

Independence in Appearance and in Fact: An Experimental Investigation

NICK DOPUCH RONALD R. KING
Washington University Washington University
RACHEL SCHWARTZ
Washington University

Abstract

In this study, we use experimental markets to assess the effect of the SEC's new Independence Rule on investors' perceptions of independence, market prices, and investors' payoff distributions. The new rule requires client firms to disclose in their annual proxy statements the amount of non-audit fees paid to their auditors. The new disclosure is intended to inform investors of auditors' incentives to compromise their independence. Our experimental design is a 2x3 between-subject design, where we control the presence (unbiased reports) or absence of auditor independence in fact (biased reports). While independence in fact was not immediately observable to investors, we controlled for independence in appearance by varying the public disclosure of the extent of non-audit services provided by the auditor to the client. In one market setting, investors were not given any information about whether the auditor provided such non-audit services; in a second setting, investors were explicitly informed that the auditor did not provide any non-audit services, and in a third setting, investors were told that the auditor provided non-audit services that could be perceived to have an adverse effect on independence in fact.

We found that disclosures of non-audit services reduced the accuracy of investors' beliefs of auditors' independence in fact when independence in appearance was inconsistent with independence in fact. This then caused prices of assets to deviate more from their economic predictions (lower market efficiency) in the inconsistent settings relative to the no-disclosure and consistent settings. Thus, disclosures of fees for non-audit services could reduce the efficiency of capital markets if such disclosures result in investors forming inaccurate beliefs of auditor independence in fact—that is, auditors appear independent but they are not independent in fact, or vice versa. The latter is the maintained position of the AICPA, which argued against the new rule. Further research is needed to assess the degree of correspondence between independence in fact and independence in appearance.

Key Words: Auditor independence in appearance; Auditor independence in fact; Experimental economics