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How does joint provision of audit and non-audit services affect audit quality and independence? A review

David Gwilliam and Chie Min Teng, University of Exeter
Oliver Marnet, University of Southampton



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Executive summary

Motivation for this study

The primary aim of this report is to analyse changes in recent years in the market for the provision of non-audit services (NAS), with a particular focus on the joint provision of audit and non-audit services and the potential effects on independence and the quality of audit.¹ Issues of auditor independence and the public perception of auditor independence in connection with the provision of NAS to their audit clients were again recently highlighted by corporate failures related to the financial and economic crisis of 2008–09 and by perceptions that a substantial threat to auditor independence – and a consequential reduction in confidence that can be placed on an audit opinion – exists where NAS are provided by the auditor to their audit client. These perceptions are exacerbated where there is a high ratio of NAS fees to audit fees paid to a company's auditor. The scale of the issue found reflection in proposals by the Treasury Select Committee in October 2009 (and related proposals by the European Commission in 2011 – see COM(2011) 778 and COM(2011) 779) to impose a blanket prohibition on the provision of NAS by auditors' recommendations. For the time being, these proposals have not been supported in the UK, which essentially continues to rely on a threats and safeguards approach, clarification with regard to definitions, and specific prohibitions of those NAS included in ethical standards (see Ethical Standard 1 and Ethical Standard 5, Auditing Practices Board, 2011).²

This report offers critical insights into a number of current regulatory issues confronting the auditing profession in the UK, both directly in terms of whether there should be further restrictions on the provision of NAS to audit clients (NAS(A)) and indirectly regarding the background in which issues of audit competition, efficiency, pricing and value added are today on the front stage of the audit debate and audit regulation. It seeks to provide input relevant to these issues, input which will inform and be of use to firms, as well as the professional bodies, regulators and policymakers more widely.

The scope of this study

The study focuses on the extensive body of literature directed toward significant aspects of NAS provision and issues associated therewith, against a background of the dramatic market and regulatory changes ahead of and shortly after the arrival of the new millennium, and the continued pace of development in the markets for financial reporting and auditing (including reporting and assurance beyond the financial statements).

We consider this report to be directly relevant to the ongoing debate at both national and European level on issues of competition, liability and regulation in the audit market. The report seeks to contextualise the issue and provide a résumé of the arguments that have been advanced for and against allowing such joint provision, and it concludes with a brief review of possible policy options.

In order to arrive at its conclusions the underlying methodology of this study has been essentially qualitative. We have built on, and benefitted from, previous studies which have reviewed the burgeoning academic and professional literature relevant to the issues. We have added to this literature by further consideration of the relevant regulatory perspectives and official reports where these contribute to an understanding of the current debate and the environment in which audit and NAS operate. We also offer, from a quasi-normative viewpoint, a variety of thoughts on the strength of the arguments for and against the provision of NAS(A) – and how they interact with behavioural and institutional factors.

1 It is acknowledged that, although it is a concept frequently discussed and referred to, there is no universal definition of audit quality. Its nature has been considered in a number of studies, for example, that of Francis (2004) which noted that audit quality cannot be directly observed. It is, however, probable that in the Popperian sense failures in audit quality can be observed, which indirectly will provide significant insights into what audit quality actually is. The IAASB (2014) discusses factors that contribute to increasing the likelihood of quality audits being consistently performed. This framework describes different input, process, and output factors relevant to audit quality at the engagement, firm, and national levels.

2 Ethical Standards (ESs) for auditors are available at: frc.org.uk/Our-Work/Codes-Standards/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Ethical-standards-for-auditors.aspx. In September 2012 the FRC announced limited changes to the UK Corporate Governance Code and the Stewardship Code. Changes to the UK Corporate Governance Code include tendering by FTSE 350 companies of an external audit contract at least every 10 years, applied on a 'comply or explain' basis. See: frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-publishes-updates-to-UK-Corporate-Governance-C.aspx.

Key findings and conclusions

On the whole, the argumentation under review tends to uphold a perspective which would not support the provision of NAS to an audit client.

A diminished emphasis on joint provision is reflected in recent market trends, expressions of concerns by regulators, policymakers and various stakeholders, and recent regulatory responses to perceived shortcomings of audit regarding its social and economic function.

Raised client concerns about perceptions of impairment to auditor independence from the provision of NAS(A) are supported both directly and indirectly by the review of the impact of behavioural and cognitive factors on auditor judgement and auditor independence, and effects of such factors on the ability of auditors to conduct audit with the required degree of scepticism. These issues are set out separately in Chapter 3 and have in recent years received increased attention from regulators and policymakers.

