

Client-To-Auditor Employment Offers and Auditor Independence in the Post-Sarbanes-Oxley Era

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Ninety-six nonprofessional investors indicate that public accounting firms' independence is perceived to be more impaired than non-public firms when the firm audits a client who has offered a job to a member of the audit team. Although perceptions of both firms' objectivity improve as the strength of the independence safeguards increase, public company auditors are perceived as being more objective than non-public company auditors. These results bolster the argument for unified accounting standards. This study is the first to investigate nonprofessional investors' perceptions of the issue, despite their prominence in the capital markets.

INTRODUCTION

Over a decade has passed since the United States (US) Congress enacted Sarbanes-Oxley Act Section 206 (SOX Section 206). This legislative reform established a “cooling-off” period, which makes it unlawful for a registered public accounting firm to perform for an issuer any audit service if a senior financial reporting executive was employed by the firm and participated in any capacity in the audit of that issuer during the one year period preceding the date of the initiation of the audit (United States House of Representatives, 2002). The goal of SOX Section 206 – and the Sarbanes-Oxley Act (SOX) in general – was to improve both independence “in fact” and independence “in appearance.” However, DeFond and Francis (2005) suggest that SOX was designed to remedy an accounting system that was not broken. Research also questions whether SOX Section 206 increases perceptions of a firm’s independence (Geiger et al., 2008; Naiker and Sharma, 2009). Therefore, the present study investigates perceptions of auditor independence when an auditor receives an offer of employment from the client, and whether unified independence safeguards¹ should exist for both public and non-public company accounting firms.

Anecdotal evidence suggests that an audit professional’s formal receipt of an employment offer from an audit client threatens an accounting firm’s independence (Beasley et al. 2000, p. 36). However, the academic literature on this matter is inconclusive. Pre-SOX independence research reports that Canadian investors’ perceptions of independence are impaired by this threat to independence (Lindsay et al., 1987), while Bartlett (1997) finds evidence to the contrary. Despite post-SOX literature that questions the benefits of SOX Section 206 (Willis and Nicholls, 2014, p. 41), research has not concluded whether this safeguard improves perceptions of revolving door firms’ independence.

The Sarbanes-Oxley Act was enacted in part to protect investors who lack the requisite knowledge to protect themselves (Pinsker and Wheeler, 2009). Nonprofessional investors fit this description, as they have varying levels of business and accounting knowledge (Ritt, 2004). Given Cohen et al.’s (2011, p. 111) assertion that understanding nonprofessional investors’ expectations is critical to improving

information provided to investors, this study investigates whether the cooling-off period improves their perceptions of audit firms' independence.

This study is framed within the theoretical lens that unified independence standards should be required for both public and non-public company auditors, as proposed by Carmichael (2004). Although the lack of unified independence standards is a major concern among standard-setters, a lack of consensus exists as to which standards should serve as the baseline for rulemaking (Cullinan et al., 2013, p. 9). Currently, SOX Section 206 does not extend to non-public company auditors (United States House of Representatives, 2002, p. 775). However, the Public Company Accounting Oversight Board (PCAOB) suggests that it would be beneficial for non-public company auditors to comply with their auditing independence safeguards, since these companies may intend to become public companies in the future (PCAOB, 2004; SEC, 2011b). Considering the increased media attention on audit failures resulting from independence-related issues, it may behoove non-public company auditors to adopt stronger independence safeguards that may potentially reduce their exposure to independence-related litigation.

An experiment was employed to investigate whether an audit firm's independence "in appearance" is impaired when an auditor receives an employment offer from an audit client. The experiment also examines whether unified independence safeguards should be required for public and non-public company auditors. The revolving door safeguards to be examined, in order of increasing strength, are (1) the American Institute of Certified Public Accountants' (AICPA) general safeguards, (2) SOX Section 206's cooling-off period, and (3) the Independence Standards Board's (ISB) voluntary peer review safeguard.

Ninety-six nonprofessional investors indicated that in the absence of any independence safeguards, both public and non-public firms' independence is perceived to be impaired when a member of the audit team receives an employment offer from the client. Compared to non-public company auditors, public company auditors' independence is perceived to be more severely vulnerable to this threat to independence. Nonprofessional investors also indicated that the AICPA's safeguards alone would be more appropriate for non-public company auditors, whereas SOX's Section 206 safeguards alone would be more appropriate for public company auditors. Finally, the study finds that although the perceived objectivity of both types of firms improves as the strength of the safeguards increases, public company auditors were viewed more favourably than non-public company auditors.

The contributions of this study have a number of implications for research and policy. From a research perspective, the results respond to recent (Wilson, 2016; Willis and Nicholls, 2014) and prior (DeFond and Francis, 2005) calls to re-evaluate the benefits of SOX. Brivot et al. (2015, p. 25) report that the PCAOB annually inspects whether registered firms observe the audit quality standards developed by the organisation. Although a number of studies find that these inspections positively influence audit quality (Carcello et al., 2011; DeFond and Lennox, 2011), Law (2010, p. 241) reports that auditor independence remains a concern, even after the enactment of SOX. Correspondingly, the findings in the current study which suggest that both public and non-public firms' independence is impaired by the revolving door phenomenon revokes DeFond and Francis' (2005) assertion that this threat to independence is not a problem.

The present research is also the first to explore nonprofessional investors' perceptions of issues related to auditor employment with their clients prior to the auditor leaving the firm. These investors are important to the capital markets, as they have been found to own nearly one-third of the outstanding shares (Bogle, 2005). In general, nonprofessional investors are not astute about corporate governance issues. They possess varying levels of business and accounting knowledge (Ritt, 2004), which contrasts with more sophisticated investors in Dart and Chandler's (2013) research. The Securities and Exchange Commission (SEC) asserts that auditor independence is impaired if "...a reasonable investor with knowledge of *all* the facts and circumstances would conclude that the auditor is not capable of exercising objective and impartial judgement..." (SEC, 2011a). Dey and Rushe (2009) highlight the media attention that focuses on threats to independence arising from the recruitment of audit staff by audit clients. While investors may not be privy to information regarding specific firms whose auditors are contemplating an offer of employment with a client, it is plausible that the media attention on this issue has not left

investors naïve regarding the disapproval surrounding this threat to independence. Hence, it is important to examine the impact of this threat on investors' actions if they were provided with "knowledge of *all* of the facts and circumstances."

