

## THE IMPACT OF NON-AUDIT SERVICES ON INSTITUTIONAL INVESTORS' PERCEPTION OF AUDITOR INDEPENDENCE: EVIDENCE FROM TURKEY

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### THE IMPACT OF NON-AUDIT SERVICES ON INSTITUTIONAL INVESTORS' PERCEPTION OF AUDITOR INDEPENDENCE: EVIDENCE FROM TURKEY

**Abstract:** In recent years, audit profession was confronted with different regulations, revised rules on Non-Audit Services (NAS) and on Auditor Independence. In depth, Professional Accountancy Bodies amended their independence rules according to Sarbanes-Oxley Act of 2002. For instance, the Securities Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA) in the USA, Capital Market Board (SPK) in Turkey made amendments to their independence rules on Non-Audit Services and on auditor independence in light of the Sarbanes-Oxley Act of 2002. The purpose of this paper is to examine whether "non-audit services (NAS)" jeopardize institutional "investors' perception of auditor independence in Turkey". Therefore, questionnaire was administered to 34 institutional investors in Istanbul, Turkey. It was generally found that institutional investors' perception of auditor independence is not impaired at the time of joint provision of NAS and audit services to an audit client.

**Keywords:** Non-Audit Services, Auditor Independence

### KURUMSAL YATIRIMCI GÖZÜYLE DENETİM DIŞI HİZMETLERİN DENETÇİNİN BAĞIMSIZLIĞINA ETKİSİ: TÜRKİYE'DEN ÖRNEKLER

**Özet:** Son yıllarda denetim dünyası "denetim dışı hizmetler ve denetçinin bağımsızlığı" ile ilgili yeni düzenlemelerle ve yeni kurullarla tanışmıştır. Yetkili otoriteler bu yeni kuralları belirlerken temelde Amerika'daki Sarbanes-Oxley Act'i örnek almışlardır. Örneğin, Amerika'daki Sermaye Piyasası Kurulu(SEC), Amerika'daki Kamu Denetçileri Enstitüsü(AICPA), Türkiye'deki Sermaye Piyasası Kurulu(SPK) "denetim dışı hizmetler ve denetçinin bağımsızlığı" ile ilgili kurallarını revize ederken Sarbanes-Oxley Act'i temel almışlardır. Bu makalenin amacı "Türkiye'deki kurumsal yatırımcılar gözünüle, denetim dışı hizmetlerin denetçinin bağımsızlığını zedeleyip zedelediğini" ölçmektir. Bunun için anket düzenlenerek 34 kurumsal yatırımcıya dağıtılmıştır. Analizin sonunda şu sonuca ulaşılmıştır: Türkiye'deki kurumsal yatırımcıların gözünüle, denetçiler "denetim hizmetinin yanında denetim dışı hizmetleri" de "denetim müşterilerine" sağarlarsa, denetçinin bağımsızlığı zedelememektedir.

**Anahtar Kelimeler:** Denetim Dışı Hizmetler, Denetçi Bağımsızlığı

## I. INTRODUCTION

Before the Enron/Andersen demise and the amended rules on auditor independence, such as Sarbanes-Oxley Act of 2002, and SEC Regulation, etc., the Big Four started to make money from its non-audit services. Take, for instance, Ernst&Young (E&Y). E&Y's non-audit fee range was 66% of total fee revenues in 2001. Arthur Andersen's non-audit fee was 67% of total fee revenue. Moreover, PricewaterhouseCoopers' one was 75% in 2001[1]. During the audit engagement of Enron, Andersen received more than half of its revenue from consulting services. Neville Grusd and Thomas W. Morris [2] expressed that joint provision of NAS and audit services to Enron influenced the auditors' decisions on Enron financials.