We welcome the trend reflected in market data and regulatory responses, while acknowledging the possibility for specific circumstances where it could be useful for some services other than audit to be provided to an audit client, although some rationale would suggest moderate provision of selected NAS(A) can provide limited benefits. The latter proviso might make it difficult to support a blanket prohibition of the provision of NAS(A) without further research which seeks to more clearly ascertain the threat to independence from specific NAS(A).

The ultimate and overarching conclusion of this report is that if the quality of audit per se is thought to be important to the workings of capital markets and society more generally, then in circumstances where the benefits of the joint provision of NAS to client companies cannot be unequivocally demonstrated, the logical regulatory response is likely to be to prohibit, or at the least significantly restrict, the joint supply of such services to audit clients.

1. Context and background

Accounting and audit firms, and in particular the large international firms, have transformed themselves in the last 40 years from organisations, relatively modest in size with a primary focus on audit and the provision of services closely associated with audit, to multi-national organisations providing a range of services categorised loosely under the umbrella of knowledge services (for a detailed overview of the evolution and transformation of the profession during the 20th century, see Zeff, 2003a,b). Over the same period of time, there has been a perceived transformation in the role of audit from that of a periodic external check on the accuracy of a company's financial statements toward a value-adding function integrated within and contributing to the company's overall risk management profile and business performance. This transformation has been accompanied by a shift in the way in which audit firms, and to an extent their client companies, have approached the audit task, a shift in part enabled, and in part necessitated, by the dramatic changes in client technology over this period of time.

The perceived paradigm shift following the introduction of the audit risk model in the 1970s and the development in the 1990s of what was termed the 'business risk approach' has been well documented.³ The 'business risk approach' covered a range of different modes of looking at and conducting audit but, at the risk of oversimplification, it might be characterised as emphasising a greater focus on an understanding of the business risks that could find reflection in the financial statements. Concomitant with this was a greater use of analytical audit techniques and a perception, if not necessarily a reality, of a reduced reliance on, and attention paid to, more traditional detailed audit procedures. However, following a number of high-profile accounting and auditing scandals in the early years of the last decade – in particular, but not exclusively, those relating to Enron and WorldCom in the US – both regulators and audit firms have emphasised the need for continuance of traditional audit testing but within a framework of a greater understanding of the nature of the client's business and the risks inherent therein.

Alongside, and to an extent integrated with, the change in audit praxis came a very significant expansion in the provision by firms of NAS(A). Accounting firms in both the UK and the US have always provided services other than audit both to their audit clients and others. Indeed, in the earliest years as accounting practices developed, audit work was of relatively minor importance within the range of professional services offered, and it was not until the late 19th century that audit came to be seen as the primary fee earner for accounting firms.⁴ After 1900, although firms continued to offer a range of services to both audit and non-audit clients, the development of the professional audit, and the introduction in the UK of the statutory requirement for all limited companies to be audited, led to the audit function taking over as the mainspring of activity for the larger firms. This situation continued for much of the 20th century.

In the US the Second World War saw an extension of the range of services offered by accounting firms and it was there that consulting per se, as opposed to traditional NAS linked more closely to the financial statements as such, began to develop.⁵ The American Institute of Certified Public Accountants (AICPA)'s first committee on management services was formed in 1953, and in 1969 the AICPA adopted a resolution stating:

'It is an objective of the Institute, recognizing that management services are a proper function of CPAs to encourage all CPAs to perform the entire range of management services consistent with their professional competence, ethical standards and responsibility.'⁶

3 For overviews of and discussions on the development of these two audit approaches see, for example: KPMG, 1999; Elliott et al., 1999; Bagshaw, 1999; Lemon et al., 2000; Winograd et al., 2000; Eilfsen et al., 2001; Curtis, 2003; Humphrey et al., 2004; Curtis & Turley, 2005; Knechtel, 2004, 2007; Robson et al., 2007.

4 Fee schedules for Whinney, Smith and Whinney (a forerunner of what is now Ernst & Young) show that in 1870 insolvency work amounted to more than 90% of total income and it was not until 1900 that auditing services generated more than 50% of the firm's income (Jones, 1981).

5 Although Pitt and Birenbaum (1997, p17) note a wider range of consulting activity including what would now be considered to be management advisory services going back to before World War One in the US.

