

# **The Moderating Role of an Auditor Independence Clarification on the Relationship Between an Internal Control Opinion and Loan Officers' Risk Assessments and Decisions**

**Botao Chen**  
**University of the District of Columbia**

**Quinton Booker**  
**Jackson State University**

**Kayla Booker**  
**Rhodes College**

*This study examines whether an auditor independence clarification affects loan officers' lending risk assessments and lending decisions when it is integrated into an auditor's report as PCAOB has required since 2017. An experiment study is conducted with 98 nationwide commercial bank loan officers. The results indicate that an auditor independence clarification moderates the relationship between an internal control opinion and loan officers' lending risk assessments and decisions. The findings provide empirical evidence to confirm the informative value of an auditor independence clarification and support PCAOB's expectation to enhance public users' understanding of the auditor's independence obligations.*

*Keywords: auditor independence, clarification, internal control, lending risk, lending decision*

## **INTRODUCTION**

This study examines the informative value of an auditor independence clarification. An auditor independence clarification is required in a new standard proposed in 2011 and issued by the Public Company Accounting Oversight Board (PCAOB) in 2017. This new standard stems from the legitimate criticisms of the informative value of the current auditor's report. Public users think that the current auditor's report does not provide adequate relevant information to help them make judgment and decisions. A sequential series of American accounting scandals from WorldCom and Enron in the early 2000s and AIG and Lehman Brothers during the financial crisis of 2008 shook public users' confidence about the current auditor's report. The public appealed to regulators for more relevant and useful information disclosures in an auditor's report to match their needs. After a six-year effort that began with a concept statement in 2011, PCAOB issued and the U.S. Securities and Exchange Commission (SEC) approved a new auditing standard on the auditor's report. In addition to retaining auditor independence in the title of an auditor's report, i.e., "Report of Independent Registered Public Accounting Firm", the new standard requires a specific statement in the auditor's report to assert that "the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the

company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB” (PCAOB, 2017, p. 50).

Auditor independence has always been of vital concern to the public users because it is viewed as necessary for auditors to fulfill their “public watchdog” function. It is auditor independence that determines whether auditors are willing to provide negative information on financial reporting to public users (DeAngelo, 1981). Through this explicit auditor independence clarification, PCAOB (2017) aims to provide relevant and useful information to enhance public users’ understanding of the auditor independence obligations (PCAOB, 2017). However, during the public hearing for the proposed standard, some commenters question whether the statement will improve this understanding and increase any benefits or insight to public users. They argue that auditor independence, i.e., “Report of Independent Registered Public Accounting Firm” is already embedded in current title of an auditor’s report and new independence clarification statement is redundant and unnecessary. Although the standard has been finally issued, it is very important for PCAOB to provide some academic evidence to justify the relevance and usefulness of this information. To our knowledge, no related research has been done on this to date.

The purpose of this study is to examine whether an auditor clarifies his/her independence in an auditor’s report provides relevant information for public users to help their decisions. Auditor independence is a bedrock to guarantee audit quality (EC, 2010). However, public users struggle with the ambiguity of auditor independence. On one hand, stricter auditor independence regulations such as partner rotation and establishing independent audit committee enhance public perceptions of auditor independence. On the other hand, allowing some auditors’ non-audit services confound public users’ perceptions of auditor independence. Based on accountability theory by Vance et al. (2013), as PCAOB expects, an auditor has a potential obligation to explain his/her independence to public users for their decision processes. An auditor independence clarification will satisfy public user’s demands - hearing directly from auditors that they are required to be independent in accordance with applicable rules (PCAOB, 2017).

This study employs a 2×2 experimental approach to investigate the moderating effects of an auditor independence clarification on the relationship between an opinion on internal control over financial reporting (“an internal control opinion”) and loan officers’ lending risk assessments and decisions. The participants are 98 nationwide commercial bank loan officers included in the Hugo Dunhill Mailing Lists, Inc. (HDML). This study chooses loan officers as participants for two reasons. First, loan officers play a decisive role in debt markets because they are primary providers of external financing. Over the last three decades, loan officers have consistently determined more than 50 percent of total debt financing in the American debt markets (Graham, et al., 2008; Costello and Wittenberg-Moerman, 2011), of which total leveraged corporate debt outstanding has grown to a record \$2.2 trillion in 2014 (LSTA, 2014). Second, loan officers are sophisticated primary users of an audit report and their perceptions represent public users’ long-term recognitions to reporting quality and auditor independence.

The results indicate that an auditor independence clarification provides relevant information to public users. In terms of an internal control opinion, as compared to an unqualified internal control opinion, an adverse internal control opinion increases loan officers’ lending risk assessment and decreases their intent to lend. An auditor independence clarification moderates the relationship between an internal control opinion and loan officers’ lending risk assessments and decisions, such that the effects of an internal control opinion on lending risk assessments and decisions are greater when an auditor independence clarification is integrated in an auditor’s report as compared to no clarification.

The most important contribution of this study is that it contributes to prior auditor independence literature by timely examining whether the auditor independence clarification integrated in an auditor’s report affects loan officers’ lending risk assessments and their decisions. Because auditor independence regulations and certain auditors’ activities such as allowing certain non-audit services have opposite effects on the users’ judgment about auditor independence, auditors need to explicitly clarify the auditor independence to reduce the users’ implicit confusions. Although some commenters suggest that it is redundant and unnecessary to issue a new auditor independence clarification, this study provides preliminary evidence in support of PCAOB’s new standard on auditor independence. The auditor

independence included in the title is more abbreviated than the new independence clarification. The enhanced independence language includes a positive assertion of the requirement for auditor independence with reference to securities laws and SEC and PCAOB rules and regulations concerning this mandate. This new language adds transparency to an auditor's report.