What is more, after Enron/Andersen audit failure, it was observed that joint provision of audit and non-audit services (NAS) to attest client weakened the quality of the relationships between the auditors and their audit clients

and undermined the auditor independence. That's why, Sarbanes-Oxley Act, SEC Rule in the US and Capital Market Board (SPK) Regulation in Turkey prohibited auditor from rendering non-audit services-bookkeeping, financial information system design and implementation, appraisal or valuation, actuarial, internal audit, human resources, broker-dealer, expert, consulting, and legal services- to attest client. In simpler terms, apart from tax services, the NAS are the impermissible services for the audit clients.

In general, the whole stated rules endeavor to protect the auditor independence. From this viewpoint, independence is regarded as being one of the "fundamental principles" underlying auditors' work. It is held that if auditor is not truly independent then his opinion on a company's financial statements will be of no value [3].

This study is motivated by the significance of auditor independence, recent adopted rules on auditor

independence and NAS, the studies regarding perceptions of auditor independence and NAS around the world.

In the wake of these motivations, this article aims to examine the role and importance of auditor independence as perceived by institutional investors in Turkey. That's, the purpose of the study is to set out whether "non-audit services (NAS)" jeopardize institutional "investors' perception of auditor independence in Turkey".

The paper is organized as follows: Section 2 provides an overview of the "literature survey". In section 3, "research hypotheses" are stated. Section 4 describes the "research methodology". Under the research methodology, unit of analysis and questionnaire survey are explained. "Analysis and findings" are summarized in section 5. Finally, section 6 is the brief conclusion.

## II. PRIOR RESEARCH

The results of the literature survey on "non-audit services (NAS) and perceptions of auditor independence" can be categorized as three groups: "negative effects", "positive impacts", and "no effect".

From the researchers' viewpoint that NAS adversely impact on perceptions of auditor independence, collateral services create a working relationship between the auditors and the clients that is too close [4]. It is asserted that the provision of NAS by increasing an audit firm's income may increase management's power over the auditor and thereby impairing auditor independence [5]. In particular, Michael Firth [3] states that lack of auditor independence is perceived to impair investment and lending decisions. Consistent with Firth (1980) [3], Shockley (1981)[6], Lavin (1977), Dyhxoorn and Sinning (1982), Bartlett (1997,1993) [8], Canning and Gwilliam (1999) [5], Pany and Recklers (1983), Knapp (1985), Lowe, Geiger, and Pany (1999,2002) [9], Oliverio and Newman (2000)[10], Lindsay, Rennie, Murphy, and Silvester (1987), Teoh and Lim (1996), Independence Standard Board (ISB,1999,2000) [11,12], Agacer and Doupnik (1991), Dopuch and King (1991), and Goldwasser (1999) assumed that NAS is a factor "jeopardizing" auditor independence [4,7].

On the other hand, others believed that non-audit services (NAS) enhance the auditor knowledge of the client (knowledge spillovers), thus increasing the auditor's objectivity [4]. Gul (1989), Jenkins and Krawczyk (2001) [4], Reckers and Stagliano (1981), Penn, Schoen, and Berland Associates (2000), Hussey (1999), Gul and Yap (1984), Goldmen and Barkley (1974), Goldwasser (1999), Wallman (1996), Schulte (1965), and Hartley and Ross (1972) stated that provision of non-audit services to audit client increase auditor's objectivity and perceived auditor independence. In other

words, there is a "positive impact" [4,7].

In addition to adverse and positive effects, other studies indicate that provision of non-audit services to audit client has no effect on perceptions of auditor independence. Lavin (1976) [13], McKinley, Pany, and Reckers (1985), Pany and Reckers (1988), Glezen and Miller (1985), Wallman (1996), and Kinney (1999) found that provision of non-audit services to audit client has "no effect" on perceptions of auditor independence [4,7].

As seen in the above literature surveys, there is no consensus on the perceptions of auditor independence at the time of the joint provision of NAS and audit services to attest client. Despite the distinct viewpoints, the regulatory bodies in the US and in Turkey banned the auditors from providing NAS to audit clients after the "Enron saga".