6 Previts (1985) at p94.

Accounting firms in the UK were perhaps slower to move away from their traditional audit base (although accounting and taxation services were important constituents of fee income for a number of firms, large and small).⁷ Nevertheless, as the large firms in particular transformed themselves into multi-national multi-service providers, the range and extent of NAS provided and their importance in terms of fee income grew dramatically.

By the early 1990s only one of the then Big Six firms derived less than half of its total UK fee income from services other than audit, and by the end of the decade NAS far outweighed audit in terms of fees for each of the then Big Five. Furthermore, the evidence suggests that the greater proportion of these services were being provided to audit clients, with only 30% of the income accounting firms derived from their FTSE 350 clients being generated by statutory audit.⁸ Similar developments took place in the US. By the year 2000 audit accounted for just 30% of the revenues of the largest accounting firms – down from 70% in 1977. Consulting and other management advisory services represented half of fee income – up from 12% in 1977 (Levitt, 2000).

This dramatic growth in NAS provision, and in particular provision to audit clients, heightened concerns about the threat posed to auditor independence. These concerns were initially most directly articulated in the US where the Cohen Commission, which was set up in the aftermath of a series of accounting and audit failures in the early 1970s, was one of the first quasi-independent bodies to formally consider the issues involved.⁹ As the scale of the provision of NAS increased, so did the undercurrent of doubt about the relationship between this provision and that of audit. At the turn of the millennium Arthur Levitt, the then Securities and Exchange Commission (SEC) Chairman, noted that:

'As firms expand their product lines, consulting and other services may shorten the distance between the auditor and management. Independence – if not in fact, then certainly in appearance – becomes a more elusive proposition.'¹⁰

In the UK, concern was more low-key and slower to develop, particularly at the professional and regulatory level, although there were occasional expressions of disquiet from commentators and stakeholders and, as described below, some interest at the wider regulatory level. In 1986 a Department of Trade and Industry consultative document on the implementation of the Eighth Directive of the then European Community invited comments on the possibility of legislating to prohibit auditors from providing NAS(A). (No such legislation was in fact introduced although, as noted below, it was the 1989 Act, the primary purpose of which was the implementation of the Eighth Directive, which brought the first statutory requirements in the UK for disclosure of fees for NAS paid to auditors.) However, following the near financial meltdown of 2008/09 a number of quasi-legislative and regulatory bodies began to take a much more direct interest in audit and audit-related issues, including the provision of NAS(A). The deliberations and conclusions of these bodies are discussed separately below.

Over time these concerns led to the introduction of both restrictions on the provision of NAS(A) and also enhanced requirements for disclosure of those services that were being provided. The following section sketches out the development of these restrictions and disclosure requirements in the UK and the US.

1.1 Restrictions and disclosure

1.1.1 Restrictions in the UK

Statutory restrictions on the provision of NAS(A) have been minimal in the UK and this largely, but not entirely, remains the situation today. Over the years the main thrust of restriction has come via the professional bodies, restrictions which in recent years have been complemented by and overlapped with those of the standard-setting bodies and other regulators. For example, the design and installation of financial IT systems, valuation services, acting for a client in legal matters, and senior management recruitment are strongly discouraged, and as will be noted in discussion below of the Auditing Practices Board (APB)'s Ethical Standard 5 (ES5), increasingly

⁷ For example, in the Lloyd's insurance market it was commonplace before the reforms of the 1980s for auditors to provide both accounting and audit services to managing agents and syndicates (see Gwilliam, Macve and Meeks, 2000).

⁸ *Accountancy*, October 2000, p10.

⁹ The Commission (which although set up under the auspices of the AICPA considered itself to be independent of that body) found that no prohibition of NAS was warranted. Indeed, the Commission recommended that professional standards should require that public accounting firms establish policies and procedures to assure that knowledge gained from other services is made available to the partner in charge of the audit so that the partner can consider its implication for the audit function (Cohen Commission, 1978).

¹⁰ Levitt (2000).

prohibited. To take another example, recently the FRC has prohibited auditors from using internal audit staff as 'direct assistance' members of the audit team (PN 058, revising ISA 315 and 610).¹¹

From 2004 the task of ensuring that audits by appointed company auditors are 'carried out properly and with integrity and a proper degree of independence' has been delegated to the FRC and subordinated independent bodies of this regulator.¹² The ICAEW Code of Ethics (ICAEW, 2011), issued by the largest such body, contains a number of provisions designed to prevent the offering of NAS to clients compromising independence. Audit and other recurring income from any one client is restricted to 15% of gross practice income (10% in the case of listed and other public interest clients).¹³ In the provision of NAS, care must be taken not to perform management functions, nor to make management decisions. For listed and other public interest clients an auditor should not participate in the preparation of the company's accounts and accounting records, and reference is made to the need to take care when engaging in recruitment activity on behalf of a client. There are few outright prohibitions in the ICAEW Code but there is a ban on a firm auditing any financial statements which 'include the product of a specialist valuation carried out by it or an associated practice or organisation' and some rather more technical restrictions on the provision of corporate finance advice where the firm acts as auditor or adviser to two or more parties involved in a takeover subject to the City Code.