In addition, this study contributes to the literature regarding internal control reporting. Although loan officers are primary users of an auditor's report, few studies examine their risk assessments and decisions. To date, only Schneider and Church (2008) experimentally examine the effects of an internal control opinion on individual loan officers' lending risk assessments and decisions. This study extends the research. To make the experimental design more representative of real-world issues, this study specifies the most frequently identified internal control material weakness for an adverse internal control opinion. This study finds the direct effect of an internal control opinion on loan officer's risk assessments and decisions, which is consistent with Schneider and Church (2008) and thus more evidence is provided to support the informative value of an internal control opinion.

The remainder of this study is organized as follows. The next section includes a literature review and presents four hypotheses. The third section describes the methodology. The fourth section presents the results. The final section includes discussions and conclusions.

## **LITERATURE REVIEW**

### **Expectation-transparency Gap and More Information**

Over the past two decades, public users have criticized that an auditor's report does not convey adequate relevant information, which brings uncertainty and risks to public users when they make their judgements and decisions. This legitimate criticism to an auditor's report is derived from the expectation gap between public users and auditors, which refers to a gap that "exists between what the public expects or needs and what auditors can and should reasonably expect to accomplish" (CAR, 1978, xi). There are two types of the expectation gap. The first type is an "expectation-performance gap," which is defined as "the gap between society's expectations of auditors and auditors' performance, as perceived by society" (Porter, 1993, p. 50). The second gap is defined as an "expectation-transparency gap" by this study, which refers to a communication gap between the information that public users expect in auditors' reports and the information auditors can provide based on standardized audit report requirements (Dickins and Higgs, 2009). This study focuses on an expectation-transparency gap, which is related to information disclosures in an auditor's report.

Public users call for more relevant information disclosures in an auditor's report. To respond to public users' demands and reduce the expectation-transparency gap, PCAOB continues to increase information disclosures in an auditor's report such as an auditor independence clarification requirement (PCAOB, 2017). Based on accountability theory by Vance et al. (2013), an auditor has accountability and responsibility to disclose more information. As a virtue, accountability denotes a positive quality in individuals and organizations. As a mechanism, accountability is "a process in which a person has a potential obligation to explain his/her actions to another party who has the right to pass judgment on those actions." (Vance, et al., 2013, p. 266). Since accountability is seen as positive and auditors pay much more attention to their reputations and future potential benefits (DeAngelo, 1981), the auditors have motivations to disclose more information such as auditor independence in auditors' reports.

### **Informative Value of an Internal Control Opinion and Hypotheses**

The relationship between audited financial reporting including internal control provisions and debt contracting is a fundamental accounting research issue (Kim, et al., 2011). Loan officers often include an internal control provision in their loan contracts. This provision is an affirmative covenant and requires a firm to report the internal control events (Costello and Wittenberg-Moerman, 2011). A few studies investigate the effects of internal control opinions on debt markets (e.g., Costello and Wittenberg-Moerman, 2011; Dhaliwal, et al., 2011; Kim, et al., 2011). Costello and Wittenberg-Moerman (2011) find that internal control material weakness negatively influences lenders' use of financial covenants and

financial-ratio-based performance pricing provisions while Dhaliwal et al. (2011) indicate that internal control material weakness marginally increases a firm's credit spread, thus marginally increasing a firm's cost of debt. Kim et al. (2011) examine loan contracts with firms that report internal control weakness and obtain evidence that lenders do not intend to sign loan contracts with the firms that report internal control weaknesses.

To date, Schneider and Church (2008) is the only experimental research to examine the effects of an internal control opinion on individual loan officers' decisions. They conclude that an adverse internal control opinion has significant effects on lenders' risk assessments and decisions. However, they do not specify the nature of the material weakness for the adverse internal control opinions, which leaves the material weakness vague. Thus, "it is unclear what the lenders were actually thinking as to the severity of the weakness" (Schneider and Church, 2008, p. 11). This study complements this limitation through specifying the type of internal control material weakness listed in PCAOB Auditing Standard No. 2. The type of material weakness is "sales personnel frequent contract modification revenue to manipulate revenue recognition and gross margin" (PCAOB, 2004, p. 256). The choice is categorized as a revenue recognition violation in accounting documentation and procedure. Based on University of Pennsylvania Wharton Database, revenue recognition violations rank second among all ineffective internal control accounting rule violations reported by auditors (676 reports and occupies 9.98 percent) from 2004-2011, while Tax issues/FAS 109 issues are the most reported (733 reports and occupies 10.82 percent) (Chao and Foote, 2012). Therefore, it is reasonable that the current study employs a revenue recognition violation to represent internal control material weakness.

Schneider and Church (2008) indicate that an internal control opinion significantly affects loan officers' risk assessments and decisions. That is, an unqualified internal control opinion decreases loan officers' lending risk assessments and loan officers are more likely to lend to the client; whereas an adverse internal control opinion increases loan officers' lending risk assessments and loan officers are less likely to lend to the client. This study extends Schneider and Church (2008) by specifying the nature of the material weakness for the adverse internal control opinion and posits the following two hypotheses:

*H1: An adverse internal control opinion in an integrated auditor's report will increase loan officers' lending risk assessments as compared to an unqualified internal control opinion.*

*H2: An adverse internal control opinion in an integrated audit report will decrease loan officers' intent to lend to the client as compared to an unqualified internal control opinion.*

### **Moderating Role of an Auditor Independence Clarification and Hypotheses**

Auditor independence is very important to users because it is a determinant of auditors' loyalty to the public and thus affects audit quality (DeAngelo, 1981). Among 153 international respondents in a CFA survey (CFA, 2010), 72 percent desire information on auditor independence. To restore public users' confidence about auditors and their work, a series of auditor independence requirements have been issued sequentially. In 2002, SOX set stricter rules on auditor independence. In 2008, PCAOB adopted Ethics and Independence Rule 3526 to require that auditors should confirm, in writing, their independence to audit committees before the audit engagement (PCAOB, 2008). In 2017, after a six-year effort, PCAOB issues a new auditor's reporting standard to require that auditors should explicitly clarify auditor independence in an auditor's report to public users. As a new standard, the informative value of this auditor independence clarification should be empirically tested.