From a policy perspective, the results support Basioudis' (2007) call for additional safeguards to increase the level of auditor independence. The findings that investors support similar independence safeguards for both public and non-public company auditors may provide a baseline for creating unified standards, since regulators identify the absence of baseline standards as an obstacle to creating unified standards (Cullinan, 2013, p. 9). However, the absence of a significant difference between the perceived objectivity of both types of firms suggests that resources must be devoted to improving the perceptions of non-public company auditors in order to realise the full benefits of stronger independence standards.

The remainder of the article proceeds as follows. The next section develops the hypothesis and research questions, followed by an overview of the methodology and the results. The study concludes with a discussion of the results, limitations, and avenues for future research.

LITERATURE REVIEW

The theory which suggests that an audit team's independence is threatened when one of their auditors receives an offer of employment from the client was first publicised by the US Congress in the Metcalf Report (Imhoff, 1978, p. 870; U.S. Senate, 1976, p. 21). While at least one US study has examined this issue (Bartlett, 1997), the majority of the limited research on this threat to independence originated in the United Kingdom (Dart and Chandler, 2013) and Canada (Lindsay et al., 1987).

The motivation for examining this threat to independence in the US arises from Dart and Chandler (2013), who report that no known United Kingdom research examined this issue prior to ratifying their independence rules. Prior to the implementation of SOX Section 206 in the United States (US), no known published US-based research investigated investors' perceptions of the revolving door threat to independence. However, post-SOX literature questions the validity of the alleged threat which preceded the enactment of SOX (DeFond and Francis, 2005), and the necessity of SOX (Willis and Nicholls, 2014). The present study responds to these voids in the literature by providing empirical evidence of US nonprofessional investors' perceptions of this threat to auditor independence.

Hypothesis Development

Dart and Chandler (2013) categorise revolving door independence literature into pre- and post-departure revolving door literature. Several post-departure studies find no evidence that an audit firm's independence is threatened when the ex-auditor works for the audit client (Imhoff, 1978; Geiger et al., 2005; Geiger and North, 2006). For example, recent research (Dart and Chandler, 2013) reported that approximately 17.1 percent of institutional investors in the United Kingdom were not overwhelmingly concerned about the quality of a final audit prior to an auditor leaving the firm. On the contrary, both pre- and post-SOX research create tension regarding this threat to independence, with evidence that this threat impairs perceptions of auditor independence (Firth, 1980; Lindsay et al., 1987; Koh and Mahatheva, 1993; Parlin and Bartlett, 1994; Beasley et al., 2000; Dowdell and Krishnan, 2004; Menon and Williams, 2004; Lennox, 2005; Basioudis, 2007).

It is clear from the passage of SOX Section 206 that accounting regulators perceive auditor independence to be impaired when a member of the audit team receives an offer of employment from an audit client. Evidence from the United Kingdom suggests that auditors may not exercise an appropriate level of professional scepticism when they encounter this perceived threat to independence (Dart and Chandler, 2013; Lindsay et al., 1987). Beasley et al. (2000, p. 36) concur, albeit without empirical evidence. However, Bartlett's (1997) research reports that over fifty-one percent (51.5 percent) of sophisticated financial statement users (bankers) believe that Certified Public Accountants would report their client's earnings management activities even after receiving a lucrative employment offer from their client.

Notwithstanding the results from these studies, extant post-SOX literature has not examined US' investors' perceptions of issues related to auditor employment with the client prior to the auditor leaving the firm. Two studies find that SOX Section 206 neither improves the factual nor perceptual aspects of independence after the auditor begins working with the client (Geiger et al., 2005; Wilson, 2016, respectively). One adverse outcome of nonprofessional investors perceiving that this threat will impair the firm's independence is the potentially negative impact on the capital markets. Cohen et al. (2011, p. 111) assert that understanding their expectations is critical to the improvement of information provided to them. Thus, it is incumbent on the profession to understand the extent to which this threat impairs perceptions of auditor independence in order to develop the regulation that meets the needs of this growing capital market investor group. The following hypothesis investigates this issue:

H1: Perceptions of public and non-public company audit firms' independence are impaired when a member of the audit team receives an offer of employment from their audit client to become a senior financial reporting executive.

Unified Strength of Safeguards for Public and Non-public Company Auditors

Carmichael (2004) theorised that unified independence standards should exist for public and non-public company audit firms. This theory is in contrast to the current differential independence standards in the US. Although the lack of unified independence standards is a major concern among standard-setters, a lack of consensus exists as to which standards should serve as the baseline for rulemaking (Cullinan et al., 2013, p. 9).

With increased media attention on the audit failures of public company auditors, anecdotal evidence suggests that nonprofessional investors may demand stronger independence safeguards for both public and non-public company audit firms. However, Wilson (2016) reports that increasing the strength of the revolving door safeguards does not improve perceptions of public company auditors' independence. In addition, the attribution theory suggests that even if stronger safeguards improve perceptions of the objectivity of both types of firms individually, it is likely that no significant difference will exist when comparing the perceived objectivity of both types of firms. The research questions in this section investigate the tension between these theories.