To a great extent the ICAEW Code overlaps with the threats and safeguards approach contained in ES5, initially issued by the then APB in 2004 and revised in 2011. ES5 (APB, 2011) builds on the auditing standard requirement introduced in SAS 610 'Communication of audit matters to those charged with governance' (APB, 2001) (replaced by ISA 260 of the same title, APB, 2009), that the audit committee should consider the scale and nature of NAS provided to the company by its auditor. ES5 outlines safeguards that audit firms or engagement partners are required to apply in order to eliminate, or reduce to an acceptable level, threats to auditors' independence resulting from the provision of NAS(A). In addition, it identifies specific NAS which, according to ES5, present a threat to auditors' independence so significant that no safeguards are likely to reduce the threat(s) to independence to an acceptable level. Hence, audit firms are effectively prohibited from providing these services to their audit clients. The 2011 ES5 prohibitions are not dissimilar to those prohibited by the Sarbanes-Oxley Act of 2002 (SOX 2002), s201 (outlined later in this report). Examples of services that auditors are not permitted to provide to their audit clients under ES5 are summarised in Figure 1. For the services identified, no safeguards are deemed available to reduce the threat these pose to auditors' independence to an acceptable level.

11 'Prohibiting direct assistance supports stakeholders' expectation that external auditors should be free from threats to their independence. In determining the effective date of the prohibition, the FRC has taken into consideration that planning the use of the work of internal auditors may take place early in the financial period being reported on.' Nick Land, FRC Board member and Chairman of the Audit and Assurance Council, see frc.org.uk/News-and-Events/FRC-Press/Press/2013/June/FRC-prohibits-the-use-of-internal-audit-staff-on-t.aspx, and FRC (2013b,c).

12 The APB was established in April 2002, replacing a previous APB which had been in place since 1991. The APB became part of the Financial Reporting Council in 2003. From June 2012 work on audit and assurance has been carried out within the FRC by the Audit and Assurance Council, which formally replaced the APB. Matters related to the establishment of high standards of auditing, meeting the developing needs of users of financial information, and ensuring public confidence in the auditing process now fall under the direct remit of the FRC Board and its Codes and Standards Committee, with the input and advice of the Audit and Assurance Council. Buijink et al. (1996) noted that in Europe similar disclosure requirements then existed in Ireland, Norway, Denmark, Belgium and Italy.

13 See Buijink et al. (1996, pp76-77) for details of income restrictions across EU countries.

Figure 1: Non-audit services UK auditors may not provide to their audit clients

Non-audit services	Threats to independence ¹⁴		
	Self-review	Management	Advocacy
Internal audit services, especially where these involve outsourcing substantially all of the internal audit function to the audit firm or the audit cannot be performed without placing significant reliance on the internal audit work performed.	√	√	
Services involving the design, provision or implementation of information technology systems which are important to any significant part of the accounting system or preparation of the financial statements.	√	√	
Valuation (including actuarial) services where the resulting valuations have a material effect on the financial statements.	√	√	
Tax services in cases where the audit firm provides a significant portion of the client's tax planning and compliance work, or tax work that results in calculations likely to be used in the preparation of accounting entries that are material to the financial statements.	√	√	
Tax services that result in the auditor (or firm) acting as an advocate for the client in an appeals court or tribunal in relation to a matter that is material to the financial statements or an audit judgment.	√		√
Corporate finance services (including taking responsibility for dealing in, underwriting or promoting shares) and other transaction-related services (such as due diligence investigations and investigations of the tax affairs of possible acquisitions or disposals).	√	√	√
Recruitment and remuneration where such services involve the audit firm taking responsibility for appointing a director or employee, for recruiting a person to a key management position, or providing advice on the remuneration of a director or key management position of the client.		√	
Litigation support services that involve the audit firm estimating the likely outcome of a pending legal matter that could be material to an amount or other disclosure in the financial statements.	√		
Legal services that involve the audit firm acting as the client's solicitor, representing the client in the resolution of a dispute or litigation which is material to an amount or other disclosure in the financial statements.	√		√

Source: Porter et al. (2014), used with permission.