The demand for an auditor independence clarification is derived from the fact that conflicts and complexities of regulatory reforms and practical issues have confused public users' perceptions of auditor independence and public users have difficulty making decisions. On one hand, since the enactment of SOX, a series of regulatory reforms strengthen auditor independence such as partner rotation rules, banning some non-audit services and requiring preapproval of other non-audit services by the audit committee, establishing audit committee and its member independence requirements, requiring auditor independence confirmation and communication to audit committee (PCAOB, 2008), and shareholders'

voting on auditor selection (U.S. DoT, 2008). These reforms are evidenced by recent empirical research related to auditor independence (e.g., Asthana and Booue, 2012; Dao, et al., 2012; Daugherty, et al., 2012; Fiolleau, et al., 2013).

On the other hand, some auditors' behaviors and practical issues impair auditor independence. For instance, auditor independence may be considered impaired by some non-audit services with higher audit fees, or higher non-audit service fees, or higher ratio of non-audit service fees to audit fees (e.g., Raghunandan, 2003; Choi, et al., 2010; Asthana and Booue, 2012; Knechel and Sharma, 2012; Knechel, et al., 2012; Schmidt, 2012; Markelevich and Rosner, 2013; Ratzinger-Sakel, 2013; Eshleman and Guo, 2014), affiliation between a former audit firm partner on the audit committee and the current auditor (Naiker, et al., 2013), friendship between CEOs and audit committees (Bruynseels and Cardinaels, 2014), and audit firm industry specialization (Eilifsen and Knivsflo, 2013).

These regulatory changes and practical services result in uncertainty and conflict of auditor independence, which makes it difficult for public users to judge auditor independence. Public users want to hear directly from auditors that auditors are independent from the client because they comply with auditor independence requirements from SOX, PCAOB, SEC and other regulators, i.e., these auditors have neither mutual nor conflicting interests with clients and they fairly judge and report on what they discover (Harris, 2011). Based on accountability theory, an auditor's explicit accountability for their independence may have positive implications for auditors. Thus, auditors have motivations to be held accountable for clarifying their independence. This is a vital link between auditors and public users. As PCAOB expects, information provided by an auditor such as an auditor independence clarification may be viewed by public users as helpful for their decisions.

This expectation suggests a moderating role of an auditor independence clarification on the effects of an auditor's opinion on loan officers' risk assessments and lending decisions. An internal control opinion significantly affects loan officers' risk assessments and decisions (Schneider and Church, 2008). An auditor independence clarification will help loan officers enhance their confidence about their lending risk assessments and decisions on an unqualified or adverse internal control opinion. This study posits the following hypotheses for the moderating effect of an auditor independence clarification:

**H3:** *The effect of an internal control opinion on loan officers' lending risk assessments is greater when an auditor independence clarification is integrated in an auditor's report as compared to no auditor independence clarification.*

**H4:** *The effect of an internal control opinion on loan offers' intent to lend is greater when an auditor independence clarification is integrated in an auditor's report as compared to no auditor independence clarification.*

## **RESEARCH METHOD**

### **Experimental Design**

This study conducted a 2×2 between-subject experiment after PCAOB (2017) was proposed in 2011. Before the experiment is conducted, an IRB approval has been obtained. The audit client is a hypothetical book wholesale company, Abookware. The financial statements are adapted from Schneider and Church (2008). The experiment presents a proposed integrated audit report including auditor independence clarification (if present), a financial statements audit opinion, and an internal control opinion. Two independent variables are manipulated: auditor independence clarification (clarification vs. no clarification) and an internal control opinion (unqualified vs. adverse). The financial statements audit opinion is always unqualified. Participants are randomly provided with experimental cases describing one of four scenarios.

## **Independent Variables**

### *An Auditor Independence Clarification*

The auditor independence clarification variable is manipulated across two levels: explicitly clarifying the auditor independence or not clarifying the auditor independence in an integrated auditor's report. This study sets 0 = not clarifying independence and 1= clarifying independence. Based on the proposal of PCAOB (2017) in 2011, when an auditor clarifies auditor independence in an auditor's report, in addition to the title "Report of Independent Registered Public Accounting Firm," the auditor indicates that the auditor has a responsibility to be independent of Abookware Co. and has complied with applicable independence requirements of the PCAOB and SEC.

### *An Internal Control Opinion*

The internal control opinion variable has two levels: unqualified and adverse. This study sets 0 = an unqualified internal control opinion and 1= an adverse internal control opinion. In terms of an adverse internal control opinion, this study specifies the type of internal control material weakness listed as an example in PCAOB (2004). This internal control weakness is related to revenue recognition manipulation, which is listed as one of the top two internal control violations amongst all ineffective internal control reported by auditors for public companies from 2004-2011 (Chao and Foote, 2012).

