

The Effect of Non-audit Services on Auditor Independence and Auditor Knowledge: from the Standpoint of Investors

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ABSTRACT

This thesis investigate the effect of non- audit services on investor judgments about auditor independence and auditor knowledge about the client firm.

Auditor independence goes to the very essence of our capital markets ,and it's linked inextricably to the efficiencies of our capital markets [23].Increasing levels of non- audit services (NAS) provided by auditors to their audit clients , have brought the issue of auditor independence to the forefront .

This study experimentally investigates investor's perceptions of auditor independence and auditor knowledge, in the presence of various types of non- audit services (NAS).

The purpose of this study was response to following questions: 1. From investor point of view, does the auditor independence have been impaired due to the provision of non- audit services by the company's independent auditor. 2. Does the auditor's knowledge affected due to the offering of non- audit services by the company's independent auditor.

In this investigation, two hypotheses have been proposed and required information have been collected in order to hypotheses test according to questionnaire and questions of sample members (securities investors and financial analysts).in this study, the T- Test and Chi-square Test have been used for evaluation of hypotheses . The results show that from investor perspective, when independent auditor provide non- audit services to the client firm, the independence of auditor is impaired. In other words findings suggest that the provision of non- audit services by the company's independent auditor does negatively affect investor's perceptions of auditor independence .The results indicate that the provision of non- audit services by the company's independent auditor increased an auditor's knowledge about the client firm. In other words results showed that perception of auditor knowledge about the client firm was positively affected by the provision of non- audit services, (auditor will able to discern a financial reporting problem, ifone exists).

KEYWORDS: non- audit services, auditor independence and auditor knowledge.

1. INTRODUCTION

In joint stock companies, accounting and auditing as well as important social role found. The subject currently under debate in the scope of auditing pertains to provision of non-audit services of auditing institutes to their clients. This subject has caused the professional circles to face the problem that whether non-audit services, provided by auditing institutes to their client firms, damage the independence of the auditor or not. Provision of such services creates some sort of financial and vocational dependence between the auditing institutes and their client With the development of capital markets and the increasing separation of ownership from management and increase investment firms. The duty of an independent audit is accreditation of financial statements and opining about their totality. The accreditation role of auditors will improve the credibility of financial statements if the users of these statements recognize their audits as honest and unbiased persons. The second standard of general standards of auditing states that the auditor or auditors should maintain their independence of declaring opinion in all aspects of auditing. This standard requires the auditors to maintain their opinion and vote independence and avoid relations and behaviors that impair their neutrality. In simple words, the independent auditors should not permit prejudgment, bias, and conflict of interests or influence of other parties to damage their unbiased behaviors in provision of specialized services [1 and 5].

Non-audit services provided by auditors to their clients are diverse. Therefore, in the current research, in addition to six non-audit services [These 6 items include: specialized services related to account correction, services of preparation and maintenance of accounting records, management consultation services, services of designing information systems, Internal accounting services, Adjustment of financial statements] that should be avoided in accordance with the professional behavior statute of Iranian Association of Certified Public Accountants during

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auditing, other non-auditing services which might affect the independence of the auditor were also identified. These services are listed below: [19 and 21]

- a. Human resources services (recruitment of executive staff for the client firm).
- b. Consulting and guidance services for preparation and adjustment of financial statements.
- c. Taxation consultation services.
- d. Insurance consultation services.
- e. Marketing and product analysis services.
- f. Educational services related to accounting.
- g. Assessing non-cash assets of shareholders
- h. Stock evaluation services.
- i. Legal consulting services.
- j. Merger and acquisition services.

Despite the fact that the auditors receive salary for their services but the auditor's ability to maintain independence is under question among the specialized circles. It seems that if the auditor earns higher salary, the client can potentially have larger influence on the auditor. Furthermore, the auditors are expected to advocate and support the client whilst doing the non-audit services. This fact is in contradiction with the duty of the auditor for supporting and advocating the public interests. In another word, higher financial benefits from the client firm might affect independence and neutrality of auditor [2].