1.1.2 Disclosure in the UK

In the UK, the 1989 Companies Act enabled the introduction of a requirement for disclosure of the aggregate amounts paid to auditors for NAS. This came into law by means of a Statutory Instrument in 1991.¹⁵ At that time the basic requirement was for disclosure of the aggregate fee amount and any disclosure beyond that was voluntary. The present UK statutory disclosure requirements are set out in the 2011 Auditor Remuneration Disclosures¹⁶ which are themselves aligned with the requirements of the APB's ethical standards. Disclosure by type of service is required for any payment to the company's auditor or to any associate of that auditor. The disclosure categories in the legislation are as follows.

1. The auditing of accounts of any associate of the company.
2. Audit-related assurance services.
3. Taxation compliance services.
4. All taxation advisory services not falling within paragraph 3.

¹⁴ The self-review threat occurs when the auditor is put in a position of reviewing significant subject matter for which the auditor was previously responsible. The advocacy threat refers to situations where the auditor promotes or is perceived to promote an audit client's position or opinion to the point where objectivity may be compromised. The management threat arises when the auditor provides NAS(A) which involves making judgements or decisions which are the responsibility of management.

¹⁵ Buijink et al. (1996) noted that in Europe similar disclosure requirements then existed in Ireland, Norway, Denmark, Belgium and Italy.

¹⁶ Department for Business, Innovation and Skills, (BIS), The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011, No. 2198. See legislation.gov.uk/uksi/2011/2198/pdfs/uksi_20112198_en.pdf

5. Internal audit services.¹⁷
6. All assurance services not falling within paragraphs 1 to 5.
7. All services relating to corporate finance transactions entered into, or proposed to be entered into, by or on behalf of the company or any of its associates not falling within paragraphs 1 to 6.
8. All non-audit services not falling within paragraphs 2 to 7.¹⁸

1.1.3 Restrictions and disclosure in the US

In the US the actual regulation of NAS(A) has not been substantively different from that in the UK, although there have been structural differences, for example, the creation of the Independence Standards Board in 1996 (the Board was wound up in 2001), the creation of the Public Oversight Board and the more specific regulatory interest of the SEC. For many years there were slightly more stringent SEC restrictions for the provision of services by accounting firms that were members of the SEC practice division, including the proscription of relatively marginal services such as psychological testing, executive recruiting, public opinion polls, merger and acquisition services for a finder's fee and actuarial services. Under the chairmanship of Arthur Levitt, the SEC proposed significantly greater proscription, but the revised rules approved in November 2000 went primarily down the route of disclosure and audit committee approval with extension of prohibition only for certain IT consultancy services, the provision of legal services and, for clients with assets in excess of \$200m, provision of more than 40% of internal audit.^{19 20}

The passing of SOX 2002 in July 2002 effectively put into law existing SEC prohibitions and extended them to include a complete ban on the provision of internal audit and a number of other management advisory services. However, other services, which specifically include taxation services, can continue to be provided to an audit client if they are pre-approved by the client's audit committee.²¹ The SEC adopted final rules to implement s208(a) of SOX 2002 in January 2003, rules that further strengthened the SEC's requirements regarding auditor independence. These revisions to the SEC's regulations related to further prohibition of the provision of NAS(A), enhancements of the role of client audit committees re pre-approval of audit and NAS by the external auditor, improved auditor communication with audit committees, tightening rotation requirements at audit partner level, prohibition of the compensation of audit partners being directly related to fees derived from NAS, and amended disclosure requirements relating to the provision of audit and NAS.²²

In terms of disclosure, in 1978 the SEC led the way by requiring disclosure of the percentage of non-audit fees relative to audit fees and disclosure across the category where provision exceeded 3% of the audit fee, together with disclosure of whether the board of directors or its audit committee had approved the NAS. However, these disclosure requirements were withdrawn in 1982, and it was not until 2000 that the SEC reintroduced the present requirements for disclosure of fees for audit services and NAS, then split by category between 'Financial Information Systems Design and Implementation' and 'All Other', further revised and refined, as noted above, in its 2003 implementation of s208(a) of SOX 2002.²³

1.2 Structural changes in the market for non-audit services

As noted above, by the earliest years of the present century NAS, whether provided to audit clients or elsewhere, had become the dominant underpinning of the revenue streams of the very large firms. However, at this time there were significant structural changes in the market for the provision of certain types of NAS as four of the then Big Five sold or spun off all or part of their consulting arms. The process began when Andersen Consulting (now Accenture) divorced itself from Arthur Andersen in August 2000 after a long-running and acrimonious dispute. In the

¹⁷ Although, in reference to ESS, it should be noted that the provision of significant internal audit services is effectively prohibited.

