Cihan Temiz Interviews Shyam Sunder on “Auditor Independence”

Shyam Sunder September 2015

In addition to the literature and empirical work already considered, Professor Shyam Sunder, a world-renowned accounting theorist and experimental economist and the James L. Frank Professor of Accounting, Economics, and Finance at the Yale School of Management was interviewed.

Professor Sunder suggests three issues for the European Commission (EC) to consider in deciding on the provision of non-audit services to audit clients: independence, information, and economics of auditing.

The independence of outside auditors who render their opinions on published financial reports of public corporations is obviously the primary concern in the EC’s analysis of the problem, and Dr. Sunder does not wish to add more discourse to this topic.

Information is the second issue. According to Professor Sunder, in the process of providing additional services to a client, the auditor becomes better informed about the affairs of the client. For instance, auditors who provide tax services are better informed about the tax obligations and the strengths and weaknesses of their clients’ tax positions. Similarly, auditors who help clients recruit their managers are better informed about the abilities and depth of their management. Thus, consulting services provided to audit client brings additional revenue as well as additional knowledge. Based on their statements, the US regulators and the EC seem to be more concerned (perhaps understandably) with the consequences of revenues earned from providing non-audit services for the independence of the audit opinions rendered to the same client. They have paid less attention to the additional knowledge gained about their clients during the process. In this sense, the approach of the EC appears to be contrary to the intention proposed in the Green Book of the EC. In making their decisions, it would be prudent for the EC and other regulators to carefully balance the consequences of both the revenue and the knowledge acquired when providing non-audit services to audit clients.

The third issue however, the audit revenue, or the dependence of the auditor on the client for the former’s livelihood, is by far in Dr. Sunder’s opinion the most obvious and dangerous threat. Auditors are chosen and paid by their clients. The additional revenue from non-audit services has a less significant impact on independence than the audit revenue. “This appointment and paymaster/contractor relationship has not engaged enough attention of the regulators to date” Dr. Sunder states. As seen in his analysis of other consequences of this relationship in his paper “Rethinking the Structure of Accounting and Auditing” (also see the theoretical section of this dissertation), he cites the potential for Akerlof’s “The Lemons Problem” in the market for audit services. Competition in a market for services whose quality is difficult for customers to discern may decrease the price as well as the quality of the service and make it a market for “lemons.” Since the quality of audit services is unobservable to its customers (i.e., the investors) promoting
competition has the effect of lowering its price and quality; high quality audit services are non-sustainable under competition.

Professor Sunder does not believe that prohibiting non-audit services would increase the audit fees. Prohibiting non-audit services to audit clients will eliminate another source of revenue from audit firms, and may only result in lowering the quality of services, instead of improving auditor independence. He also stresses that audit firms expanded their services by offering non-audit services because the audit revenues were insufficient to support quality audits in a competitive market. He concludes by stating that prohibiting non-audit services would result only in lower audit quality.

When questioned about whether he would deem a threat to auditor independence in fact or in appearance, he replied, that he does not know any investors who think auditors are independent of their clients, as long as the clients’ are auditors’ paymasters. Although investors would like to see independent auditors, prohibiting non-audit services will have a small effect on their independence. If a prohibition of non-audit services were imposed, Professor Sunder believes that audit firms may simply set up other service companies or develop agreements to refer clients to each other and circumvent the process. Such exchange relationships among apparently independent firms will be difficult to detect and monitor by regulators.

In conclusion, Professor Sunder considers the payment of an audit fee by clients as the main threat to auditor independence and wonders why regulators have ignored this issue. Regulators instead seem to focus attention on the secondary issues, such as prohibiting some of the non-audit services to audit clients, which is not likely to make much difference (because of the countervailing consequences of non-audit services for revenue and additional knowledge to the auditors). Perhaps a re-thinking of US and EC regulator priorities is in order.