The ISB's Role in the Development of Revolving Door Safeguards

Independence Standards Board No. 3 was created by the AICPA and the SEC, with the express purpose of developing independence safeguards that address issues of auditor employment with audit clients. Similar to Beasley et al. (2000, p. 36), the ISB expressed concern that departing auditors would not exercise an appropriate level of professional skepticism during their final work on the audit (ISB, 2000, para. 7). Consistent with their purpose, the ISB created an exposure draft, which included a number of safeguards that were adopted by the AICPA. As a result of this exposure draft, auditors of public and non-public companies are now subject to the AICPA's baseline revolving door independence safeguards (AICPA, 2013; PCAOB, 2003), including the ISB's financial interest safeguard (ISB, 2000, para. 16).²

In an effort to restore investors' confidence in the profession subsequent to the ethical lapses by auditors at the turn of the century, the PCAOB created more stringent independence safeguards for firms that audit public companies. The PCAOB infused the ISB's cooling-off safeguard (ISB, 2000, para. 21) into SOX and created SOX Section 206, which deems the following actions to impair an accounting firm's independence:

“It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit (United States House of Representatives, 2002).”

While SOX Section 206 only applies to auditors of publicly traded companies, SOX Section 209 empowers state regulatory authorities to make decisions regarding the independence standards applicable to auditors of non-public companies (United States House of Representatives, 2002). This opens the door to unify the current revolving door safeguards for both types of firms.

The final safeguard examined in this study is the peer review safeguard. The ISB's exposure draft "proposed a requirement that firms have their compliance with the provisions of the [ISB Exposure Draft's] standard evaluated in a peer review...firms' compliance with all auditing and quality control standards, including independence standards, is an important component of the profession's self-regulation (ISB 2000, para. 15)." The motivation for examining whether additional safeguards strengthen the current regulatory policy is motivated by Basioudis' (2007, p. 1417) suggestion that regulators should consider additional safeguards that improve perceptions of independence.

Research Question Development

Wilson (2016) finds that perceptions of an audit firm whose former employee works for the client do not improve as the strength of the revolving door safeguards increases. It is unknown, however, whether similar results persist for public and non-public company audit firms that encounter issues of auditor employment with the client prior to the auditor leaving the firm. It is also unknown whether a significant difference exists between perceptions of these firms' objectivity as the strength of the safeguards increases. Therefore, predicting whether the strength of the independence safeguards improves perceptions of non-public company auditors' objectivity is complex, as research has yet to examine this issue.

Perhaps the most threatening scenario to an audit firm's objectivity may occur when a conspiracy transpires between an auditor whose independence is compromised and the firm's client that is recruiting the auditor. Unfavourable perceptions of the firm's objectivity are most easily reached in an environment where the firm is governed by minimal independence safeguards. In the US, this environment naturally occurs when non-public company auditors are subject to minimal (AICPA) safeguards. This line of reasoning suggests that perceptions of non-public audit firms' objectivity would be unfavourable when these firms are regulated by independence safeguards of minimal strength.

Alternatively, a less cynical possibility is that perceptions of non-public company auditors' objectivity may not improve when the firm is subjected to strong independence safeguards. That is to say, if unfavourable perceptions of auditor objectivity cannot be attributed in part to minimal revolving door safeguards, by default, then the type of firm performing the audit must be the culprit. This line of reasoning is consistent with the attribution theory, which suggests that causal attributions are assigned to either the environment (strength of the safeguards) or the individual (the audit firm). Thus, if the revolving door safeguards are strong, then unfavourable perceptions of auditor objectivity must originate from the type of firm performing the audit.

In summary, this exploratory study theorises that the benefits realised at each level of the safeguards may depend on whether the firm is a public or non-public company auditor. Although anecdotal evidence suggests that stronger independence safeguards improve perceptions of objectivity, it is unknown how strong the safeguards must be in order for no significant difference to exist with respect to perceived objectivity of public and non-public firms. The attribution theory suggests that if significant differences persist between perceptions of firms' objectivity at the highest level of independence safeguards, then these differences must be attributed to the firm, not the strength of the independence safeguards. Thus, the level of objectivity at which no significant difference occurs between the firms may signal to regulators the point at which they may propose the establishment of uniform revolving door safeguards. Two research questions examine this issue:

- RQ1: Will nonprofessional investors' perceptions of public and non-public audit firms' independence improve as the strength of the safeguards increases?

RQ2: Will perceptions of public and non-public firms differ significantly at the strongest level of revolving door safeguards presented in this study?

METHODOLOGY

A within-subjects experiment was employed to achieve the objectives of the study. This methodology is appropriate for creating an environment which is representative of the decision-making context being studied (Harsha and Knapp, 1990). Audit firms routinely market the potential for prospective audit employees to work for clients later in their career as an incentive to attract prospects to public accounting (Basioudis, 2007, p. 1397). With the media's extensive focus on the egregious auditor independence violations at the turn of the century, and the rapid dissemination of information through the media, it is conceivable that investors' awareness of issues surrounding the revolving door phenomenon have heightened. For these reasons, this study employs a within-subjects methodology.

Although prior research raises concerns regarding threats to the validity of within-subjects experiments arising from participants attempting to guess the researcher's hypothesis and the presence of contextual effects, these concerns have been refuted by more recent research (Wilson, 2015; Schepanski et al., 1992; Harsha and Knapp, 1990; Berkowitz and Donnerstein, 1982). Nonetheless, several measures were employed to alleviate these concerns. First, the experimental design incorporates suggestions proposed by Schepanski et al. (1992, p. 128-129) to reduce the potential for demand bias. Second, participants were advised that "*Your responses may be the same or different for each type of firm*", a statement which is similar to those made in prior experimental studies in an effort to further reduce the potential demand effects (Wilson, 2015; Mather, 1999; Pany and Reckers, 1980).

Participants and Demographic Overview

Nonprofessional investors were recruited from a US university with a top 100 "Best Part-Time MBA Programs by the U. S. News and World Report".³ The use of MBA students as a surrogate for nonprofessional investors is consistent with Elliot et al. (2007), who suggest that surrogates behave no differently than nonprofessional investors for low integrative tasks that do not require an investment decision. The tasks in this study meet this criterion.

Nonprofessional investors are a heterogeneous group of investors with respect to age, professional background, business and accounting knowledge, and level of education (Ritt, 2004). Although prior research notes the difficulty in profiling nonprofessional investors, (Fredrickson and Miller, 2004, p. 674; Ritt, 2004, p. 28), the surrogate nonprofessional investors in this study compare favourably with those in prior studies. A total of ninety-six students participated in the study, with an average age of 26.48 years, and 61 percent (61.01%) of the participants were female. Participants also demonstrated a reasonable understanding of business and the ability to use financial statements as, on average, they had approximately 7.82 years of full-time working experience, and two years of investment experience (2.06 years). Participants indicated that they had taken roughly 5.46 accounting classes and 1.53 finance classes. Nearly 34 percent of the participants (34.04%) indicated that they currently invest in either stock or mutual funds. Participants' ability to interpret financial statements also compared favourably with MBA students in recent studies who served as a proxy for nonprofessional investors (5.74 on a 7-point Likert Scale; 1 = low and 7 = very high). Students' ability to interpret the financial statements are similar to those in Kaplan et al.'s (2015) study, which reported students' ability to understand financial reporting to be 4.97 on a 7-point Likert scale. The demographic statistics are tabulated in Table 1.

TABLE 1
Demographic Overview

Characteristics	
Age (years)	26.48
Female (percentage)	61.05
Full-time working experience (years)	7.82
Accounting / Finance Experience (years)	2.17
Investment Experience (years)	2.06
Currently invest in individual stock (percent)	34.04
Ability to interpret financial statements (1 = low, 7 = high)	5.74
Total Accounting Classes	5.46
Total Finance Classes	1.53

Overview of the Research Instrument

The experiment involved a hypothetical revolving door scenario which would have occurred prior to SOX; thus, the scenario is presented in the calendar year 1999. Prior to administration, the instrument was pretested and adjusted based on comments from audit professionals from a regional CPA firm. The scenario involves an audit manager who received an offer of employment to become a chief financial officer from two of the firm's audit clients: a publicly traded client and a non-public client. The independent variable manipulation is 'the type of firm that audits the client', which is presented in the study as "CPA firms that audit public companies" compared to "CPA firms that audit non-public companies." Investors are informed that since the audit professional is unsure which offer he will accept, then the firm will comply with the safeguards to ensure that the audit firm is independent.

Participants were then presented with three categories of revolving door safeguards: minimal safeguards (AICPA safeguards), current safeguards (AICPA, SOX Section 206 safeguards), and strong safeguards (AICPA, SOX Section 206, and ISB safeguards). Participants were not given any evidence as to the "level" of each safeguard, so as not to influence their perceptions of the strength of the safeguards. In order to minimise any bias that may be associated with the source of the safeguards based on certain regulatory bodies, the AICPA, SEC, and ISB safeguards were presented in the experiment as "general revolving door safeguards", "cooling-off safeguards", and "peer review safeguards", respectively. Following the presentation of the safeguards, participants were asked to evaluate multiple statements concerning the revolving door practice and safeguards.

The primary motivation for including the ISB's peer review safeguard in the "strong" safeguard category is accounting regulators' adoption of several of the ISB's safeguards, including the AICPA's adoption of the financial interest safeguard (ISB, 2000, par. 16) and a mandatory cooling-off period (ISB, 2000, par. 21). The peer review safeguard was initially considered for adoption, but it was concluded that the accounting profession's regulatory system should be responsible for mandating the program and for establishing the scope and content of the peer review program (ISB, 2000, p. 15). The scope of the current study is not to examine the necessary content that should be included in a peer review program. This study investigates whether audit quality is improved when firms voluntarily adopt a peer review program. Prior literature highlights numerous benefits associated with peer review practices. For example, they have been found to mitigate independence risk (Johnstone et al., 2001), provide financial statement users with assurance that firms are in compliance with their safeguards (Elliott and Jacobson, 1998), and increase audit quality when there is an expectation that the audit is subject to review (Deis and Giroux, 1992). For these reasons, this study increases the strength of the current revolving door policy by adding the ISB's peer review safeguards.

Dependent Measures

After reading the scenario in the experiment, nonprofessional investors were asked to provide their perceptions of the independence of firms that audit public or non-public companies. Seven statements are provided to investigate these issues. All statements were measured using a seven-point Likert scale (anchored at 1 = No Confidence, and 7 = Extremely Confident) with the exception of statement 1, which required participants to rank the individual effectiveness of the independence safeguards examined in the study. When discussed in terms of levels of agreement, responses grouped as follows: “1” through “3” = “Do not agree”; “5” through “7” = “Agree”

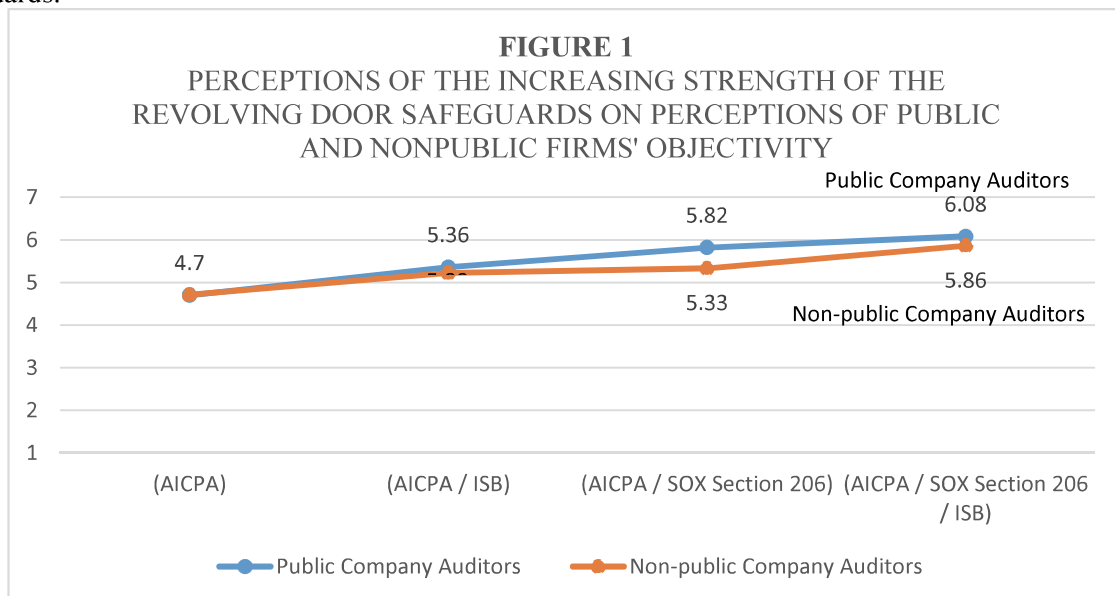
Statement 2 examines whether nonprofessional investors perceive audit firms as having a conflict of interest when an audit professional receives an offer of employment from an audit client. The structure of this question (CPA firms may be perceived as having a “conflict of interest”) is consistent with prior literature that examines independence by asking whether a conflict of interest exists (DeZoort et al., 2012).