## **Dependent Variables**

Two dependent variables lending risk assessments and intent to lend are tested. Lending risk assessment is measured on an 11-point Likert scale anchored at 0 (Very Low Risk) and 10 (Very High Risk); whereas intent to lend is measured on an 11-point Likert scale anchored at 0 (Definitely Not Lend) and 10 (Definitely Lend). The measurements follow the designs of Schneider and Church (2008) and Lopez et al. (2009). In addition, this study also measures loan officers' perceptions of auditor independence and perceptions of financial reporting reliability as covariates. Similar to Jennings et al. (2006), both of these perceptions are measured on an 11-point Likert scale ranging from 0 (No Confidence) to 10 (Extreme Confidence).

## **Materials and Procedures**

### *Case Materials*

This study uses a short case of a hypothetical book wholesale company, Abookware, which is a mid-size publicly traded company and perceived as being neither very strong nor very weak. The case information consists of two parts. The first part is background information that contains the brief introduction of the company and its financial statements including balance sheet, income statement, and statement of cash flow. The background information is adapted from the appendix of Schneider and Church (2008). All participants are provided the identical background information.

The second part of this case is the auditor's report that contains a hypothetical auditor and its title, an auditor independence clarification (if present), a financial statements audit opinion, and an internal control opinion. The financial statements audit opinion is unqualified and identical in four scenarios. Also, the auditor and its report title "Independent Registered Public Accounting Firm" are identical. Two independent variables, an auditor independence clarification and internal control opinion, are manipulated and created four scenarios as previously described.

### *Procedures*

This study uses a paper questionnaire in booklet form to mail to the participants. Each booklet contains seven items of information: (1) a cover letter and a business reply envelope; (2) background information of the company; (3) a manipulated auditor's report; (4) questions on loan officers' assessments and decisions; (5) manipulation checks; (6) supplemental questions on the factors other than manipulated independent variables; and (7) demographic questions. The booklet also includes a cover letter and a business reply envelope to encourage participation. If loan officers did not respond to the first mailing after thirty days, a second request mailing was sent.

In the booklet, the participants are asked to assess the lending risk and express the extent to which they intend to lend to the client. After the participants answer these questions, this study conducts manipulation checks. Before answering the manipulation check questions, the participants are requested not to look back and refer to prior pages. The manipulation checks consist of two questions related to an auditor independence clarification and internal control opinion, respectively. After the manipulation checks, as a supplementary part of the questionnaire, the participants are asked to value several key factors that are embodied in the instrument and might influence their judgments and decisions. These factors include the balance sheet, income statement, statement of cash flows, company growth, Big Four CPA firm audit (vs. non-Big Four CPA firm), explicit clarification auditor independence (vs. or not), audit opinion on financial statements and audit opinion on internal control. The last part of this questionnaire requests the participants to provide demographic information and task-related information to examine conditional effects of loan officers' assessments and decisions.

## **Participants**

This study first randomly selects 1,500 commercial bank loan officers from the Hugo Dunhill Mailing Lists, Inc. (HDML). This database provides national commercial bank loan officers mailing list information. The loan officers are randomly assigned to one of four groups, which in turn are randomly assigned to four scenarios.

The experimental instrument is then mailed to the 1,500 loan officers. Two rounds of mailings are done. One hundred and thirty-one responses are received, of which 23 responses are undeliverable and returned and 10 responses are incomplete. Thus, the final sample is 98 usable responses, which include the responses that failed the post-experimental manipulation checks. The detailed analysis is described in the beginning of the next section. In addition, this study compares the characteristics of the respondents from the first and second rounds and finds no significant difference between them.

The final sample of 98 responses result in 6.6 percent response rate. Although relatively low, the response rate is consistent with mail and online surveys in accounting research related to auditing and financial reporting issues. For example, De Rassenfosse and Fischer (2016) report a 10 percent response rate using electronic mailing method to examine venture debt lenders' decisions. Graham and Harvey (2001) report a 9 percent response rate using mail surveys of CFOs for corporate financing; Graham et al. (2005) report an 8.4 percent response rate using online surveys of executives for financial reported earnings and disclosure decisions; Anderson and Lillis (2011) report 6 percent response rate using an online survey of AICPA members for corporate frugality; Burton et al. (2012) report a 6.9 percent net response rate using email requests of MBA alumni for internal auditor recommendations; Dichev et al. (2013) report a 5.4 percent response rate using online surveys of CFOs for earning quality.

## **RESULTS**

### **Manipulation Checks**

After completing the questions with respect to loan officers' lending risk assessments and their decisions, the participants are asked two post-experimental questions that serve as manipulation checks. First, the participants are requested to indicate whether the auditors explicitly clarify their independence. Among the 98 respondents who provide useable responses, 70 respond correctly and 28 fail, resulting in pass rate of 71.4 percent for *an auditor independence clarification*. Second, the participants are requested to identify the type of an internal control opinion in the given auditor's report (unqualified or adverse). Eighty-seven out of 98 respondents answer correctly and 11 respondents fail, which represents pass rate of 88.8 percent for *an internal control opinion*. A total of sixty-two out of 98 respondents (63.3 percent) provide correct answers to both questions. This study analyzes the data both including and excluding the respondents who fail manipulation checks and find the results are substantially the same. Therefore, all 98 responses are remained in the presentation of the results. This method is consistent with the recent literature related to auditing issues such as Asare and Wright (2012), Burton et al. (2012), Kadous and Mercer (2012), Yen (2012), and Taylor and Curtis (2013).

### Descriptive Analysis

The demographic information includes: (1) gender; (2) work experience; (3) understanding of the auditor's opinion; (4) use of audit reports; (5) use of financial statements; and (6) prior experiences with audit report use or auditors. The results indicate that 90 respondents are males (92 percent), 89 respondents have over 10 years work experience (92 percent), and 86 percent of all respondents frequently use financial statements. Moreover, with respect to audit experience, the statistics indicates the majority of 98 respondents are familiar with audit reports. Ninety-two percent of the respondents generally understand ("fully" and "average") the auditors' opinions, 79 percent often use ("frequently" and "average") audit reports, and 97 percent of the respondents have positive and neutral prior experience with audit report use and auditors. Therefore, these 98 participants represent experienced loan officers and qualified to participate in the experiment.