¹⁸ BIS, The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011, No. 2198. Schedule 2A, Regulation 5(3).

¹⁹ 'After careful consideration of the arguments on all sides, and for the reasons discussed below, we have determined not to adopt a total ban on non-audit services, despite the recommendations of some, and instead to identify certain non-audit services that, if provided to an audit client, render the auditor not independent of that client.' (SEC, 2000).

²⁰ Details of the rules are available on sec.gov/rules/final/33-7919.htm

²¹ Under SOX 2002 and subsequent SEC rules, auditors are prohibited from simultaneously supplying any of the following NAS to an audit client: bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser or investment banking services; legal services and expert services unrelated to the audit; and any other service that the Public Company Accounting Oversight Board (PCAOB) determines to be impermissible.

²² Effective May 6 2003, subject to transition periods, Securities and Exchange Commission Release Nos. 33 – 8183; 34 – 47265; 35 – 27642; IC – 25915; IA – 2103; FR – 68; File No. S7 – 49 – 02. A copy of the release is available at sec.gov/rules/final/33-8183.htm

²³ See the SEC website at sec.gov/rules/final/33-8183.htm. This rule amends disclosures regarding fees paid to auditors. Effective 6 May 2003, companies are required to disclose fees paid in the last two fiscal years to their principal independent accountant in the following categories: (1) audit fees; (2) audit related fees; (3) tax fees; and (4) all other fees. Non-audit fees have to be further classified in subcategories.

same year Ernst & Young spun off its consulting business to the Paris-based consulting and information technology group Cap Gemini. KPMG floated KPMG Consulting in February 2001 and in October 2002 PwC sold its management consulting and technology services arm to IBM Global Business Services.

Discussion of why these changes took place is largely beyond the scope of this report and no doubt a number of factors were at play. Included within these might have been issues relating to the provision of NAS(A) but it is probable that the main drivers related to issues of control, power and management capability within the firms. The interplay between these and a desire to realise the high commercial value of the consulting businesses are likely to have been crucial. Changes in market conditions meant that some firms were more fortunate in the timing of their disposals than others. PwC initially agreed a sale to Hewlett Packard for approximately \$17bn but adverse reaction from the Hewlett Packard shareholders meant that the deal did not go through. In the end the disposal of a similar portfolio was achieved for just £3.9bn.

A separate development in recent years has been the growth of mid-size accounting firms, other than the more traditional and well known 'second tier' firms. These new conglomerations, loosely termed 'consolidators', have sought to absorb smaller firms – and for many, markets other than audit have been the main focus of their economic model. Although their rise, and to an extent fall, has been an interesting market development and one with relevance to issues of NAS it is again beyond the scope of this report to consider them in great detail.

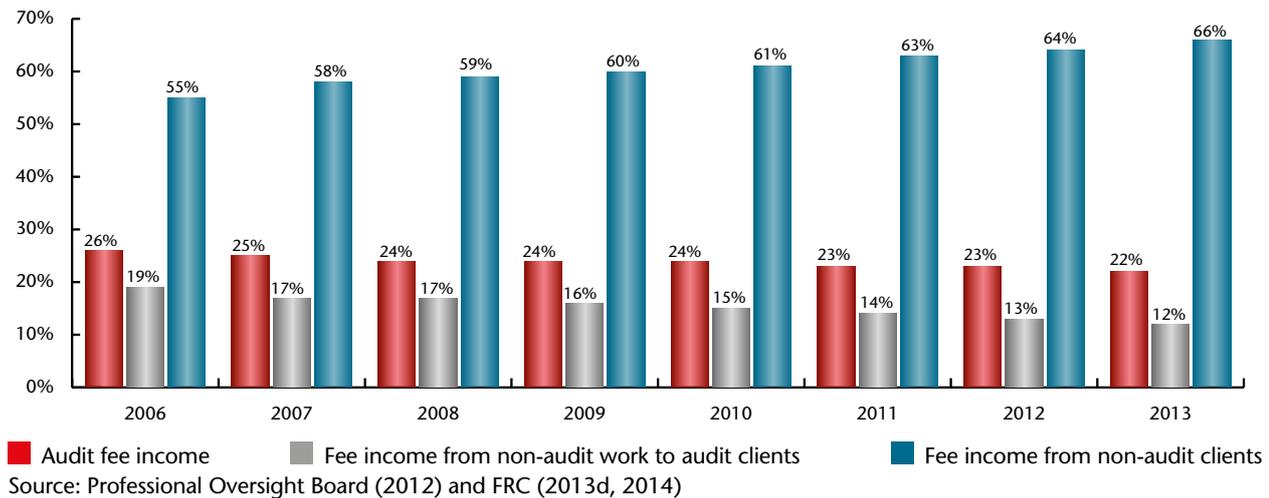
The provision of consulting services has become an increasingly important source of revenue for the Big Four²⁴ over the past decade but there has, at the same time, been a significant and steady decline in the provision of NAS(A), a trend which may reflect raised client concerns about perceptions of impairment to auditor independence from the provision of NAS(A). Recent data provides an insight into the manner in which the nature of revenue streams associated with NAS provision has changed over the last decade. The main publicly-available UK studies are those of the APB (2010a), the Professional Oversight Board (2012) and the FRC (2013d, 2014). The APB (2010a) study related to listed companies reporting in 2008 and its key findings are listed below.