Three dependent measures (Statement 3, Statement 4, Statement 5) investigate whether nonprofessional investors perceive various combinations of the independence safeguards to motivate (i.e. influence, stimulate) revolving door firms to remain independent. Understanding the role of safeguards in motivating auditor independence extends prior research, which has found safeguards such as reputational loss and the threat of litigation to be sufficient in promoting auditor independence (DeFond et al., 2002, p. 1251). Finally, Statement 6 and Statement 7 measure how well investors perceive the combination of various safeguards will ensure that the audit firm is independent.

RESULTS

Preliminary Analysis

Figure 1 provides an overview of participants’ mean responses of the perceived objectivity of public and non-public firms’ objectivity for each of the safeguards examined in the study. Overall, participants perceived an increase in the objectivity of both types of firms as the independence standards were increased. However, the perceived benefit of stronger standards appears to diminish more for public company auditors than for non-public company auditors. In addition, the mean responses for public company auditors are consistently higher than those for non-public company auditors. These observations suggest that unfavourable perceptions of the ability of the safeguards to promote objectivity may be contingent upon the type of firm performing the audit as opposed to the strength of the independence standards.



Hypothesis 1 Analysis

Table 2 provides the statistical test for Hypothesis 1, which investigates whether nonprofessional investors perceive an audit firm’s independence to be threatened when an audit team member receives an employment offer from an audit client.

TABLE 2
Perceptions of Auditor Independence Violations Arising From Client-to-Auditor Employment Offers

PANEL A: Analysis of Perceived Independence Violations by Firm Type

Statement 2: In the absence of any revolving door safeguards, CPA firms may be perceived as having a conflict of interest [independence] with a client when it is known that one of the firm's audit team members is strongly considering a job offer with the audit client.

<u>Statistics</u>	<u>Public Company Audit Firms</u>	<u>Non-Public Company Audit Firms</u>
Mean	6.26	5.47
Standard Deviation	(1.102)	(1.665)
t-statistic	24.127	11.425
p-value	p = 0.000	p = 0.000

PANEL B: Comparison of Perceived Independence Violations by Firm Type

Statement 2: In the absence of any revolving door safeguards, CPA firms may be perceived as having a conflict of interest [independence] with a client when it is known that one of the firm's audit team members is strongly considering a job offer with the audit client.

	Mean (s.d.)	Strongly Disagree	(2)	(3)	(4)	(5)	(6)	Strongly Agree
Public	6.26 (1.102)	0.0%	0.0%	3.2%	6.5%	11.8%	18.3%	60.2%
Non-public	5.47 (1.665) t = 4.541 p = 0.000	2.2%	3.2%	8.6%	15.1%	16.1%	11.8%	43.0%

PANEL C: Perceived Effectiveness of Revolving Door Safeguard Components

Statement 1: How effective do you believe that each of these safeguards will be in motivating CPA firms to be objective when the CPA firm audits a client, and it is known that one of the firm's audit team members is strongly considering a job offer with the audit client?

	<u>AICPA</u>	<u>SOX Section 206</u>	<u>ISB</u>
Public	40.6%	52.1%	7.3%
Non-public	86.5%	7.3%	6.3%
	$X^2 = 52.865$ p = 0.000		

Note: All individual responses measured using a seven-point scale with the following anchors:
1 = Strongly Disagree; 7 = Strongly Agree.

The analysis indicates that investors' mean perceptions of both public ($t = 24.127$, $p = 0.000$) and non-public firms' ($t = 11.425$, $p = 0.000$) independence were significantly different from the midpoint. These findings suggest that an audit firm's independence may be threatened when its employee receives an offer of employment from the client, which challenges DeFond and Francis' (2005) assertion that SOX was created without a problem which needed a solution. Hypothesis one is supported.

Two additional analyses were performed. The first analysis measures whether perceptions of public or non-public firms are more negatively impacted by auditors who work on an engagement after receiving an offer of employment from the client (Table 2, Panel B). Over ninety percent (90.3 percent) of respondents agree that the perceived independence of firms that audit public companies is impaired by this threat to independence, compared to 70.9 percent for non-public company auditors. The mean difference between the perceptions of each type of firm is statistically significant ($t = 4.541$, $p = 0.000$).

The finding that public company auditors are perceived as being more affected by this threat to independence than non-public firms may frustrate accounting regulators' attempts to establish baseline independence standards. Therefore, investors were instructed to rank the individual effectiveness by which they perceive each of the safeguards to promote auditor objectivity (Table 2, Panel C). Slightly over fifty-two percent (52.1 percent) of investors indicated that SOX Section 206 would be most effective in promoting objectivity among firms that audit public companies. However, an overwhelming 86.5 percent of respondents indicated that the AICPA's safeguards were most effective in encouraging auditors of non-public companies to remain independent. The differences were statistically significant ($X^2 = 52.865$, $p = 0.000$). Collectively, these results imply that investors may not expect public and non-public company auditors to have unified independence standards.

Research Question 1 Analysis

Research question 1 compares nonprofessional investors' perceptions of public and non-public company audit firms' objectivity during the audit as the strength of the independence safeguards increases. Investors were first asked to evaluate the perceived ability of each component of SOX Section 206 to motivate each type of firm to be objective during the audit (Table 3, Panel A and Panel B). Finally, participants were asked whether the current policy is more likely to ensure that public or non-public firms will remain objective during the audit (Table 3 Panel C).

When asked whether the AICPA's general revolving door safeguards alone would motivate public and non-public company auditors to be objective during the audit (Table 3, Panel A), participants' responses were not statistically different for either firm (public mean = 4.70 and non-public mean = 4.71; $t = 0.081$, $p = 0.935$). However, a substantially higher percentage of investors agree that SOX Section 206's cooling-off period alone is effective for firms that audit public companies (73.7 percent), compared to less than half (47.9 percent) who believe the same for firms that audit non-public companies (Table 3, Panel B). The mean responses were significantly different (public mean = 5.31 and non-public mean = 4.12; $t = 6.055$, $p = 0.000$).

Nonprofessional investors were also asked whether increasing the minimal (AICPA) independence safeguards to the current safeguards (AICPA / SOX Section 206) improves perceptions of public and non-public company firms' objectivity during the audit (Table 3, Panel C). The results suggest that the current revolving door policy is significantly more effective for public companies than for non-public companies (public mean = 5.82 and non-public mean = 5.33, respectively; $t = 3.536$, $p = 0.000$).

TABLE 3

The Impact of the Current Revolving Door Safeguards on Perceptions of Independence

PANEL A: The AICPA’s Safeguards Impact on Revolving Door Firms’ Independence

Statement 3: How confident are you that the general revolving door safeguards will motivate the CPA firm to be objective during the audit when it is known that one of the firm's audit team members is strongly considering a job offer with the audit client?

	Mean (s.d.)	No Confidence	(2)	(3)	(4)	(5)	(6)	Extremely Confident
Public	4.70 (1.619)	3.2%	9.6%	9.6%	17.0%	26.6%	20.2%	13.8%
Non-public	4.71 (1.507)	3.2%	5.3%	11.6%	21.1%	25.3%	23.2%	10.5%
	t = 0.081 p = 0.935							

PANEL B: SOX Section 206’s Impact on Revolving Door Firms’ Independence

Statement 5: How confident are you that the cooling-off safeguard will motivate each firm to remain objective during the audit when it is known that one of the firm's audit team members is strongly considering a job offer with the audit client?

	Mean (s.d.)	No Confidence	(2)	(3)	(4)	(5)	(6)	Extremely Confident
Public	5.31 (1.459)	1.1%	4.2%	7.4%	13.7%	20.0%	31.6%	22.1%
Non-public	4.12 (1.765)	8.5%	14.9%	14.9%	13.8%	18.1%	25.5%	4.3%
	t = 6.055 p = 0.000							

Panel C: AICPA/SOX Section 206 Safeguard Impact on Revolving Door Firms

Statement 6: How confident are you that the combination of (1) the general revolving door safeguards and (2) the cooling-off safeguard will effectively ensure that the audit firm remains objective when it is known that one of the firm's audit team members is strongly considering a job offer with the audit client?

	Mean (s.d.)	No Confidence	(2)	(3)	(4)	(5)	(6)	Extremely Confident
Public	5.82 (1.154)	0.0%	0.0%	6.3%	8.3%	15.6%	38.5%	31.3%
Non-public	5.33 (1.307)	0.0%	2.1%	9.5%	12.6%	23.2%	33.7%	18.9%
	t = 3.536 p = 0.000							

Note: All individual responses measured using a seven-point scale with the following anchors: 1 = No Confidence; 7 = Extremely Confident.

The analysis in Table 4 extends this discussion to investigate whether the AICPA / SOX Section 206 combination of safeguards significantly improves perceptions of independence. The analysis in Table 4 (Panel A) suggests that the perceived independence of public company auditors is significantly higher in the AICPA / SOX Section 206 condition compared to the AICPA safeguards alone (t = 7.282, p = 0.000).

Table 4 (Panel B) indicates that similar results exist for firms that audit non-public companies ($t = 3.536$, $p = 0.001$). Collectively, the results from the analyses in Table 3 and Table 4 support the implementation of the cooling-off period for public company auditors.

Basioudis (2007, p. 1417) suggests that accounting regulators should consider increasing the strength of safeguards if they increase audit firms' independence. Thus, investors' perceptions of the independence safeguards (AICPA / SOX Section 206) are compared with the strong independence safeguard (AICPA / SOX Section 206 / ISB). Paired-samples t-tests indicate that perceptions of auditor objectivity increased significantly for both types of firms when the ISB's peer review safeguard was added to the AICPA safeguards (Table 5). Participants' responses were significantly different for firms that audit public companies ($t = 2.412$, $p = 0.018$) and for those that audit non-public companies ($t = 4.178$, $p = 0.000$). Collectively, the results from research question 1 appear to indicate that perceptions of public and non-public audit firms' independence improve as the strength of the safeguards increased from the minimal, current, to strong safeguards.

TABLE 4
Investors' Confidence in AICPA Safeguards versus the Combined AICPA/SOX Section 206 Safeguards

Panel A: Public Accounting Firms

	<u>Mean</u> <u>(s.d.)</u>	<u>No</u> <u>Confidence</u>	<u>(2)</u>	<u>(3)</u>	<u>(4)</u>	<u>(5)</u>	<u>(6)</u>	<u>Extremely</u> <u>Confident</u>
AICPA	4.70	3.2%	9.6%	9.6%	17.0%	26.6%	20.2%	13.8%
(Statement 3)	(1.619)							
AICPA / SOX Section 206	5.82	0.0%	0.0%	6.3%	8.3%	15.6%	38.5%	31.3%
(Statement 6)	(1.154)							
	$t = 7.282$							
	$p = 0.000$							

Panel B: Non-public Accounting Firms

	<u>Mean</u> <u>(s.d.)</u>	<u>No</u> <u>Confidence</u>	<u>(2)</u>	<u>(3)</u>	<u>(4)</u>	<u>(5)</u>	<u>(6)</u>	<u>Extremely</u> <u>Confident</u>
AICPA	4.71	3.2%	5.3%	11.6%	21.1%	25.3%	23.2%	10.5%
(Statement 3)	(1.507)							
AICPA / SOX Section 206	5.33	0.0%	2.1%	9.5%	12.6%	23.2%	33.7%	18.9%
(Statement 6)	(1.307)							
	$t = 3.536$							
	$p = 0.001$							

Note: All individual responses measured using a seven-point scale with the following anchors: 1 = No Confidence; 7 = Extremely Confident.

TABLE 5
Investors' Confidence in the
Current Revolving Door Safeguards (AICPA / SOX Section 206)
Versus Proposed Stronger Safeguards (AICPA / SOX Section 206 / ISB)

Panel A: Public Accounting Firms

	Mean (s.d.)	No Confidence	(2)	(3)	(4)	(5)	(6)	Extremely Confident
AICPA SOX Section 206 (Statement 6)	5.82 (1.154)	0.0%	0.0%	6.3%	8.3%	15.6%	38.5%	31.3%
AICPA SOX Section 206 ISB (Statement 7)	6.07 (1.216)	0.0%	2.1%	3.1%	5.2%	14.6%	25.0%	50.0%

t = 2.412
p = 0.018

Panel B: Non-public Accounting Firms

	Mean (s.d.)	No Confidence	(2)	(3)	(4)	(5)	(6)	Extremely Confident
AICPA SOX Section 206 (Statement 6)	5.33 (1.307)	0.0%	2.1%	9.5%	12.6%	23.2%	33.7%	18.9%
AICPA SOX Section 206 ISB (Statement 7)	5.86 (1.318)	0.0%	2.1%	6.3%	6.3%	15.8%	27.4%	42.1%

t = 4.178
p = 0.000

Note: All individual responses measured using a seven-point scale with the following anchors: 1 = No Confidence; 7 = Extremely Confident.

Additional Analysis

An additional analysis was performed to understand whether an option other than SOX Section 206's safeguard would improve perceptions of audit firms' independence (Table 6). This analysis is motivated by Basioudis (2007), who cautions that the cooling-off period may limit an auditor's career trajectory, and by concerns that it may result in excess costs to the public, the client, and the accounting profession. As a result of these concerns, the present study substitutes the ISB's peer review safeguard in place of SOX Section 206's safeguard, and compares whether the modified safeguard (AICPA / ISB) significantly improves perceptions of objectivity. This particular safeguard was selected since it is less likely to interfere with the trajectory of an auditors' career. Additionally, it would not force the auditor to be dissociated from the audit team during the one-year cooling-off period which is now in effect.

TABLE 6
Investors' Perceptions of the Combined AICPA/ISB Safeguards

Panel A: Public accounting firms

	<u>Mean</u> <u>(s.d.)</u>	<u>No</u> <u>Confidence</u>	<u>(2)</u>	<u>(3)</u>	<u>(4)</u>	<u>(5)</u>	<u>(6)</u>	<u>Extremely</u> <u>Confident</u>
AICPA (Statement 3)	4.70 (1.619)	3.2%	9.6%	9.6%	17.0%	26.6%	20.2%	13.8%
AICPA / ISB (Statement 4)	5.36 (1.302)	1.0%	3.1%	3.1%	13.5%	30.2%	29.2%	19.8%
	t = 4.039 p = 0.000							

Panel B: Non-public accounting firms

	<u>Mean</u> <u>(s.d.)</u>	<u>No</u> <u>Confidence</u>	<u>(2)</u>	<u>(3)</u>	<u>(4)</u>	<u>(5)</u>	<u>(6)</u>	<u>Extremely</u> <u>Confident</u>
AICPA (Statement 3)	4.71 (1.507)	3.2%	5.3%	11.6%	21.1%	25.3%	23.2%	10.5%
AICPA / ISB (Statement 4)	5.22 (1.385)	1.1%	4.2%	5.3%	15.8%	25.3%	30.5%	17.9%
	t = 3.315 p = 0.001							

PANEL C: Comparison of alternative revolving door policy

	<u>Mean</u> <u>(s.d.)</u>	<u>No</u> <u>Confidence</u>	<u>(2)</u>	<u>(3)</u>	<u>(4)</u>	<u>(5)</u>	<u>(6)</u>	<u>Extremely</u> <u>Confident</u>
Public								
AICPA / ISB	5.36 (1.302)	1.0%	3.1%	3.1%	13.5%	30.2%	29.2%	19.8%
AICPA SOX Section 206	5.82 (1.154)	0.0%	0.0%	6.3%	8.3%	15.6%	38.5%	31.3%
	t = 3.619 p = 0.000							
Non-public								
AICPA / ISB	5.22 (1.385)	1.1%	4.2%	5.3%	15.8%	25.3%	30.5%	17.9%
AICPA SOX Section 206	5.33 (1.307)	0.0%	2.1%	9.5%	12.6%	23.2%	33.7%	18.9%
	t = 0.628 p = 0.532							

Note: All individual responses measured using a seven-point scale with the following anchors: 1 = No Confidence; 7 = Extremely Confident.

Table 6 (Panel A and Panel B) indicates that the AICPA / ISB safeguard combination increases perceptions of auditor objectivity for both public company auditors (AICPA / ISB mean = 5.36 and AICPA mean = 4.70; $t = 4.039$, $p = 0.000$) and non-public company auditors (AICPA / ISB mean = 5.22 and AICPA mean = 4.71; $t = 3.315$, $p = 0.001$). However, Table 6 (Panel C) reveals that investors continue to perceive public company auditors' objectivity to be higher when they are subject to the current AICPA / SOX Section 206 safeguard than the AICPA / ISB safeguard (mean = 5.82 and mean = 5.36, respectively; $t = 3.619$, $p = 0.000$). In contrast, the means of firms that audit non-public companies were not significantly different ($t = 0.628$; $p = 0.532$). Taken together, the results suggest accounting regulators' implementation of the cooling-off period – as opposed to the peer review of the public company firms' safeguards – appears to be more effective for public company auditors.

Research Question 2 Analysis

The previous analyses indicate that nonprofessional investors' perceptions of public and non-public firms' objectivity improved as the strength of the safeguards increases. This section examines research question 2, which investigates whether investors will perceive a significant difference between objectivity of both types of firms when they operate in the strong safeguard condition. Table 7 reports that the objectivity of public company auditors is perceived as being higher than that of non-public company auditors (public mean = 6.08 and non-public company mean = 5.86, respectively; $t = 2.150$, $p = 0.034$).

TABLE 7
Investors' Confidence in Public and Non-Public Companies' Objectivity
In the Presence of Strong Safeguards (AICPA / SOX Section 206 / ISB)

	Mean (s.d.)	No Confidence	(2)	(3)	(4)	(5)	(6)	Extremely Confident
Public Firms	6.07 (1.154)	0.0%	2.1%	3.1%	5.2%	14.6%	25.0%	50.0%
Non-Public Firms	5.86 (1.216) $t = 2.150$ $p = 0.034$	0.0%	2.1%	6.3%	6.3%	15.8%	27.4%	42.1%

Note: All individual responses measured using a seven-point scale with the following anchors: 1 = No Confidence; 7 = Extremely Confident.

Combined with the analysis from Table 3 (Panel C), the findings for research question 2 are consistent with the attribution theory discussed in the literature review. This theory implies that if the revolving door safeguards seem strong (the environment), then unfavourable perceptions of auditor objectivity must originate from perceptions of the type of firm performing the audit. The practical implications of these findings imply that regulators' efforts to improve nonprofessional investors' perceptions of the quality of non-public company audit firms must be undertaken to maximise the benefits of increasing the revolving door safeguards.

DISCUSSION

As the intended benefits of SOX continue to be scrutinised more than a decade after its enactment, the need to understand perceptions of key beneficiaries, particularly nonprofessional investors, remains unfulfilled. Very little is known as to whether SOX Section 206 increases investors' perceptions of audit firms' independence when an audit professional receives an offer of employment from an audit client. Moreover, it is unknown whether this scenario impairs the perceived independence of both public and

non-public audit firms in the post-SOX era. These gaps in the literature provide a key motivation for understanding whether the current independence safeguards increase perceptions of revolving door firms' independence.

The central finding of this exploratory study is that nonprofessional investors perceive both public and non-public audit firms' independence to be threatened when an audit team member receives an offer of employment from the client. However, this threat appears to be more pronounced for firms that audit public companies than for firms that audit non-public companies. Equally important are the findings regarding the impact of the firms on the perceived effectiveness of the strength of the safeguards. Although investors perceive that the AICPA / SOX Section 206 safeguard improves auditor objectivity, this safeguard appears to be more effective for public company auditors compared to non-public company auditors. Finally, investors perceive the objectivity of firms that audit public companies to be significantly higher than that of firms that audit non-public companies under both the current and strong safeguard conditions. Taken together, the practical significance of this finding is that accounting regulators in the US may elect to initially focus on improving the perceived quality of non-public firms prior to attempting to unify the revolving door independence standards.

This study is subject to limitations that are inherent when employing a behavioural methodology. One major limitation which accounting regulators should be aware of is the extent to which they generalise the results of the study to future policy decisions. Accounting regulators who seek to make policy decisions should be aware that not all nonprofessional investors will recognise the revolving door as a threat to independence, as was the case in this study. The reason being is that nonprofessional investors are a diverse group of investors with respect to their accounting and business knowledge (Ritt, 2004). Knowing that the SEC (2016) does not differentiate with respect to the "level" of investors which it seeks to protect, the analysis for research question 1 included the responses of all participants. However, it would be prudent for accounting regulators to recognise this when incorporating the results of this study into future policy decisions.

A second limitation resulting from the restrictive guidelines of the Institutional Review Board is that participants in the current study were recruited from one university. However, comfort may be taken that their demographics are comparable to those in other studies which employ MBA students as a proxy for nonprofessional investors. Opportunities for future research rest on further stratifying nonprofessional investors into subgroups (e.g. limited knowledge investors, mutual fund versus individual stock investors), which will result in a more comprehensive understanding of this threat to independence.

Future research may concentrate on state board of accountancy members' perceptions of the scope or content that should be included in a peer review safeguard. In light of the findings that investors perceive auditors to be more independent when the ISB peer review safeguards are added to the current AICPA and SOX Section 206 safeguards, opportunities exist for both investors' and accounting regulators' input regarding the content and the scope to be included in the ISB peer review safeguard. Finally, future archival research may explore the factual aspect of independence by comparing audit quality in the event year (the year prior to the audit professional leaving the firm) to audit quality in years prior to the event year, which may reveal whether the firm's independence is impaired in the year of the cooling-off period.

ENDNOTES

1. Dart and Chandler (2013) classify threats to independence arising from the revolving door phenomenon as those that occur (1) prior to or (2) after an auditor begins working with the client. The current study focuses on threats to independence prior to the auditor leaving the firm that arise when an audit team member receives an offer of employment from an audit client. This scenario may be referred to as a "threat to independence" throughout the manuscript. In addition, the phrases "accounting firm" and "audit firm" are used interchangeably in this manuscript.
2. The AICPA safeguards included the following: (1) amounts due to the departing auditor must remain fixed throughout the payout period; (2) the departing auditor is not in a position to influence the firm's operations or financial policies; (3) the departing auditor must not participate or appear to participate in, and is not associated with the firm following employment or

- association with the client; (4) The client's audit team must consider whether modifications to the current audit procedures are needed so that the former audit cannot circumvent the audit procedures; (5) the firm must evaluate whether the audit team's level of experience is appropriate to handle the departed auditor; (6) the professional skepticism of the audit team must be evaluated to ensure that the appropriate level was exercised during the audit.
3. Students were provided the opportunity to earn up to one-half a letter grade on their final exam for completing the experiment and providing a narrative regarding how the revolving door practice may impact their career.

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