Increasing levels of non-audit services (NAS) provided by auditors to their audit clients, along with large-scale investigations of questionable accounting practices employed by major firms, have brought the issue of auditor independence to the forefront. The magnitude of these NAS fees, as well as the advocacy issues they raise, increase concerns, not only about the ability of the auditor to be independent, but also how these conflicting roles affect the investing public's perception of the auditor and the financial statements themselves. While research evidence has not usually shown that auditors lose their independence when providing non-audit services, the risk that they could do so is still a concern to regulators and financial report users [6].

According to above mentioned discussions, the present paper investigates the effects of various non-audit services on independence and knowledge of auditor aiming to attract the attention of professional circles for increasing the limitations and prohibitions of provision of non-audit services.

2. LITERATURE REVIEW

The domain of non-audit services provided by auditing institutes to their clients had been developing till 2003, when the professional ethics of Iranian Association of Certified Public Accountants was legally enforced in early 2004. This statute states while independent certified accountants provide professional and specialized services, they cannot undertake auditing of that specific fiscal period. These specialized and professional services include account adjustment, preparation and preservation of accounting records, consultation services, designing information systems, internal auditing, and adjustment of financial statement. At the beginning of 1960, researchers' concerns increased about provision of various non-auditing services provided by independent auditors to their client firms. Consequently, US Securities and Exchange Commission obligated the public corporate companies to disclose the salaries paid for non-audit services as a percentage of total auditing fees in a report attached to the financial statements. If the auditor fees is higher than 3% of total auditing fees, the service should be listed separately. In addition, it should be clarified that the non-auditing services have been confirmed by auditing committee or board of directors (this rule was repudiated in 1982). In early 1997, extensive increase in provision of non-auditing services by auditors to their clients and increment of fees of independent auditors forced the Securities and Exchange Commission to investigate about the independence of auditor once again. Due to this fact, Securities and Exchange Commission with corporation of the American Institute of Certified Public Accountants (AICPA) established an institution, named Independence Standard Board, in 1997 to codify the auditors' independence standards in public corporate companies. The concern of Securities and Exchange Commission was the fact that development of non-audit services might endanger the auditor's independence. This board is a private sector consisting of eight members, four certified accountants, and four public members. The head of the board is selected out of the four public members.

Three main duties of the board are:

- 1- Codification of a theoretical framework for evaluating independence of certified accountants.
- 2- Identification of independence problems through Committee on Independence Issues
- 3- Publication of standards and rules that advise auditing institutions from permitting the contracts that might affect the quality and independence of financial statement auditing in public corporate companies.

In June of 2000, Securities and Exchange Commission imposed extensive limitations on non-audit services including elimination of any kind of designing service provision, information system implementation, and internal auditing by auditing institutes to their clients. A public poll conducted by American Institute of Certified Public Accountants from investors in 2000 showed that large majority of individual investors (91 percent) trust in yearly auditing of financial statements of institutes in which they have invested. Most of them believed that auditing committee and board of directors usually behave in order to achieve maximum benefits for shareholders. They also reported that 79% believed higher knowledge of auditor from the client would provide higher quality of auditing. In 21 November 2000, Securities and Exchange Commission published a new set of regulations governing auditing independence. Although, Securities and Exchange Commission canceled the prohibition for providing any kind of non-auditing services but it restricted the value and domain of some services. For example, maximal permissible service for provision of non-auditing services by institutes for the clients firms with assets costing over 200 million dollars had been determined to be 40 percent of total hours of internal auditing. Provision of designing services and implementation of information system were also allowed. The new regulations also prohibited provision of any kind of managerial responsibilities or supervision [6]. The researches on influence of non-audit services on auditor's independence can be classified into three categories:

A. The researches that imply negative impact of non-audit services on auditor's independence:

Some of the previous researches asserted that provision of non-audit services has negative influence on auditor's independence (in another word, the auditor independence is impaired due to provision of non-audit services).

Antle (1984) defined the auditor's independence as freedom of auditors from influence and leverage of the company's management. Based on his economic model, since the management controls the auditing salaries, the auditors with minimal welfare might ignore their independence due to management request unless control mechanisms are applied. Reputation and prestige are two control mechanisms that might be used for auditing (The auditors maintain their independence due to their reputation and prestige)[3].

Wines (1994) claimed that the auditor receiving fees for non-audit services is less likely to make conditional statements compared to the auditors not receiving such a fees. He proposed this claim based on the experimental analyses on published auditing reports for 76 registered institutes in Australia Securities Exchange in the interval of 1980 to 1989[24].

Also, using data of Australian companies, Gul (1999) stated that provision of management advisory services by their auditors affects information content of profit. He obtained experiential evidences that the explanatory power of earnings for the companies receiving management advisory services from their auditors is smaller in prediction of future efficiencies [10]. Frankel et al., (2002) experientially found that the optional liabilities levels is higher in companies whose auditors provided non-audit services compared to companies whose auditors did not provide such services. Higher levels of liabilities make higher possibility for profit [7]. Lowe and Jenkins (1999) in their investigations about their auditors' behaviors reached to the conclusion that 63 percent of respondents stated when the auditor is pressurized by the client due to an accounting disagreement, the possibility of client's lose is an important parameter and should be taken into account. Also, despite 59 percent of participants stated that the main duty of auditor is maintaining the interests of creditors and investors, almost a third of the participants held the opinion that the primary responsibility of the auditor is to advocate and endorse the client. The researches shows that provision of non-audit services and the risk of client lose can lower the perception of financial statement users from auditor independence [11]. Knapp (1985) developed a research to study the perception of expert and experienced users of financial statements (top managers and staff of loaning) about the auditor's ability to resist against client pressure in disagreements, considering the presence or absence of management consultation services. He found that if the provision of management advisory services is at a considerable level, the auditor will be more likely to ignore the unregistered debts under client's pressure [14]. Shockley (1981) found in his experimental researches that provision of management consultation services and smaller size of the auditing institute increase the risk of auditor's independence impairment [18]. Lowe and Pany (1999) investigated the effect of outsourcing of internal auditor (transferring the work of internal auditor to independent auditors of companies) on auditor's independence. They realized that the auditor's independence is not damaged unless the auditors do the managerial duties for their clients or the same employees of auditing institute do the internal and external (independent) auditing. However, the auditor's independence will be impaired if different auditors do the internal and independent auditing. In this experimental investigation, they also analyzed that reliability of financial statements (meaning the assuring about absence of intentional and unintentional wrong comments in financial statements) and achieved similar results. They realized that the auditor is more likely to discover the wrong statements in the case that internal auditing is carried out by independent auditing institute of the company but by different employees [15].

Pany and Recker (1989) found out through experience that the users of financial statements are greatly concerned about impairment of auditor's independence while the auditors provide consulting services to their client firms. Yet, this concern is alleviated when a different and separate sector of CPA (certificated public Accountants) undertake the consulting services [17]. Swanger et al (2001) experientially found that financial analysts' perception of auditor's independence will be stronger as long as the internal auditing is performed by the employees of the same client firm or by another auditing institute compared to the state where the duty is fulfilled by the independent auditor of the firm [20].

B) Researches which indicate no impact of non-audit services on auditor's independence

Glezen (1985) practically analyzed impact of new regulations for disclosure of non-audit service fees on shareholders. It was stated that shareholders mainly expressed their concerns about non-audit services during voting for reelection of the present auditor. During 1976 to 1979, no difference was observed in percentages of shareholders' choices for a subset of the companies whose shareholders must determine the auditor fees. And also statistically, no significant correlation was detected between assessments of shareholders' choices and fees amount of non-audit services. The researchers figured out that provision of non-audit services does not affect shareholders' assessment [8]. Kinney (1999) studied the 20-year experimental research works and observed virtually no evidence and document of independence impairment in terms of provision of non-audit services [13]. Wallman (1996) also stated that provision of non-audit services does not impair apparent independence of auditor [22]. Palmorse (1999) found that less than one percent of auditing lawsuits pertains to non-audit services [16].