- The 2008 average ratio of non-audit to audit fees for listed companies was 76%.
- In 2008, 300 of the 1,740 listed UK companies had ratios of non-audit to audit fees that were equal to or exceeded 1:1. Two thirds of these companies had a ratio of 2:1 or less, and only a few had ratios above 5:1.
- Those 300 listed companies with ratios in excess of 1:1 in 2008 accounted for about 49% of the total value of non-audit services fees reported by the 1,740 listed companies.
- In 2008, FTSE 100 companies accounted for about 70% of the total of all non-audit services fees (and 66% of the audit fees) reported by the 1,740 listed companies.

In relation to FTSE 100 companies, the APB (2010a) found that the fees for NAS provided by the auditors between 2002 and 2009 reduced in absolute terms by 30%, and reduced as a percentage of audit fees from 191% to 61%. The trends identified by the APB in the level of NAS fees to individual audited entities are broadly consistent with those identified in the data released by the Professional Oversight Board (2012) and the FRC (2013d, 2014). This data is presented in Figure 2 on the following page, which shows that in the eight years to 2013, the proportion of overall fee income of the Big Four derived from the provision of audit services fell from just over a quarter of total income in 2006 to well under a quarter of total income in 2013. The concomitant rise in fees from NAS to nearly 80% of total fees over the same period masked a significant trend whereby fees from NAS provided to clients other than audit clients rose steadily from 55% of total fee income in 2006 to 66% of total fee income in 2013, whereas fees from NAS(A) declined from 19% of total fee income in 2006 to just 12% in 2013.

²⁴ The 'Big Four' is a commonly-used term for the four largest international accounting and auditing firms/networks. These are Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers. They have emerged by a combination of generic growth and merger from an earlier 'Big Eight' then a 'Big Six', a 'Big Five' and after the demise of Andersen to the current situation. Although it is possible that in future years their position might be challenged – for example, by firms based in the Far East – they currently occupy a dominant position in many developed and developing countries (eg, Deng, S. and Macve, R. (2013), 'The origination and development of China's audit firms', paper presented at the Euro-Asia Economic Forum, Xi'an, PRC (September): LSE Working Paper).

Figure 2: Big Four fee income (2006–2013)



Essentially these studies are in agreement that, since the divestment at the start of the new millennium, the very large firms have rebuilt their consulting and other activities beyond audit to levels of fee income on a par in relative terms to those before the divestment (and in absolute terms significantly higher). However, the engine of this growth has entirely been **NAS provided to clients other than audit clients**. NAS(A) have declined very significantly relative to overall fee income and, although to a smaller extent, in absolute terms as well, the key trend being the large reductions in the amount of NAS provided by incumbent auditors.²⁵

1.3 Recent regulatory concern

The earlier section of this chapter traced both previous expressions of concern and the development of the guidance and regulation relating to the provision of NAS(A) that is in place in the UK today. As has been seen for much of the time, criticism of this provision has been internalised and regulatory concern muted. However, that has not been the case in recent years in which, in the UK at least, audit and aspects associated with audit, including the provision of NAS(A), have come under much closer scrutiny than in previous years. The reasons for this are varied and include issues over the levels of competition in the audit market and also a degree of ‘push’ from supra-national institutions, in particular the EU, but there is no doubt that a significant driver has been the near meltdown in financial services of 2008 and 2009 and the 2010 House of Lords enquiry into the role of audit in failing to head off, mitigate – or at least warn – of the potential for disaster ahead (HoL, 2011).

