short and medium tenure but does not change between medium and long tenure.

In sum, the aforementioned studies suggest that short tenure is associated with low financial reporting quality. Gul et al. (2009) find that this association is weaker for firms audited by industry specialists compared with those audited by non-specialists. The positive role of industry specialist is confirmed by Lim and Tan (2010). Meanwhile, regulatory changes can also affect the relation between tenure and audit quality. Davis, Soo, and Trompeter (2009) document that short- and long-term tenure is associated with the increased use of discretionary accruals to meet earnings forecast before the enactment of SOX; however, these results disappear in the post-SOX period.

Users' Perceptions and Behaviors

The extant literature largely suggests that financial statement users do not perceive long tenure as impairing auditor independence. Based on a survey of bankers and financial analysts, Shockley (1981) concludes that auditor tenure exceeding 5 years is not perceived as reducing independence. Ghosh and Moon (2005) find that longer tenure is associated with better earnings quality as perceived by equity market investors, which is reflected in larger ERCs.

As for the debt market, Mansi, Maxwell, and Miller (2004) find that longer tenure is associated with lower cost of debt in the bond market. However, Ghosh and Moon (2005) suggest that tenure does not influence debt-market analysts' perception of earnings quality. Similarly, Fortin and Pittman (2007) report no relation between tenure and the yield spread of private firms.

Boone, Khurana, and Raman (2008) suggest that the relation between audit firm tenure and investor perception of independence is not linear, as reflected in the equity risk premium. Similarly, in Australia, Azizkhani, Monroe, and Shailer (2013) find that audit partner tenure has a non-linear relation with cost of equity. They also find that cost of equity increases following partner rotation. However, in Taiwan, Chi, Huang, Liao, and Xie (2009) do not find any impact of partner rotation on actual audit quality (proxied by abnormal accruals) or perceived audit quality (proxied by the ERC).

Summary. Most studies conclude that long auditor tenure does not impair auditor independence. Some studies find that long tenure actually improves audit quality and that short tenure is associated with lower audit quality. Meanwhile, research on auditor tenure generally supports the notion that auditors tolerate less earnings management in larger clients. Financial statement users generally do not perceive long tenure as impairing auditor independence.

Client Affiliation With Audit Firms

Imhoff (1978) raises three issues concerning the auditor–client relationship, which may impair independence: (a) the auditor may view the client as a potential employer; (b) the auditor's closeness with management may create a distance between the auditor and shareholders, the real employer of the auditor; and (c) the auditor may have difficulty in maintaining independence in front of their former colleagues. In relation to these concerns, SOX requires a 1-year cooling-off period before the audit partner or other engagement team members can work for the client as a financial officer. There is limited evidence on the affiliation threat, probably because it occurs less frequently than generally expected (Francis, 2004).

Auditors' Incentives, Perceptions, and Behaviors

Imhoff (1978) is one of the first to explore the auditor–client employment issue and reports that Certified Public Accountants (CPAs) are less critical than financial statement users regarding independence.

In addition to the scenario where the client hires the auditor (referred to as ''employment affiliation''), Lennox (2005) also examines the case where the company hires its officer's former employer as the auditor (''alma-mater affiliation''). He finds that auditors are more likely to issue clean audit opinions to companies with either employment- or alma-mater-affiliated executives than to those without. Similarly, Ye, Carson, and Simnett (2011) find that auditors are less likely to issue GCOs to clients with both alumni directors and significant NAS purchases in Australia.

Clients' Incentives, Perceptions, and Behaviors

The existing research indicates that companies have incentives for affiliation with audit firms. Lennox (2005) finds that after the auditor issues clean opinions, the turnover of affiliated executives is lower than that of unaffiliated ones, suggesting the value of affiliation being recognized by the client. Menon and Williams (2004) report that firms with former partners are more likely than those without to just meet analyst forecasts, which suggests that client management may benefit from their affiliation with audit firms.

Apart from the potential benefits to clients, the ex-auditor, employed by the client, may encourage the alma-mater affiliation (Iyer, Bamber, & Barefield, 1997). A later study by Lennox and Park (2007) confirms that the probability of appointing a particular auditing firm is higher if its alumni are client officers. In addition, more NAS are purchased from the auditor in the presence of alumni directors and longer audit firm tenure in Australia (Ye et al., 2011). In contrast, Naiker, Sharma, and Sharma (2013) find that the presence of former audit partner on audit committees, regardless of affiliation with the current auditor, results in decreased NAS procured from the auditor.

Financial Reporting Quality

The existing research has yielded conflicting results on the effect of client affiliation with auditors on financial reporting quality. Menon and Williams (2004) find that companies employing former partners as officers or directors have larger abnormal accruals than control firms. Meanwhile, some research indicates the absence of adverse effects of revolving-door appointments on financial reporting quality. Geiger, North, and O'Connell (2005) document that firms hiring financial reporting officers directly from their audit firms do not manage earnings to a greater extent. Geiger, Lennox, and North (2008) report no evidence of lower financial reporting quality, proxied by accruals and the likelihood of receiving AAERs, following revolving-door appointments.

Users' Perceptions and Behaviors

There is limited evidence regarding the threat to independence arising from outplacement of former auditors in client firms. As mentioned in ''Auditors' Incentives, Perceptions, and Behaviors'' section, financial statement users seem to perceive the threat to independence more critically than CPAs (Imhoff, 1978). However, Geiger et al. (2008) argue that the

revolving-door appointment may also be perceived as bringing potential benefits to auditees, through the knowledge and expertise of the ex-auditor. Their event-study findings indicate that the stock market views the appointment of firms' external auditors as their financial officers positively for smaller firms.

Summary. There is mixed evidence regarding the impact of client affiliation with auditors on audit quality. Some studies find this affiliation compromises auditor independence and audit quality. Other studies report no such evidence. There is some limited evidence suggesting that financial statement users view the revolving-door appointment positively for smaller firms, even though they perceive this affiliation threat more critically than auditors.

Concluding Remarks and Suggestions for Future Research

Auditor independence has long drawn the attention of regulators, investors, auditors, and researchers. To help interested parties better understand the impact of auditor independence on audit quality, we review articles published from 1976 to 2013 in nine leading journals. We organize our review around four main threats to auditor independence, namely, (a) client importance, (b) non-audit services, (c) auditor tenure, and (d) client affiliation with audit firms.

Based on our review, we conclude that there is limited evidence that auditor independence is compromised in the presence of client importance and NAS. SOX has led to improvements in audit quality and financial reporting. Financial statement users generally perceive NAS as a threat to auditor independence, whereas the evidence regarding actual audit quality suggests otherwise; in particular, tax-related NAS actually improve audit quality.

Most studies conclude that long auditor tenure does not impair independence. Some find that long tenure actually improves audit quality and that short tenure is associated with lower audit quality. Only a few studies have examined the client affiliation threat and the evidence is mixed, therefore more research in this arena is needed. Below, we provide some suggestions for future research, first centered on the four main threats and then extended to general settings.

Client Importance

The existing studies on client importance are mostly performed at the national and office level. However, in practice, decisions for audit engagement are made at the partner level. As partner compensation scheme may affect auditor independence (e.g., Trompeter, 1994), further research at the partner level may provide additional insights into this topic. In addition, the threat of client importance to auditor independence is consistent with the notion that abnormally high audit fees are seen as a red flag (e.g., Choi, Kim, & Zang, 2010). Meanwhile, abnormally low fees are worth investigating as well, as they suggest strong client bargaining power, which may influence auditor independence and ultimately affect audit quality (e.g., Asthana & Boone, 2012).

Non-Audit Services

Most U.S. studies find no evidence that NAS impair actual audit quality, based on examining auditors' reporting decisions. However, a German study reports that Big 4 auditors

are less likely than non–Big 4 counterparts to issue GCOs to clients with high NAS fees (Ratzinger-Sakel, 2013). This finding is at least in part due to low litigation risk in Germany, as the ''deep pockets'' of Big 4 auditors expose them to high litigation risk in the United States, but not in Germany. Therefore, this German finding suggests that the concerns over litigation, rather than over reputation, play a more important role in lessening the economic bond between the client and the auditor. As the archival NAS studies mostly use the U.S. data, it would be useful to conduct this line of research in other countries. Because the U.S. setting is generally recognized as extremely litigious, foreign jurisdictions with low litigation risk would provide a useful setting in which the litigation effects are reduced and the reputation effects can be better observed.

Moreover, research concerning auditor independence and audit quality may benefit from cross-country comparisons due to regulatory and cultural differences. Examination of various countries would likely reveal differences in the incentives, perceptions, and behaviors of the multiple parties (auditors, clients, and financial report users). For example, using a sample of Big 6 auditors from seven European countries, Arnold, Bernardi, and Neidermeyer (1999) find some association between litigation risk and the auditor's consideration to perform additional audit work.

Auditor Tenure

Much research on auditor tenure has been performed at the audit firm level, and there have been increasing studies conducted at the partner level. Some tenure studies report that audit partner tenure, as well as audit firm tenure, affects financial reporting quality (e.g., C. Chen et al., 2008). Further research on audit partner tenure may help achieve a better understanding of the different incentives of audit firms and audit partners (e.g., Bamber & Iyer, 2007) and help justify the audit partner rotation required in many countries.

Apart from mandatory rotation, replacing a partner early could be a signal of impaired auditor independence.[10] Given the SOX partner-rotation requirement has been in place for about a decade in the United States, we call for research on the topic of early replacement/rotation (before the end of the fifth year), which can provide some insight into this phenomenon.

Regarding firm rotation, an experimental study shows that mandatory firm rotation results in improved auditor independence (Wang & Tuttle, 2009). However, archival evidence in Spain does not lend any support to mandatory firm rotation (Ruiz-Barbadillo et al., 2009). Furthermore, a modeling study shows that mandatory firm rotation reduces investment efficiency in the absence of opinion shopping (Lu & Sivaramakrishnan, 2009). These findings should be of interest to the PCAOB, as its proposal on mandatory firm rotation won support from only a minority of comment letters (PCAOB, 2011b).

Client Affiliation With Audit Firms

Only few studies have examined whether client affiliation with auditors has an impact on audit quality, a topic where we recommend further research. In particular, there is limited evidence suggesting that financial statement users perceive the revolving-door appointment positively for smaller firms, even though they view this affiliation threat more critically than auditors. Therefore, future studies may want to examine whether the perceived benefits of the revolving-door appointment actually result in improved financial reporting quality in those firms arguably benefiting from the expertise of the ex-auditor.

Future research on the revolving-door phenomenon in the auditing field can also be motivated by findings in other settings. For example, deHaan, Kedia, Koh, and Rajgopal (2014) examine whether the revolving-door affects the SEC's enforcement results. They find that enforcement outcomes are tougher for lawyers departing the SEC to join law firms and defending before the SEC, which is consistent with those SEC lawyers pursuing more enforcement effort to showcase their expertise to prospective employers (a ''human-capital'' hypothesis). Therefore, it would be interesting to explore if this hypothesis is supported with regard to the auditing revolving-door phenomenon.

Other Research Avenues

Based on our review, we note only two studies have examined auditor independence and audit quality in the financial services industry (Gaver & Paterson, 2007; Kanagaretnam et al., 2010). Yet bank audits by the world's six largest accounting firms have been found to be ''persistently riddled with flaws,'' according to the results of a survey conducted in 2013 by the International Forum of Independent Audit Regulators.[11] As the regulators have pointed out that these audits often had deficiencies related to auditing loan-loss allowances, loan impairments, and investment valuation, we encourage researchers to conduct studies in this relatively under-explored area. Furthermore, the Federal Reserve already requires bank holding companies to provide the identity of their audit engagement partners. This required disclosure facilitates research on auditor independence in the financial services sector as disclosing the engagement partner is believed to improve auditor objectivity and independence.

The disclosure requirement is expected to apply to all U.S. public firms in 2014.[12] Therefore, once this regulation is enacted, it will provide a promising avenue for research at the partner level in the United States, as some studies have already explored other jurisdictions with the signature requirement in place.[13] Findings in these studies invite similar research in the U.S. setting once the partner-level data become available. Then, we have a better understanding of whether this new regulation helps improve auditor independence and audit quality.

Appendix

List of Nine Leading Journals

1. *Auditing: A Journal of Practice and Theory*
2. *Accounting, Organizations, and Society*
3. *Contemporary Accounting Research*
4. *Journal of Accounting, Auditing, and Finance*
5. *Journal of Accounting and Economics*
6. *Journal of Accounting and Public Policy*
7. *Journal of Accounting Research*
8. *Review of Accounting Studies*
9. *The Accounting Review*

Authors' Note

The views and opinions in this article are those of the authors, and all errors remain their own.

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Notes

1. The Public Company Accounting Oversight Board (PCAOB, 2011a) believes that this requirement would increase transparency and accountability of the engagement partner.
2. See Francis (2011) for a general framework for studying factors affecting audit quality. See Francis (2004) and Watkins, Hillison, and Morecroft (2004) for reviews of the literature on audit quality, with the former focusing on empirical research and the latter encompassing both theory and empirical evidence.
3. The appendix lists the nine leading journals covered in our literature review. Summaries of every article reviewed, grouped by topic into four tables, are available at *SAGE Open*.
4. For example, the International Auditing and Assurance Standards Board has released a proposal requiring the disclosure of the engagement partner's name, and the PCAOB is expected to make a final decision on this requirement in 2014.
5. For example, although non-audit services may hinder independence, these services may also enhance auditor competency due to knowledge spillovers (Simunic, 1984).
6. PCAOB Rule 3521 prohibiting auditors from charging contingent fees that depend on a finding or result of the audit (PCAOB, 2006) to some extent helps alleviate auditor economic dependence on clients. However, to the best of our knowledge, there is no regulatory requirement in the United States directly addressing the magnitude of client importance. In Australia, an auditing standard explicitly cautions auditors to avoid an economic dependence situation where a client or group of connected clients constitutes a significant part of an auditor's revenue. The standard also suggests 15% as the bright-line threshold (Australian Society of Certified Public Accountants Members Handbook, Statement of Auditing Practice AUP 32, para. 28, cited in Reynolds & Francis, 2001).
7. Despite a decrease, the association remains positive, indicating that Sarbanes–Oxley (SOX) Act mitigates but does not completely eliminate investor concerns about the threat of auditor economic dependency (Hollingsworth & Li, 2012).
8. See Schneider, Church, and Ely (2006) for a review of the literature on non-audit services and auditor independence.
9. Since 1982, the SEC has issued Accounting and Auditing Enforcement Releases (AAERs), which describe its investigations against companies or auditors for alleged accounting and/or auditing misconduct.
10. For example, one partner was removed from the audit team for Enron because he did not agree with certain Enron's accounting practices.
11. http://www.nytimes.com/2014/04/11/business/survey-finds-audit-flaws-by-the-big-accounting-firms.html.

12. The disclosure requirement issue has long been on the PCAOB's agenda. In 2009, the PCAOB issued a concept release that would require the lead engagement partner's signature. In 2011, the PCAOB issued a proposal that would have required the disclosure of the engagement partner's name without requiring a signature (PCAOB, 2011a). In the current 2013 proposal under consideration, the PCAOB believes that disclosing an audit partner's name and not signature would provide most of the same potential benefits while mitigating personal liability concerns (PCAOB, 2013). The PCAOB is expected to make a final decision on this requirement in 2014.
13. For example, in the U.K. setting, the engagement partner signature requirement leads to improved audit quality (Carcello & Li, 2013); in Sweden, investors react to different reporting patterns of individual audit partners (Knechel, Vanstraelen, & Zerni, 2013); in Australia, individual audit partners earn individual audit fee premiums (or discounts) that are not attributable to their firms (Taylor, 2011).

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