Recker & Pany (1989) stated the results of their assessment of financial analysts and loan granters as follows: non-audit services do not impair auditor's independence. They offered financial information about large store companies to two participant groups and manipulated levels of non-audit services (designing of internal controls) as zero percent, 25 percent, 60 percent, and 90 percent of auditing salary. Also, both groups were ensured about departure of financial statements from fraud and official mistakes and their obedience of Generally Accepted Accounting Principles (GAAP), and, auditors' independence was defined as their capability so as to act sincerely and objectively (realistically and impartially). They did not find any statistically significant correlation between manipulations of non-audit service levels [17].

Jenkins et al (2000) asked 200 registered accountants and 101 investors to express their perceptions of auditor's independence, and also auditor's sincerity and objectivity (neutrality) for two scenarios in one of which non-audit services are not provided or are provided in slight level (3 % of total revenue of the client firm), and the second one in which significant value of non-audit services (40% of total revenue of the client firm) are provided. Furthermore, he changed type of non-audit services (internal auditing services, insurance services, software instruction and legal services). However, he inferred that the investors' perception of auditor's independence and decision-making on whether to invest or not are not influenced by any of provision level of non-audit services. Investors considered 40% level in their investment decision-makings [12].

C) Researches which imply positive impact of non-audit services on auditor's independence:

Goldman & Barlev (1974) theoretically assumed that the discontinuous services provided by auditors improve their independence. They argued that it is not easy to replace the auditor who provides consulting services as well (replacement of company's auditor). And consequently, s/he has more power to resist against the will and taste of the client [9]. DeAnglo (1981) assumed that repetitive auditing and provision of non-audit services enhance auditing quality. He recognized that provision of non-audit services do not impair auditor's independence and auditing quality [5]. Lowe & Pany (1999) concluded that outsourcing of internal auditing task out of the independent auditing institutes enhances confidence of loan granters about auditor's independence and evaluation of loan agreement provided that internal auditing is carried out by different staffs of the auditing institute [15].

Jenkins et al (2000) found that some decision-makers (professional and experienced accountants) promote their perception of auditor's independence in the case of availability of non-audit services [12].

In summary, the former research works have not provided a clear conclusion about impact of non-audit services on auditor's independence. Certain theoretical researches have approved the notion that provision of non-audit services improves the auditor's independence, whereas other theoretical researches assert that such services impair the auditor's independence [3].

The research works imply that due to high level of optional liabilities [7], reduction of information content of profit [10] and decrease of conditional comments in auditing reports [24], provision of non-audit services will impair the auditor's independence if significant non-audit services are present whereas other findings suggest that non-audit services have no impact on auditor's independence [8].

Another experimental research conducted on impairment of actual independence is reflective of further bias and subjectivity in auditor’s decision-making when non-audit services are already provided [4].

The evidences and documents collected by Shockley (1981) and Swanger (2001) suggest negative effect of non-audit services on perception of independence and objectivity (neutrality and realism) [18and20], while other experiential evidences and documents have led to other conclusions [15].

3. RESEARCH HYPOTHESIS

The research in the present paper incorporates two hypotheses as below:

Hypothesis 1: From investors’ viewpoint, provision of non-audit services by auditing institutes to their client firms leads to impairment of auditor’s independence level.

In other words, it is assumed in the first hypothesis that there exists a negative correlation between provision of non-audit services and investors’ perception of auditor’s independence.

Hypothesis 2: From investors’ viewpoint, provision of non-audit services by auditing institutes to their client firms leads to improvement of auditor’s knowledge level.

In other words, the second hypothesis assumes that there exists a positive correlation between provision of non-audit services and investors’ perception of auditor’s knowledge.

Research Method

The method applied in the research is descriptive survey. In this research, library research method has been for data collection with theoretical basis and also in order to access data and for hypotheses processing, Field research method is used. The needed information for testing the hypothesis was collected based on questionnaires and through asking the opinions of sample members (Tehran security and stock exchange investors and financial analysts). Since the research investigates impact of non-audit services on auditor’s independence and auditor’s knowledge about the client firm from the investors’ viewpoint in stocks of companies, the research population accordingly consists of all individual investors in the stock of companies accepted in Tehran Stock Exchange. Taking into account the fact that the investors were generally expected not to be sufficiently familiar with auditor’s independence issues, thus financial analysts were also included in the statistical population of the present research in order to increase the validity of the results. Simple randomized sampling method was used in the research to select the samples.

Sample size was 96 persons of individual investors in stock of the companies accepted in Tehran Stock Exchange and financial analysts. To ensure delivery of questionnaires, 125 questionnaires were distributed, and finally, results of 96 questionnaires were analyzed.

As the questions in the questionnaire are posed based on Likert spectrum scale (very low, low, moderate, high, and very high) and since the evaluation scale of responses is qualitative, numbers 1, 2, 3, 4 and 5 are respectively assigned for their conversion for each of the abovementioned choices. And, the respective numerical value is multiplied by coefficients of frequency values to utilize the obtained results for statistical analyses. Parametric T test of mean values comparison and chi-2 non-parametric test were used for testing the research hypotheses. Also, Friedman’s test (comparison of average ranks) for ranking the different factors related to each hypothesis.

4. DATA ANALYSIS

The first research hypothesis states: from investors’ viewpoint, provision of non-audit services by auditing institutes to their firm clients leads to impairment of auditor’s independence level.

The first hypothesis of the research was tested using non-parametric test of mean values comparison (T-test) and chi-2 non-parametric test.

According to the results acquired from the test, the null hypothesis is rejected because the calculated t value is larger than the critical value (lies in H0 rejection interval) [Table 1].

HYP01	N	Mean	Std. Deviation	t	df	Std. Error Mean	Sig 2-tailed
	96	3.73	0.27163	44.5	95	0.02772	0.000

Table1: result of non-parametric test of mean values comparison (T-test) for hypothesis 1.

The first research hypothesis was verified via chi-2 test and similar result was obtained. In other words, null hypothesis is rejected and the first hypothesis was confirmed because the calculated significance level is less than 0.05 according to the test result [Table-2].

Choices	Observed	Expected	Residual
Moderate	12	31	-19
High	77	31	46
Very High	4	31	-27
Total	93	-	-

Chi-2 value	103.4
Degree of freedom	2
Significance level	0.000

Table2: result of chi-2 test for hypothesis 1.

Consequently, from investors' viewpoint, auditor's independence is impaired concerning provision of non-audit services to their clients. In other words, in investors' opinion, the auditors' independence is impaired when the independent audit of a company provides the client firm with non-audit services in addition to auditing of financial statements. In another word, provision of non-audit services and auditor's independence are inversely correlated.

The second research hypothesis states that: from investors' viewpoint, provision of non-audit services by the auditing companies to their client firm leads to improvement of auditor's knowledge level about the client firm. The second research hypothesis was verified via parametric mean values comparison test and non-parametric chi-2 test. According to t-test results, the null hypothesis is rejected and the second research hypothesis is confirmed because the obtained t value through the test is larger than the values in the table (in H0 rejection interval) [Table3].

HYPO2	N	Mean	Std. Deviation	t	df	Std. Error Mean	Sig 2-tailed
	96	3.6936	0.22701	51.5	95	0.2317	0.000

Table3: result of non-parametric test of mean values comparison (T-test) for hypothesis 2.

The second research hypothesis was also verified using chi-2 test and similar results were obtained. In other words, the null hypothesis is rejected and the second research hypothesis is confirmed because the calculated significance level is less than 0.05 according to the test results [Table-4].

Choices	Observed	Expected	Residual
Moderate	9	30.7	-21.7
High	82	30.7	51.3
Very High	1	30.7	-29.7
Total	92	-	-

Chi-2 value	129.9
Degree of freedom	2
Significance level	0.000

Table4: result of chi-2 test for hypothesis 2.

As a result, from investors' viewpoint, provision of non-audit services by auditing institutes to their client firms leads to improvement of auditor's knowledge level about the client firm. In other words, there exists a positive correlation between provision of non-audit service and auditor's knowledge about the client firm.

Since the non-audit services which might be provided by the independent auditor to their client firm is diverse, for the same reason, Friedman's test was applied to rank these services for determining impact level of each of these services.

According to Friedman's test performed for hypothesis 1, it was observed that the following services respectively have negative impacts on the auditor's independence: services related to assessment of stocks of other companies for investment, the services associated with methods of increasing the earning per share (EPS), analysis of merger and acquisition plans, insurance consultation services, legal consultation, tax-related consulting, educational services in the field of accounting and financial reporting, human resources services (recruitment of executive personnel), product and marketing analysis services, the services pertaining to company's stock pricing for subscription and sales, assessment of non-cash income services, and finally, services related to preparation and adjustment of financial statements. The Friedman's test result was obtained equal to 415.4 at significance level of P = 0.0000. Difference between the aforementioned factors is significant because the error value is below 5 percent (Table5).

Ranking of variables in hypothesis 1 using Friedman’s test:

Average Rank	Variables
8.57	services related to assessment of other companies’ stocks for investment
8.45	services associated with methods of increasing EPS
8.34	analysis of merging and acquisition plans
8.20	insurance consultation services
7.92	legal consultation services
7.56	tax-related consulting services
6.60	educational services in the field of accounting and financial reporting
5.63	human resources services (recruitment of executive personnel)
5.34	product and marketing analysis services
5.05	services pertaining to company’s stock pricing for subscription and sales
4.88	assessment of non-cash investment
1.45	services related to preparation and adjustment of financial statements

96	Quantity
415.4	Chi-2 value
11	Degree of freedom
0.000	Significance level

Table5:Friedman’s test result for hypothesis 1

According to Friedman’s test performed for hypothesis 2, it was observed that the following parameters have the largest impacts on improvement of auditor’s knowledge: services related to company’s stock pricing for subscription and sales, analysis of merging and acquisition plans, services associated with methods of increasing EPS, product and marketing analysis services, insurance consultation services, human resources services, legal consultation services, tax-related consulting services, services related to preparation and adjustment of financial statements, assessment of non-cash income services. Difference of the abovementioned factors was obtained equal to 484.6 at significance level of P=0.000 according to Friedman’s test result, and hence, is significant because the error value is less than 5 percent (Table-6).

Ranking of variables in hypothesis 2 using Friedman’s test:

Average Rank	Variables
5.07	services related to assessment of other companies’ stocks for investment
9.07	services associated with methods of increasing EPS
9.48	analysis of merging and acquisition plans
7.46	insurance consultation services
5.60	legal consultation services
5.11	tax-related consulting services
4.02	educational services in the field of accounting and financial reporting
6.4	human resources services (recruitment of executive personnel)
8.31	product and marketing analysis services
9.90	services pertaining to company’s stock pricing for subscription and sales
2.99	assessment of non-cash investment
4.57	services related to preparation and adjustment of financial statements

96	Quantity
484.6	Chi-2 value
11	Degree of freedom
0.000	Significance level

Table6:Friedman’s test result for hypothesis 2

5. CONCLUSIONS

The results of the research suggest that auditor’s independence is impaired from viewpoint of investors and financial analysts when an independent auditor of company provides non-audit services in addition to auditing of financial statements. In other word, the economical dependency between auditor and client firm increases when the auditor provides the client firm with non-audit services, and as a result, the influence of the client firm is augmented leading to devastation and impairment of auditor’s independence (i.e. provision of non-audit services leaves a negative impact on auditor’s independence). Furthermore, from investors’ viewpoint, auditor’s knowledge about the client firm when an independent auditor of a company provides non-audit services to the client firm in addition to

auditing of financial statements. And consequently, the auditor is more likely to discover the mistakes in the systems and outputs of the client firm.

According to the results obtained for the first research hypothesis based on which simultaneous provision of non-audit services and auditing of financial statements leads to impairment of auditor's independence level, it seems that the imposed restrictions and constraints with regard to simultaneous provision of some non-audit services with auditing of financial statements by independent auditors will contribute to improvement of auditor's independence. Also, based on the results obtained for the second research hypothesis which indicate simultaneous provision of non-audit services and auditing of financial statements leads to improvement of auditor's knowledge level about the client firm, the limitations concerning provision of non-audit services shall be alleviated as far as no damage is inflicted to the auditor's independence because provision of such services lead to enhancement of auditor's knowledge level.

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