For the analysis of demographic characteristics of respondents, chi-square analysis is used to analyze the differences of frequency distribution among four groups and one-way ANOVA (also Kruskal-Wallis test) is conducted to analyze the mean differences among four groups (excluding *Gender*). The results of chi-square indicate that there is no significant difference for each variable while the results of one-way ANOVA show that *Understanding of auditor's opinion* is significantly different among groups. However, the correlation analysis indicates that this variable is not significantly related to any dependent variable. Furthermore, including and excluding this variable does not affect the results of later general linear model ANCOVA analysis. Thus, *Understanding of auditor's opinion* is not considered a covariate in the hypothesis tests.

### Correlations Between Variables

Table 1 presents bivariate correlations between all independent and dependent variables. As hypothesized, an internal control opinion is positively related to lending risk assessment but negatively related to intent to lend ( $r = 0.411$ ,  $p < 0.01$ ;  $r = -0.409$ ,  $p < 0.01$ , respectively). Although an internal control opinion is negatively related to an auditor independence clarification ( $r = -0.219$ ,  $p < 0.05$ ), the relationship is weak because of  $r = -0.219 < 0.3$ . In terms of covariates, the result indicates that perception of auditor independence and perception of financial reporting reliability are positively related to intent to lend ( $r = 0.363$ ,  $p < 0.01$ ;  $r = 0.541$ ,  $p < 0.01$ , respectively); whereas perception of financial reporting reliability is inversely related to lending risk assessment ( $r = -0.369$ ,  $p < 0.01$ ). Accordingly, the above correlations are in the expected directions.

**TABLE 1**  
**PEARSON CORRELATIONS BETWEEN VARIABLES**

<u>Variable</u>	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>
1 IC <sup>a</sup>	1					
2 Clarification <sup>b</sup>	-0.219*	1				
3 Perception of Auditor Independence	-0.250*	0.015	1			
4 Perception of Financial Reporting Reliability	-0.556**	0.113	0.603**	1		
5 Lending Risk Assessment	0.411**	0.015	-0.134	-0.369**	1	
6 Intent to Lend	-0.409**	0.035	0.363**	0.541**	-0.620**	1

\*  $p < 0.05$ , two-tailed

\*\*  $p < 0.01$ , two-tailed

<sup>a</sup>IC = 0 for an unqualified internal control opinion and =1 for an adverse internal control opinion

<sup>b</sup>Clarification = 0 for no independence clarification and =1 for an independence clarification



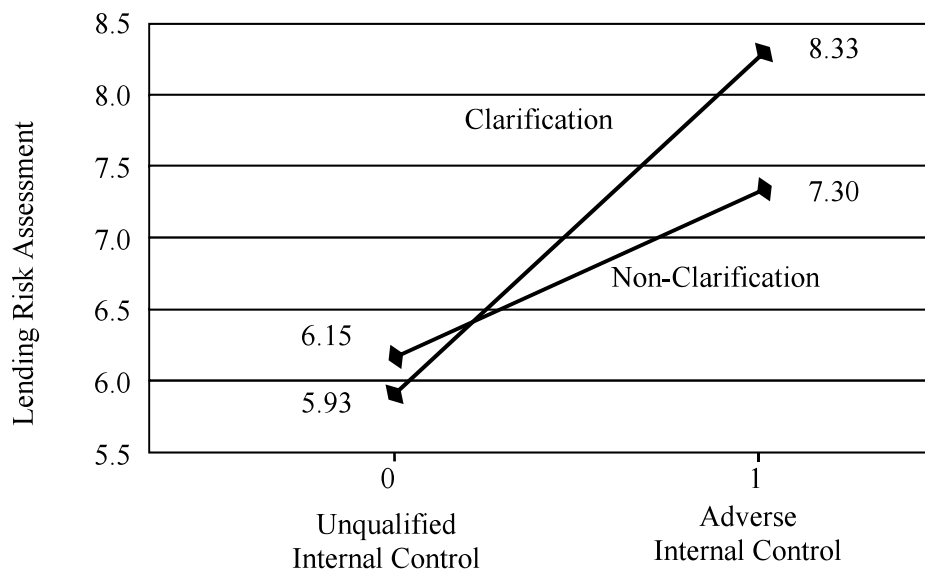
### Using MANCOVA and ANCOVA to Test the Hypotheses

Using General Linear Model in SPSS (MANCOVA vs. ANCOVA), this study conducts both multivariate and univariate analysis to examine the effects of an internal control opinion (unqualified vs. adverse) and auditor independence clarification (clarification vs. no clarification) on the loan officers' lending risk assessments and intent to lend. Perceptions of auditor independence and perceptions of financial reporting reliability are two covariates. The MANOVA and ANCOVA results are similar and indicate that loan officers' lending risk assessments and intent to lend are affected by an internal control opinion and the interaction of an internal control opinion and auditor independence clarification. Perceptions of financial reporting reliability also affect loan officers' lending risk assessments and intent to lend. In the following two sections 4.5 and 4.6, the ANCOVA results are discussed in detail.

### Test of Hypotheses 1 and 3: Lending Risk Assessments

Table 2 presents the results of GLM ANCOVA and planned contrast for the effect of an auditor independence clarification on loan officers' lending risk assessments. The result of the GLM ANCOVA indicates that the main effect of an internal control opinion is significant (Panel A,  $F_{1, 89} = 6.157$ ,  $p = 0.008$ , one-tailed). H1 is supported. Also, this study finds that the interaction effect between an internal control opinion and an auditor independence clarification is marginally significant (Panel A,  $F_{1, 89} = 1.985$ ,  $p = 0.081$ , one-tailed). H3 is partly supported. Further analysis using planned contrast reveals that the effect of an adverse internal control opinion is greater when an auditor independence clarification is integrated in an auditor's report as compared to no auditor independence clarification (Panel B,  $p = 0.039$ , non-clarification vs.  $p = 0.000$ , clarification, one-tailed). Consistent with prior literature, an adverse internal control opinion significantly increases the lending risk assessments (Panel C, non-clarification, Mean = 6.15, SD = 1.82 unqualified vs. Mean = 7.30, SD = 1.82 adverse). An auditor independence clarification further enhances these assessments (Panel C, clarification, Mean = 5.93, SD = 2.09 unqualified vs. Mean = 8.33, SD = 1.95 adverse). In addition, the result indicates that perception of financial reporting reliability also marginally significantly decreases lending risk assessment (Panel A,  $F_{1, 89} = 2.506$ ,  $p = 0.059$ , one-tailed).

**FIGURE 1**  
**CELL MEANS FOR LENDING RISK ASSESSMENTS**



**ABLE 2**  
**EFFECTS OF AN AUDITOR INDEPENDENCE CLARIFICATION**  
**ON LENDING RISK ASSESSMENTS<sup>a</sup>**

Panel A: Analysis of Variance					
<u>Source<sup>b</sup></u>	<u>Sum of Squares</u>	<u>df</u>	<u>Mean Square</u>	<u>F</u>	<u>Significance<sup>c</sup></u>
Test Variables					
IC	22.959	1	22.959	6.157	0.008
Clarification	2.818	1	2.818	0.756	0.194
IC*Clarification	7.401	1	7.401	1.985	0.081
Covariates					
Perception of Auditor Independence	0.880	1	0.880	0.236	0.314
Perception of Financial Reporting Reliability	9.347	1	9.347	2.506	0.059
Error	331.879	89	3.729		

\*R<sup>2</sup>=0.217

Panel B: Planned Contrast			
<u>Clarification</u>	<u>Internal Control</u>	<u>t-stat</u>	<u>p-value (One-tailed)</u>
No Clarification	Unqualified Vs. Adverse	1.782	0.039
Clarification	Unqualified Vs. Adverse	4.494	0.000

Panel C: Descriptive Statistics (Mean, Standard Deviation, and N)				
		<u>Non-Clarification</u>	<u>Clarification</u>	<u>Total</u>
IC-Unqualified	<i>Mean</i>	6.15	5.93	6.00
	<i>SD</i>	1.82	2.09	1.99
	<i>N</i>	13	29	42
IC-Adverse	<i>Mean</i>	7.30	8.33	7.76
	<i>SD</i>	1.82	1.95	1.93
	<i>N</i>	30	24	54
Total	<i>Mean</i>	6.95	7.02	6.99
	<i>SD</i>	1.88	2.34	2.14
	<i>N</i>	43	53	96

<sup>a</sup> *Lending Risk Assessment* is measured on an 11-point Likert scale anchored at 0 (Very Low Risk) and 10 (Very High Risk).

<sup>b</sup> Variable coding:

*Clarification*=0 for no independence clarification and =1 for an independence clarification;

*IC*=0 for an unqualified internal control opinion and =1 for an adverse internal control opinion;

*Perception of Auditor Independence* and *Perception of Financial Reporting Reliability* are measured on an 11-point Likert scale anchored at 0 (No Confidence) and 10 (Extreme Confidence), respectively.

<sup>c</sup> One-tailed p-Value based on directional hypotheses.

Comparing the above risk assessments, this study finds the moderating effect of an auditor independence clarification exists. When an auditor independence clarification is integrated with an unqualified internal control opinion, as compared to no clarification, lending risk assessment decreases (Panel C, non-clarification = 6.15 vs. clarification = 5.93); whereas when an auditor independence clarification is integrated with an adverse internal control opinion, as compared to no clarification, lending risk assessment increases (Panel C, non-clarification = 7.30 vs. clarification = 8.33). Figure 1 shows a graphical depiction.

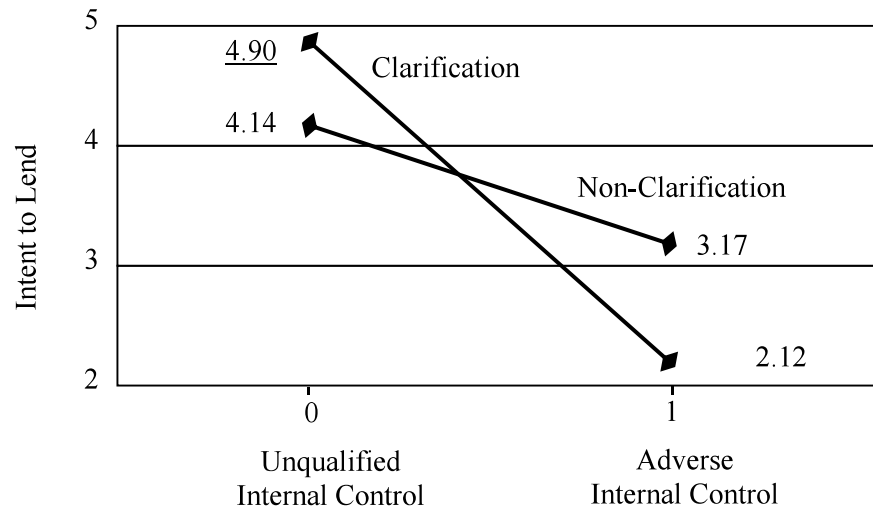
The marginal significant interaction effect suggests that an auditor independence clarification enhances loan officers' confidence about their risk-related judgements on an internal control opinion. That is, an auditor independence clarification adds credibility to an internal control opinion. Through this clarification, loan officers understand that the auditor satisfies the independence requirements of PCAOB and SEC and does not represent the interests of management. Accordingly, they put more trust in the auditor's report and have more confidence about their risk assessments based on this auditor's report.