The outcome of this regulatory investigation and enquiry has been embodied in a number of reports – not all of them directly focused on audit per se. These have included:

- the Report of the Treasury Select Committee on the Banking Crisis;
- the resultant APB Consultation;
- the House of Lords Economic Affairs Committee enquiry on Auditors – ‘Market concentration and their role’ (HoL, 2011);
- the Competition Commission’s Statutory Audit Services Market Investigation (2012/13);
- the EU Green Paper²⁶, the revised Green paper, EC proposals and EU discussion (2011/12/13); and
- the UK response to EU consultation and proposals.

THE TREASURY SELECT COMMITTEE

The Report of the Treasury Select Committee was one of the earliest responses to the banking crisis. Although audit was not its primary focus, it did touch directly upon issues of auditor independence and called for specific prohibition of the provision of NAS(A).

‘We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. Representatives of the investor community

25 In a 2009 study, Deloitte found that NAS provision to FTSE 100 audit clients dropped from a peak of over 300% of audit fees in 2001 to 75% in 2008.

26 The EC’s Green Paper is a consultation document. Formal proposals by the European Commission for EU legislation can subsequently be based on such a consultation document.

told us of their scepticism that audit independence could be maintained under such circumstances. This problem is exacerbated by the concentration of audit work in so few major firms. We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.²⁷

The FRC consultation was directed via the APB and this is discussed below.

THE APB RESPONSE

In seeking to address the issue, the APB generated both the consultation paper already referred to (APB, 2009) and a feedback paper (APB, 2010a) which provided a summary of responses to the earlier consultation paper and set out explanations for proposed amendments to APB Ethical Standards for Auditors (revised versions issued in 2011) and FRC Guidance on Audit Committees (2010 version, revised in 2012, see FRC, 2012). In December 2010 the APB issued a revised set of auditor independence standards, to apply from the end of April 2011 (with transitional arrangements). The standards sought to retain the basic threats and safeguards approach but introduced some additional prohibitions and specific requirements to further enhance and maintain auditor independence. These included the following items.

For all audits:

- tightening of some tax NAS and contingency fee restrictions;
- narrowing of the exemptions for providing valuations etc, where the auditor is permitted to carry out the work by law or regulation;
- widening of the definitions of contingent fee and of those who cannot be remunerated or compensated for selling NAS;
- prohibiting auditors being an officer of the client;²⁸ and
- specific requirements in many areas (including providing restructuring services) to consider threats and apply safeguards – while this is already, at least implicitly, required, there will be a need for an enhanced focus on the relevant documentation.

For listed company audits:

- prohibition of the provision of some types of restructuring services;
- enhanced disclosure to audit committees;
- tightening of the prohibitions on the provision of tax numbers to clients for use in the financial statements; and
- a requirement to discuss fee ratios with the designated ethics partner where NAS fees exceed audit fees.

THE HOUSE OF LORDS TREASURY SELECT COMMITTEE ON ECONOMIC AFFAIRS

In 2010 the House of Lords Treasury Select Committee on Economic Affairs enquired into market concentration and the role of the audit industry, noting in its terms of reference that the narrow field of choice raised concerns about competition and the quality of audited accounts, and about possible conflicts of interest between audit and consulting arms. The Final Report by the Treasury Select Committee on Economic Affairs (HoL, 2011) was less than complimentary. It expressed overall disappointment with both audit and the manner in which the large audit firms approached their audit role. Their Lordships did not accept that auditors did all that was required of them, they found the defence by auditors of audit quality disconcertingly complacent, they had serious misgivings about auditors' assessment of managements' going concern assertion, and specifically did not accept that the prospects of a bailout by government should at any time be a decisive consideration in making the 'going concern' judgement (HoL, 2011, paras 133, 142, 144–151, 199).

In its recommendations, the Treasury Select Committee made reference to and voiced opinions on, among other things, the level of competition in the audit market, the possibility of mandatory joint audit, the possibility for the mandatory tendering of audit contracts, the provision of NAS(A), and the possibilities for the provision of broader assurance to users of financial statements (including on such matters related to risk management, the firm's business model and the business review). While not considering that a complete ban on the provision of NAS(A) was necessary or appropriate, the Select Committee recommended a ban on the provision of internal audit, tax advisory services, and advice to an audit client's risk committee (with additional

²⁷ Treasury – 'