ARTICLE IN PRESS

Research in Accounting Regulation ■■ (2015) ■■–■■

Contents lists available at ScienceDirect

Research in Accounting Regulation

journal homepage: www.elsevier.com/locate/racreg

Regular Paper

Bank loan officers' perceptions concerning independence, objectivity, and reliability when external auditors also perform tax compliance activities for nonpublic clients

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ARTICLE INFO

Article history:
Available online

Keywords:
Auditor independence
Objectivity and reliability
Tax compliance services

ABSTRACT

This study examines bank loan officers' perceptions of auditor independence, objectivity and the reliability of the report on the financial statement when the attest auditors also provide (1) tax compliance services to the nonpublic entity that they audit, and (2) tax compliance services to executives of said entities. The primary issues addressed are (1) whether performing the external audit and providing tax compliance services for the same entity affects the aforementioned perceptions, and (2) whether adding tax compliance work for the executives of the entity affects these perceptions. We used a between-subject design and bank loan officers as participants. Findings based on 181 participants indicate that bank loan officers generally perceive a significant difference in independence and objectivity when the auditor also performs tax compliance work for the audited entity. On the other hand, loan officers do not perceive a significant difference concerning the reliability of the report on the financial statements. Similar results hold when tax compliance services for entity executives are added to the services performed with the exception that perceptions regarding the reliability of the report on the financial statements are also reduced significantly. Implications and limitation of these findings are discussed.

Introduction

The American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct and the Securities and Exchange Commission (SEC) continue to allow auditor-provided tax services (ATS). Much has been written over the past decade on the pros and cons associated with ATS (e.g., Gleason & Mills, 2011; Krishnan, Visvanathan, & Yu, 2013; Roberts, 2010; Robinson, 2008; Terando & Kurtenbach, 2009). Allowing the incumbent auditor to also provide tax services is controversial since this increases the auditor's economic dependence on the client, and arguably results in auditors auditing some of their own work. This in turn may raise questions regarding auditor independence and objectivity and may decrease the extent to which third parties rely on audited financial statements. Notwithstanding, some argue that ATS provides the auditor with superior knowledge that improves the quality of audited financial statements (e.g., Gleason & Mills, 2011). The PCAOB continues to study this issue (PCAOB, 2014). Nonetheless, given these concerns associated with ATS, there is a trend toward decoupling audit and tax services at large public companies (Krishnan et al., 2013; Maydew & Shackelford, 2006).

The objective of this study is to provide empirical evidence regarding third-party users' perceptions of ATS to entities in the nonpublic sector. Our study is motivated by the lack of empirical evidence regarding third-party users' perceptions of ATS to entities in this sector. A trend toward decoupling audit and tax services has not been reported for nonpublic companies. The nonpublic sector is large and important to the U. S. economy. The vast majority of businesses in the United States are private (Anderson, 2009). Contrary

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http://dx.doi.org/10.1016/j.racreg.2015.03.002
1052-0457/

to what one might expect, many nonpublic entities are comparable in size to many of the large public entities. Revenues range from 3.3 to 134 billion dollars for companies on Forbes' list of 220 of America's Largest Private Companies (Murphy & DeCarlo, 2012).

We focus on nonpublic entities for additional reasons. The Sarbanes–Oxley Act (SOX) (U.S. House of Representatives, 2002) and related SEC regulations directly addressed the issue of ATS in the public environment. ATS are allowed only after approval of the audit committee regarding the potential effects of the services on the independence of the firm (PCAOB, 2006d). In the public company environment, the audit committee in effect acts as a safeguard to look out for the best interest of the users of the financial statements. There is no similar safeguard in place in the nonpublic company environment. Moreover, in the public company environment, the audit firm is not deemed independent of the client if the firm provides certain types of ATS to key personnel of the entity (PCAOB, 2006c). AICPA Ethics Rule 101, *Independence*, and related Interpretation 101-3, *Nonattest Services* (2013), are more liberal as they do not prohibit ATS to executives of the entity. ATS to entity executives may increase the auditor's economic dependence on the client and result in greater concerns regarding auditor independence. One purpose of this study is to investigate whether users of audited financial statements of nonpublic entities are sensitive to ATS. If so, SOX-type restrictions (or other safeguards) should also apply in the nonpublic company environment. The AICPA argues that SOX-type restrictions in place for public companies are not appropriate for nonpublic companies (AICPA, 2003). We believe that this is an empirical question that should be answered based in part on empirical evidence – this study provides such evidence. External parties (e.g., bankers) often rely on audited financial statements of nonpublic entities. These parties deserve the same protections as those afforded investors of public companies (Carmichael, 2004; Capital Market Institute, 2003).

This study examines bank loan officers' perceptions of ATS. We used a between-subject design experiment. Findings indicate that bank loan officers generally perceive a significant difference in auditor independence and objectivity when the incumbent auditor also performs tax compliance work for the audited entity. On the other hand, loan officers do not perceive a significant difference concerning the reliability of the report on the financial statements. Similar results hold when tax compliance services for entity executives are added to the services performed by the incumbent entity auditor with the exception that perceptions regarding the reliability of the report on the financial statements are also reduced significantly.

The remainder of this paper is organized as follows. Section two includes background information and research questions. Section three covers methods and procedures. Section four provides results. Summary, conclusions, and limitations are in section five.

Background, literature and research questions

This section provides limited background information relative to auditors providing nonaudit tax services. We provide a general overview of existing rules for public companies and for nonpublic companies. We also review prior literature relative to auditor independence for nonpublic companies and we present research questions.

Public companies rules

After the passage of SOX, the PCAOB carefully examined the potential implication of ATS for auditor independence (PCAOB, 2004, 2005). After considering several alternatives, the Board recommended and the SEC approved limited ATS. Current ATS regulations are contained in PCAOB Rules 3522, 3523, and 3524 (PCAOB, 2006a, 2006b).

PCAOB Rules 3522 and 3523 (2006a) address tax services not allowed to be performed by the entity's independent auditor during the professional engagement period to perform the audit. Rule 3522 (2006b) specifically indicates that auditors engaged in marketing, planning, or opining in favor of the tax treatment of "confidential" or "aggressive" tax position transactions are not independent. Rule 3523 (2006a) indicates that auditors providing any tax services to executives in a "financial reporting oversight role" at the audit client are not independent.

Rule 3524 specifically addresses the conditions for performing other permissible tax services. The auditor must seek pre-approval from the audit committee prior to performing tax services. Committee approval may be granted only after the auditor has (1) provided the audit committee with details (scope, fees, related compensation arrangements, referral agreements) regarding the tax services, (2) discussed with the committee the potential effects of the services on firm independence, and (3) documented the substance of said discussions. As indicated earlier, there is a trend toward decoupling audit and tax work since these rules have been put in place (Krishnan et al., 2013). Findings on whether non-audited services (NAS) in general compromise auditor independence as well as findings on whether ATS compromise independence are mixed (see Schneider, Church, & Ely, 2006 and Krishnan et al., 2013 for reviews). Nonetheless, we interpret the decoupling of the audit from tax services as a signal from audit committees that it is plausible that ATS may impair independence in fact or in theory, i.e., the risk of allowing ATS is simply not worth any potential benefits (knowledge spillover, fee savings, etc.) to be derived from allowing the auditor to provide both services.

The AICPA rules

The AICPA's general position on ATS to audited entities is significantly different from the SEC's position. Moreover, the AICPA does not specifically address the issue of ATS to certain parties associated with the audited entity. The AICPA Code of Professional Conduct addresses the auditor providing NAS in general, and it includes limited guidance on ATS in Code Subsection 101-3 – *Nonattest Services* (2013).

Members are specifically instructed to first consider independence requirements of applicable authoritative regulatory bodies (e.g., state board of accountancy, SEC, PCAOB, Department of Labor) which may be more restrictive than AICPA Code – the violation of applicable more restrictive rules is deemed a violation of the AICPA's rules (AICPA, 2013). Assuming that more restrictive rules do not apply to the engagement, the auditor is allowed to provide NAS if the following three requirements are met. First, the auditor must not assume management responsibilities for the attest client (e.g., making decisions regarding significant tax positions). Second, the client must agree to perform specified tasks relative to the NAS. These include assuming all management responsibilities, overseeing the adequacy and results of the services, and accepting responsibility for results. Third, before completing the work, the auditor must establish and document in writing the understanding between the auditor and client relative to NAS to be performed. Assuming the aforementioned requirements are met, the auditor is allowed to perform NAS including key tax compliance services (AICPA, 2013). Again, the AICPA does not specifically prohibit the auditor from providing any tax services to executives in a "financial reporting oversight role" at the audit client.

Literature and research questions

As recently as 2010 researchers continue to call for additional studies relative to the policy and research implications of evolving independence rules for public company auditors (Gramling, Jenkins, & Taylor, 2010). More importantly, there is a void in the literature as it relates to ATS for nonpublic companies. Three studies have addressed auditor independence issues as they relate specifically to nonpublic companies. Hill and Booker (2007) addressed the issue of the independence of the external auditor when performing internal audit activities for nonpublic clients. Wright and Booker (2010) addressed the effects of a cooling-off period on perceived independence of external auditor as it relates to the nonpublic regulatory environment. Warrick (2012) addressed auditor independence and the revolving door as it relates to nonpublic companies. These studies suggest that users of financial statements of nonpublic companies are sensitive to auditor independence issues. Users believe that the auditor should be independent in fact and appearance and they call into question different independent rules for public versus nonpublic companies.

Significant controversy remains regarding auditors of nonpublic companies providing tax services. Furthermore, differences exist between AICPA and PCAOB/SEC independence rules regarding the prerequisites for ATS and ATS to certain entity executives. Should the independent auditor be allowed to provide these additional services? Should auditors of nonpublic entities be afforded the flexibility to provide services which are limited and must be provided under more stringent circumstances in the public environment? We investigate these issues for users of financial statements in the nonpublic company context. We also include the related concepts of auditor objectivity and perceptions of financial statement reliability. Our research questions follow:

RQ1a: Does the provision of tax compliance services to the client by attest auditors affect bank loan officers' perceptions of the auditor's (a) independence, (b) objectivity and (c) audit opinion reliability?

RQ1b: What is the impact, if any, in allowing the attest auditor to also perform tax compliance services for client's executives?

RQ2: Do bank loan officers support or oppose allowing the attest auditor to perform tax compliance work to (a) the clients or (b) the client and client's executives?

Method

We used a between-subject experimental design for this study, developing three versions of the case. The versions of the case differ regarding how the entity handled its tax compliance services and whether the auditor also performed tax compliance services for entity executives. This section addresses participants, independent and dependent measures, data gathering, and statistical methods.

Participants

Experimental participants are bank loan officers. We purchased a commercial prepared list of 1500 bank loan officers from Hugo Dunhill. Bank loan officers are used because they are regarded as sophisticated users of financial statements. Also, similar studies used bank loan officers (Hill & Booker, 2007; Lowe, Geiger, & Pany, 1999; Lowe & Pany, 1995).

Table 1 provides an overview of response rate information. A total of 202 instruments were returned undeliverable. Two-hundred-fifteen responses were received. However, 15 instruments were incomplete and 19 respondents failed the manipulation check. After making the aforementioned adjustments, 181 (215-15-19) responses are used in this study. The adjusted usable response rate is 14 percent.

Table 2 provides aggregate information on respondents and disaggregated information for the three groups. The 181 participants are composed of a control group (Group 1) of 55 participants, a treatment group (Group 2) of 50 participants, and a treatment group (Group 3) of 76 participants. The results show that each group is similar in terms of the demographic information. The majority (85.1 percent) of the respondents are CEOs/presidents or vice presidents of their respective companies, and a majority (95 percent) indicated that they are at least somewhat knowledgeable about auditing. Approximately 89 percent have 10 years or more of lending experience, and 83.8 percent work at institutions

Table 1
Overview of response rate.

	No. of cases	Percent
Total mailed instruments	1500	100%
Undeliverable (returned) instruments	202	14%
Incomplete responses	15	1%
Complete responses	200	15%[a]
Failed manipulation check	19	1%
Complete and usable responses	181	14%[b]

[a] 200/1500-202.
[b] 181/1500-202.

Table 2
Demographics of respondents of the experiment.[a]

	Group 1	Group 2	Group 3	Count	Percent
Group size	55	50	76	181	100.0%
Title or current position					
CEO/President	65.5%	68.0%	68.0%	122	67.4%
Vice President	20.0%	14.0%	18.7%	32	17.7%
Loan Officer	5.5%	8.0%	5.3%	11	6.1%
Credit Analyst	1.8%	2.0%	0.0%	2	1.1%
Other	7.2%	8.0%	8.0%	14	7.7%
	100.0%	100.0%	100.0%	181	100%
Knowledge of auditing					
Not knowledgeable	7.3%	6.1%	2.7%	9	5.0%
Somewhat knowledgeable	49.1%	51.0%	66.7%	102	57.0%
Knowledgeable	36.4%	34.7%	25.3%	56	31.3%
Very knowledgeable	7.2%	8.2%	5.3%	12	6.7%
	100.0%	100.0%	100.0%	179	100.0%
Lending experience					
Less than 1 year	1.8%	0.0%	2.7%	3	1.7%
1–5 years	0.0%	6.0%	2.7%	5	2.8%
Over 5 years but less than 10 years	7.3%	10.0%	4.0%	12	6.6%
10 years or more	90.9%	84.0%	90.6%	160	88.9%
	100.0%	100.0%	100.0%	180	100.0%
Company size					
Less than $1 billion	87.3%	76.0%	86.5%	150	83.8%
$1 Billion but less than $50 billion	3.6%	18.0%	6.8%	16	8.9%
$50 Billion but less than $100 billion	0.0%	4.0%	4.1%	5	2.8%
Over $100 billion	9.1%	2.0%	2.6%	8	4.5%
	100.0%	100.0%	100.0%	179	100.0%
Gender					
Male	83.6%	80.0%	90.7%	154	85.6%
Female	16.4%	20.0%	9.3%	26	14.4%
	100.0%	100.0%	100.0%	180	100.0%
Age					
Less than 25	0.0%	0.0%	0.0%	0	0.0%
25–40	10.9%	10.0%	5.3%	15	8.3%
41–55	43.6%	42.0%	48.0%	81	45.0%
Over 55	45.5%	48.0%	46.7%	84	46.7%
	100.0%	100.0%	100.0%	180	100.0%
Highest education attained					
High school diploma	5.5%	2.0%	5.3%	8	4.4%
Associate's degree	5.5%	16.0%	5.3%	15	8.3%
Bachelor's degree	65.5%	46.0%	68.0%	110	61.1%
Master's degree	18.2%	20.0%	13.3%	30	16.7%
Doctorate degree	0.0%	4.0%	0.0%	2	1.1%
Other	5.3%	12.0%	8.1%	15	8.4%
	100.0%	100.0%	100.0%	180	100.0%

[a] For various reasons, some respondents did not complete some of the demographic questions.

with less than $1 billion in revenues. More than 90 percent are 41 years of age or older, and 87.3 percent indicate that they had earned a baccalaureate degree or higher. These results show that the respondents are highly experienced and accomplished individuals with knowledge in the lending industry.

Independent and dependent measures

This study utilizes one independent measure manipulated at three levels. This independent measure addresses three possible ways of handling tax compliance services for a nonpublic entity and executives of the entity. In the control case (Group 1), entity tax compliance services are not outsourced (NO) to the external auditor – this function is done internally. This is also the base case used to measure the effect of the other two measures. In the second case (Group 2), entity tax compliance is outsourced (ECO) to the external auditor. In the third case (Group 3), entity tax compliance is the external auditor, and the external auditor also performs tax compliance for the executives (EECO).

This study utilizes four dependent variables: independence, objectivity, reliability, and approval of the services. The first three are measured on a scale of "0" (no confidence) to "10" extreme confidence relative to the bankers perceptions of independence, objectivity, and reliability. The fourth question of the case study is used to examine whether the bankers approved of the auditor providing all services in the case. This is a variable coded "0" for no and "1" for yes.

Data gathering process

We mailed each participant a cover letter and one version of the experimental instrument. The cover letter indicated

Table 3
Bank loan officers' perceptions of independence, objectivity, reliability, and percentage approving specified services.

Groups	Auditor independence[a]	Auditor objectivity[a]	Auditor reliability[a]	Percentage approving[b]
No outsourcing (NO)	7.04 (1.692)	6.71 (1.82)	6.73 (1.96)	67%
Entity Tax Compliance Outsourced (ECO)	5.58 (2.76)	5.52 (2.68)	5.88 (2.57)	46%
Entity and Executive Tax Compliance Outsourced (EECO)	4.65 (2.65)	4.76 (2.63)	4.88 (2.56)	27%
Significance of overall difference across groups	p < .001	p < .001	p < .001	p < .001
Pairwise differences:[c]				
NO versus ECO	p = .012	p = .047	p = .212	p = .081
NO versus EECO	p < .001	p < .001	p < .001	p < .001
ECO versus EECO	p = .114	p = .230	p = .074	p = .085

[a] Means (standard deviations) of auditor independence, objectivity, and audit report reliability are measured on an 11-point scale anchored at 0 (no confidence) to 10 (extreme confidence). Significance of overall differences in means are assessed using AVOVA: F-Statistics (2 and 176 df) = 14.83; (2 and 177 df) = 9.85; and (2 and 175 df) = 9.17, respectively for independence, objectivity, and reliability.
[b] This is a dichotomous variable indicating the percentage of loan officers who approved of the auditor offering all services specified in the cases. The overall difference is assessed using Chi-square test of proportions; $x^2 = 20.185$. All cases, including the NO case, also entailed that the auditor also provides limited technical advice to the company to implement prior year audit recommendation for which a separate fee was not charged.
[c] Scheffé Test of Multiple Comparisons used for pairwise comparisons.

that the study addressed users' perceptions of financial statements but did not directly address the independent variables. In addition, the cover letter reassured participants that responses would be held in confidence. Finally, the cover letter gave instructions to the participants to return the documents in the enclosed self-addressed pre-stamped envelope.

We asked each participant to read a case scenario based on the manipulation identified earlier and answer the following four questions: (1) How confident are you that the CPA firm is independent in performing the financial statement audit? (2) How confident are you that the CPA firm is objective in performing the financial statement audit? (3) How confident are you on the reliability of the auditor's opinion regarding audited financial statements? (4) Is it appropriate for the attest auditor to perform all of the services indicated in the scenario? As indicated earlier, the first three questions were answered using an eleven point scale anchored at "0" for no confidence, and "10 for extreme confidence. The fourth question was answered using the dichotomous scale or "Yes or "No."

The instrument was pretested prior to its actual use. The pretest involved sending the experimental instruments to a small sample of respondents to investigate whether the questions were understandable and to discover if any defects were present in the instruments. A small group of local bank loan officers was used to pretest the instruments. Minor adjustments were made after pretesting to address the improved instrument and address concerns expressed.

Statistical methods

We use ANOVA and chi-square statistics as our primary statistical techniques. ANOVA is used to compare the variances between different groups for the first three questions. To determine which groups differ, we used the Scheffé post-hoc comparison. We used chi-squared to analyze responses to our dichotomous question (question four).

Results

This section presents results in two subsections; research questions 1a and 1b, and research question 2.

Research questions 1a and 1b

The ANOVA results for the first research questions are presented in Table 3. Relative to independence, objectivity, and reliability (Questions 1a and 1b), results are provided for each of the scenarios: (1) No Outsourcing (NO) of any tax services, (2) Entity Tax Compliance Outsourced (ECO), and (3) Entity and Executive Tax Compliance Outsourced (EECO). Research Question 1 asks whether the provision of tax compliance services to the client by attest auditors affect bank loan officers' perceptions of the auditor's (a) independence (b) objectivity and (c) financial statement reliability[1] (1a), and what is the impact, if any, of also allowing the attest auditor to also perform tax compliance services for client's executive (1b)?

The means of the NO, ECO, and EECO scenarios are 7.04, 5.58, 4, 65 (independence); 6.71, 5.52, 4.76 (objectivity); and 6.73, 5.88, 4.88 (reliability). The ANOVA results indicate that perceptions are significantly different at p < .001 among the three groups for each of the variables (F's = 14.83, 9.85, and 9.17, respectively).

We used Scheffé Tests of Multiple Comparisons to assess the significance of between-group differences for each variable (independence, objectivity, and reliability). Means for each dependent variable decline across groups as expected. The NO group is significantly different from the EECO group at p < .001 for each of the dependent variables. Relative

[1] Since the study utilized related dependent measures, a multivariate analysis of variance (MANOVA) test was performed to analyze whether responses taken together are significantly different across all three levels of the experimental manipulation. MANOVA results for the continuous dependent measures were significant (F = 5.29, p = .000).

to independence, NO is significantly different from ECO ($p = .012$) but ECO is not significantly different from EECO ($p = .114$). Concerning Objectivity, NO is significantly different from ECO ($p = .047$) but ECO is not significantly different from EECO ($p = .230$). Concerning reliability, NO is not significantly different from ECO ($p = .212$), but ECO is marginally different from EECO ($p = .074$). In summary, bank loan officers generally perceive a significant difference in independence and objectivity when the auditor also performs tax compliance work for the audited entity. However, loan officers do not perceive a significant difference concerning the reliability of the auditor's report on the financial statements. These findings hold when tax compliance services are also performed for the executives with the exception that perceptions regarding the reliability on the auditor's report on the financial statements are also reduced significantly.

Research question 2

Research Question 2 asks whether Bank loan officers support or oppose allowing the attest auditor to perform tax compliance work for (a) the client or (b) the client and client's executives. Table 3 also provides these results. Chi-square results for the percentage of bankers approving the various services are significant at $X^2 = 20.185$, $p < .001$. The percent approving the services decline across the groups as expected. The "Yes/" "No" response rates for the NO case is 67 percent "yes" and 33 percent "no." The majority of the bank loan officers indicated that providing the audit and the limited technical advice embedded in all scenarios is appropriate. Comparing the NO case with the ECO case, the percentage approving the services declined from 67 percent to only 46 percent (a decline of .21) with the difference significant at $p = .081$. Thus, a majority of the bankers do not approve of the auditor providing services beyond the audit and the limited technical advice embedded in the NO case. The percent approving the services declined to only 27 percent for the EECO case, a drop of .40 from the NO case. This reduction is significant at $p < .001$. Approval rates for the ECO and EECO cases are 46 percent and 27 percent, respectively. The difference is significant at $p = .085$. These results indicate that lending officers are sensitive to the attest auditor providing tax compliance services to the attest client. Moreover, providing tax compliance services to the client and to executives of the client provokes a strong reaction from lending officers that the attest auditor should not be allowed to perform the services.

Conclusions and limitations

This study suggests that users of financial statements of nonpublic companies are sensitive to ATS. Lending officers generally perceive a significant difference in independence and objectivity when the auditor also performed tax compliance work for the audited entity (NO vs. ECO). However, loan officers do not perceive a significant difference concerning the reliability of the auditor's report on the financial statements. Similar findings hold when we compare the base case to the case where compliance services are also performed for the executives (NO vs. EECO) with the exception that perceptions regarding the reliability of the auditor's report on the financial statements are also reduced significantly. Relative to the dichotomous variable ("Do you approve of the services provided by the auditor?") differences between and among the groups are also significant (NO vs. EECO, $p = .000$) or marginally significant (NO vs. ECO, $p = .081$; ECO vs. EECO, $p = .085$). Less than a majority of bank loan officers approved ATS.

The results of the study also suggest that the status of an entity as public versus nonpublic may not be a factor relative to users' perceptions of audit firm independence, objectivity and the reliability of the financial statement reports. Current regulatory standards allow nonpublic entities to use the same audit firm for entity audit and tax services for executives, including those in a financial oversight role. Nonpublic entities that use the same firm for said services should exercise caution in doing so. At a minimum safeguards such as the use of different firm personnel should be utilized.

Nonpublic regulators should not be willing to risk the possibility of any loss of confidence in the audit function associated with ATS. The AICPA and state regulators should study if there is a need to add required safeguards (for example to AICPA Code of Professional Conduct) related to ATS. Auditor may well be independent in fact when providing ATS, and they may gain superior knowledge related to ATS. Nonetheless, additional safeguards are a transparent mechanism to address the perceived threat to independence and objectivity associated with ATS.

This research, like most research of this nature, has limitations that must be considered when interpreting the results. First, this research was conducted using an experiment that involved one company. Studies involving other case situations could produce different results. Second, this study was conducted using bank loan officers which only represent one category of stakeholders. The views of other stakeholders may differ from the views of the bank loan officers.

Appendix: Supplementary material

Supplementary data to this article can be found online at doi: 10.1016/j.racreg.2015.03.002.

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Please cite this article in press as: Dave Thompson Jr., Quinton Booker, Bank loan officers' perceptions concerning independence, objectivity, and reliability when external auditors also perform tax compliance activities for nonpublic clients, Research in Accounting Regulation (2015), doi: 10.1016/j.racreg.2015.03.002