#### **Test of Hypotheses 2 and 4: Intent to Lend**

Table 3 provides the results of GLM ANCOVA and planned contrast for the effect of an auditor independence clarification on loan officers' intent to lend. The result of the GLM ANCOVA indicates that the main effect of an internal control opinion is marginally significant (Panel A,  $F_{1, 90} = 1.706$ ,  $p = 0.098$ , one-tailed). H2 is supported. Also, this study finds that the interaction effect between an internal control opinion and an auditor independence clarification is significant (Panel A,  $F_{1, 90} = 5.323$ ,  $p = 0.012$ , one-tailed). H4 is supported. Further analysis using planned contrast reveals that the effect of an internal control opinion is greater when an auditor independence clarification is integrated in an auditor's report as compared to no auditor independence clarification (Panel B,  $p = 0.083$ , non-clarification vs.  $p = 0.000$ , clarification, one-tailed). Consistent with prior literature, an adverse internal control opinion significantly decreases loan officers' intent to lend (Panel C, non-clarification, Mean = 4.14, SD = 2.45 unqualified vs. Mean = 3.17, SD = 1.93 adverse). An auditor independence clarification further enhances the lending decisions (Panel C, clarification, Mean = 4.90, SD = 2.37 unqualified vs. Mean = 2.12, SD = 1.97 adverse). In addition, the result indicates that perception of financial reporting reliability also significantly increases intent to lend (Panel A,  $F_{1, 90} = 8.043$ ,  $p = 0.003$ , one-tailed).

Comparing the above lending decisions, this study finds the moderating effect of an auditor independence clarification exists. When an auditor independence clarification is integrated with an unqualified internal control opinion, as compared to no clarification, loan officers' intent to lend increases (Panel C, non-clarification = 4.14 vs. clarification = 4.90); whereas when an auditor independence clarification is integrated with an adverse internal control opinion, as compared to no clarification, loan officers' intent to lend decreases (Panel C, non-clarification = 3.17 vs. clarification = 2.21). The graphic depiction is shown in Figure 2.

**FIGURE 2**  
**CELL MEANS FOR LENDING DECISIONS – INTENT TO LEND**



**TABLE 3**  
**EFFECTS OF AN AUDITOR INDEPENDENCE CLARIFICATION ON INTENT TO LEND<sup>a</sup>**

Panel A: Analysis of Variance					
<u>Source<sup>b</sup></u>	<u>Sum of Squares</u>	<u>df</u>	<u>Mean Square</u>	<u>F</u>	<u>Significance<sup>c</sup></u>
<i>Test Variables</i>					
IC	6.655	1	6.655	1.706	0.098
Clarification	0.018	1	0.018	0.005	0.473
IC*Clarification	20.767	1	20.767	5.323	0.012
<i>Covariates</i>					
Perception of Auditor Independence	5.196	1	5.196	1.332	0.126
Perception of Financial Reporting Reliability	31.378	1	31.378	8.043	0.003
Error	351.110	90	3.901		
*R <sup>2</sup> =0.339					
Panel B: Planned Contrast					
<u>Clarification</u>	<u>Internal Control</u>	<u>t-stat</u>	<u>p-value (One-tailed)</u>		
No Clarification	Unqualified Vs. Adverse	-1.397	0.083		
Clarification	Unqualified Vs. Adverse	-4.654	0.000		

Panel C: Descriptive Statistics (Mean, Standard Deviation, and N)				
		<u>Non-Clarification</u>	<u>Clarification</u>	<u>Total</u>
IC-Unqualified	<i>Mean</i>	4.14	4.90	4.65
	<i>SD</i>	2.45	2.37	2.39
	<i>N</i>	14	29	43
IC-Adverse	<i>Mean</i>	3.17	2.12	2.70
	<i>SD</i>	1.93	1.97	2.01
	<i>N</i>	30	24	54
Total	<i>Mean</i>	3.48	3.64	3.57
	<i>SD</i>	2.13	2.59	2.38
	<i>N</i>	44	53	97

<sup>a</sup> Intent to lend is measured on an 11-point Likert scale anchored at 0 (Definitely Not Lend) and 10 (Definitely Lend).

<sup>b</sup> Variable coding:

*Clarification*=0 for no independence clarification and =1 for an independence clarification;

*IC*=0 for an unqualified internal control opinion and =1 for an adverse internal control opinion;

*Perception of Auditor Independence* and *Perception of Financial Reporting Reliability* are measured on an 11-point Likert scale anchored at 0 (No Confidence) and 10 (Extreme Confidence), respectively.

<sup>c</sup> One-tailed p-Value based on directional hypotheses.

The significant interaction effect suggests that an auditor independence clarification moderates the effect of an internal control opinion on loan officers' decisions. Consistent with prior literature, when an adverse internal control opinion is issued, loan officers doubt the management's willingness and ability to fairly present its financial statements and thus significantly decrease their willingness to lend. An auditor independence clarification enhances the loan officers' confidence about their lending decisions. That is, this clarification adds credibility to an internal control opinion in the same auditor's report. As PCAOB (2017) expects, a clarification states that the auditor complies with the independence requirements of PCAOB and SEC and the auditor does not represent the interest of the client. Thus, the auditor's report deserves loan officers' trust and is helpful for loan officers to make lending decisions.

### Supplemental Analysis - Importance Scores for Key Factors

This study conducts supplemental analysis to provide additional insight on the effect of an auditor independence clarification as well as the effect of an internal control opinion. Similar to Schneider and Church (2008), participants are requested to rate the importance of all factors addressed in the experimental instruments. These factors include *income statement*, *balance sheet*, *statement of cash flows*, *company growth*, *Big Four CPA firm audit (vs. non-Big Four CPA firm)*, *explicit clarification of auditor independence (vs. or not)*, *auditor's opinion on financial statements*, and *auditor's opinion on internal control*. This study uses GLM ANCOVA to compare the importance scores among four groups. In terms of the effect of an internal control opinion, an adverse internal control opinion significantly decreases importance scores of statement of cash flows ( $p = 0.020$ , one-tailed), and Big Four CPA firm audit (vs. non-Big Four CPA firm) ( $p = 0.005$ , one-tailed) but significantly increases the importance scores of auditor's opinion on internal control ( $p = 0.015$ , one-tailed). The results suggest that an adverse internal control opinion reduces loan officers' confidence about statement of cash flow as well as the auditors themselves. This suggestion justifies the view that as compared to investors, loan officers have shorter-term perspectives and pay more attentions to cash flows than accrual-based earnings (Schneider and Church, 2008). Moreover, an adverse internal control opinion makes loan officers put more weight on an internal control opinion as compared to an unqualified internal control opinion. In terms of an auditor independence clarification, the results indicate that a clarification significantly increases the importance rate of explicit auditor independence clarification (vs. or not) ( $p = 0.038$ , one-tailed). This implies that the

statement of auditor independence clarification makes loan officers pay more attention to this statement. The standard is more important when it is provided than when it is not provided. These results corroborate our primary tests.

## **DISCUSSIONS AND CONCLUSIONS**

The objective of this study is to provide experimental evidence on the informative value of an auditor independence clarification in an integrated audit report. The results reveal that an auditor independence clarification provides relevant and credible information concerning loan officers' decision-making process. An auditor independence clarification moderates the relationship between an internal control opinion and loan officers' decisions. When loan officers make their lending risk assessments and decisions, they first consider whether an internal control opinion is unqualified or adverse. The presence of an adverse internal control opinion increases loan officers' lending risk assessments and decreases their willingness to lend. An auditor independence clarification enhances loan officers' confidence about their assessments and decisions. When an auditor independence clarification is integrated in an auditor's report, as compared to no auditor independence clarification, the effects of an internal control opinion on loan officers' assessed lending risk and their willingness to lend are greater.

The contributions of this study are threefold. First, for the first time, this study experimentally tests the influences of an auditor independence clarification on loan officers' assessments and decisions. Through a hypothetical integrated audit report, the auditor claims that the auditor is independent and has complied with the independence requirements of the SEC and PCAOB. This study confirms the informative value of an auditor independence clarification, which is the expectations of the new standard PCAOB (2017). The exploration is very important because loan officers are one of the primary users of an auditor's report and their perceptions represent the public's attitudes to an auditor independence clarification, which in turn significantly influence regulators such as PCAOB and SEC's further reforms. Second, this study provides preliminary evidence to the literature regarding the interaction between an auditor independence clarification and internal control opinion. The results of this study confirm not only the direct effect of an internal control opinion but also the moderating effect of an auditor independence clarification. The final contribution is to experimental literature. In this study, an auditor independence clarification is a new standard and lacks systematic data collection and documentation. Therefore, archival research cannot be conducted. This study uses the experimental approach to overcome the lack of the data and explain loan officers' psychological processes that affect their decisions. In addition, the experimental approach isolates an internal control opinion and auditor independence clarification from other "noisy" factors.

This study has several limitations. The first limitation is the limited information involved in the experimental instrument. In order to increase the response rate, this study kept the experimental instrument at a reasonable length. Thus, the experimental instrument did not include all information released by financial reporting in the real world. Some participants may feel that the information is not sufficient for them to make decisions. The second limitation is the generalization of the findings of this study. This study utilizes loan officers as participants. However, loan officers are not the only representatives of public users. Investors are another important representative of public users. Actually, investors have different characteristics from loan officers. For instance, investors focus more on accrual-based earnings while loan officers pay more attention to statements of cash flows due to their short-term perspective (Schneider and Church 2008). Therefore, the findings derived from loan officers may not directly map to other public users such as investors.

Future research has several promising avenues. First, to overcome the shortcomings of the limited information in the experimental instruments of the study, future research can provide more information to participants to conduct similar studies. For example, future research can provide two years of comparative balance sheets and three years of income statements in accordance with the SEC requirement. However, considering the increased length of the experimental instruments, the best way for future research to collect data may be to utilize some face-to-face experimental methods. Second, considering the different

characteristics of investors, who are another important representative of public users, future research can investigate whether the findings of this study can be generalized to investors. This is an encouraging direction because investors and loan officers are two main groups of public users and their responses to an auditor independence clarification are meaningful to PCAOB. Third, future research can measure the effects of an auditor independence clarification from auditors' perspective. For instance, future research can explore how an auditor independence clarification affects auditors' perceptions of their obligations. Fourth, this study explores the informative value of an auditor independence clarification under different types of internal control opinions with an unqualified financial statements audit opinion condition. This is the first step in understanding an auditor independence clarification. Because the auditor independence clarification is a new standard proposed by PCAOB (2017), more future research is necessary to provide further empirical evidence to PCAOB. For instance, future research can examine the informative value of this new auditor independence clarification under different types of a financial statements audit opinion.

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