On the basis of the above researches, the whole literature survey compiled up to now took placed out of Turkey; hence, this study aims to present paperwork for institutional investors' perceptions of auditor independence in "Turkey".

## III. RESEARCH HYPOTHESES

This study investigates the effects of NAS on institutional investors' perceptions of auditor independence. The formal hypothesis is:

H<sub>01</sub>: "Institutional investors" perceive that auditor independence is not impaired at the time auditors provide both Non-audit services (NAS) and audit service to attest client.

As stated in the introduction part, since NAS comprise 11 services, such as bookkeeping, financial information system design and implementation, appraisal or valuation, actuarial, internal audit, human resources, broker-dealer, expert, consulting, legal, and tax services, and each services could have different impact on perceptions of auditor independence, the following sub-hypotheses are also developed.

H<sub>02</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both "bookkeeping" service and audit service to attest client.

H<sub>03</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both "internal audit service" and audit service to attest client.

H<sub>04</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide

both “financial information system design and implementation” service and audit service to attest client.

H<sub>05</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both “valuation” service and audit service to attest client.

H<sub>06</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both “actuarial” service and audit service to attest client.

H<sub>07</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both “broker-dealer or investment banking” service and audit service to attest client.

H<sub>08</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both “legal” service and audit service to attest client.

H<sub>09</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both “Expert” service and audit service to attest client.

H<sub>010</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both “tax” service and audit service to attest client.

H<sub>011</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both “management advisory” service and audit service to attest client.

H<sub>012</sub>: Institutional investors perceive that auditor independence is not impaired at the time auditors provide both “human resources” service and audit service to attest client.

**IV. RESEARCH METHODOLOGY**

**IV.1. Unit of Analysis**

The study subjects were 34 institutional investors (inst. Invest.) from the 109 intermediary institutions [14] in Istanbul, Turkey. More specifically, 34 portfolio or fund managers are named as “institutional investors” in this study, for they are in charge of deciding on which public company should be added to investment portfolio. By a selecting 34 institutional investors out of 109, our coverage for institutional investors is % 31.19.

**IV.2. Questionnaire Survey**

To test the hypotheses, the questionnaire survey was utilized. This survey questionnaire is made up of introduction part, demographic questionnaire, and perception questionnaire. In the introduction part, the

definitions of selected terms on auditing are given to inform the respondents.

In the demographic questionnaire, it is aimed to define the characteristics of the target group. Therefore, age, sex, and education level are asked to participants.

Then, in the perception questionnaire, the survey asked participants to rate 11 non-audit services (NAS) defined in the Sarbanes-Oxley Act of 2002 in order to reflect their perceptions of auditor independence. The scale was the interval scale and 7-point Lickert Scale. The independence rating scale was bounded by “too independent (7)” and “not independent at all (1)”.

**V. ANALYSIS AND FINDINGS**

The variables were analyzed by means of “T-test” since it was an interval scale, population was assumed to be normal and population was “somewhat” above the 30. The below results were computed via T-test under the “SPSS” program.

Before the results of the T-test, the following table 1, table 2, and table 3 present the outcomes of the characteristics of the unit of analysis.

**Table.1. The Result of the Demographic Survey- Percentages & Age**

AGE (%)							
	Upto 20	21-30	31-40	41-50	51-60	Above 60	Total
Inst. Invest	0.0	20.6	55.9	17.6	5.9	0.0	100.0

**Table.2. The Result of the Demographic Survey- Percentages & Gender**

GENDER (%)			
	Female	Male	TOTAL
Inst. Invest	26.5	73.5	100.0

**Table.3. The Result of the Demographic Survey- Percentages & Education**

Education (%)				
	High School	University	Master	TOTAL
Inst. Invest	11.8	70.6	17.6	100.0

On the basis of the above outcomes, the 55.9 percent of the institutional investors ranged from the ages of 31 to 40. 73.5 percent of the institutional investors were Male. Besides, 70.6 % of the institutional investors had undergraduate degree.

**Table.4. The Result of the H<sub>01</sub>**

Test	N	T-Value	P-Value	Significance
T-Test	34	-0,641	0,05	0,526

Table.4 depicts that since significance (0,526) is greater than p-value (0,05), null hypothesis will not be rejected. That is, “institutional investors” perceive that auditor independence is not impaired at the time auditors provide both non-audit services (NAS) and audit service to attest client.

**Table.5. The Outcome of the Hypotheses H<sub>02</sub>- H<sub>012</sub>**

NAS	T-Value	Sig.	As	Conclusion
Bookkeeping	-4.226	0.000	Sig.<0.05	Reject the null hypothesis
Internal Audit	-1.486	0.147	Sig.>0.05	Accept the null hypoth.
Fin. Info. System. Design	-0.304	0.763	Sig.>0.05	Accept the null hypoth.
Valuation	0.399	0.692	Sig.>0.05	Accept null hypoth.
Actuarial	0.380	0.706	Sig.>0.05	Accept the null hypoth.
Broker-Dealer	-2.423	0.021	Sig.<0.05	Reject the null hypothesis
Legal	0.551	0.585	Sig.>0.05	Accept the null hypoth.
Expert	1.370	0.180	Sig.>0.05	Accept the null hypoth.
Tax	0.648	0.522	Sig.>0.05	Accept the null hypoth.
Mng. Advisory (MAS)	-1.000	0.325	Sig.>0.05	Accept the null hypoth.
Human Resources (HR)	-0.307	0.761	Sig.>0.05	Accept the null hypoth.

Table.5 presents that institutional investors perceive that only a joint provision of “bookkeeping” or “broker-dealer” service and audit service to attest client *impairs* auditor independence. That’s, for the rest of the NAS, auditor independence is not compromised at the time of joint provision.

After the detailed analyses, it is intended to summarize the whole findings under the succeeding table.

**Table.6. The Overall Findings**

Inst. Invest. Perceptions of Auditor Independence	
NAS	Not impaired
Bookkeeping	Impaired
Internal Audit	Not impaired
Fin. Info. System. Design	Not impaired
Valuation	Not impaired
Actuarial	Not impaired
Broker-Dealer	Impaired
Legal	Not impaired
Expert	Not impaired
Tax	Not impaired
Mng. Advisory (MAS)	Not impaired
Human Resources (HR)	Not impaired

As seen above, even though the result of the average calculation of each NAS entitled “NAS” in the table.6 is “not impaired”, the each non-audit service has different effect on institutional investors perceptions of auditor independence.

Finally, apart from the “bookkeeping” and “broker-dealer” services, joint provision of NAS and audit services to auditee does not compromise auditor independence from the institutional investors’ point of view in Istanbul, Turkey.

## VI. CONCLUSION

After the momentous incident, Enron/Andersen in the U.S, audit profession was confronted with amended regulations regarding “auditor independence and NAS” in the US and in Turkey. Regulatory bodies banned auditor from rendering NAS to auditee. The revised regulations have been enacted to promote investors’ confidence in auditor independence after the above mentioned audit failures.

Under such circumstances, the literature surveys regarding “perceptions of auditor independence and NAS” were examined. It was noticed that all the studies took place out of Turkey and there is no consensus on this topic.

That’s why, this paper aims to present a study about Turkey and to contribute to the existing literature. This study probed into the institutional investors’ perception of auditor independence in Turkey.

Overall, consistent with the studies of Jenkins and Krawczyk (2001) [4], Reckers and Stagliano (1981), Penn, Schoen, and Berland Associates (2000), etc., it was found that institutional investors' perception of auditor independence are not compromised at the time of the joint provision of NAS and audit services to attest client [7].

Finally, in spite of the distinct viewpoints and the different results of the studies, it was realized that after the collapse of Enron/Andersen, shattered confidence in auditor independence and in corporate America, and the loss of wealth in one night in the stock exchange, not allowing auditors to render NAS to auditee in the US and in Turkey was the most sensible thing to do.

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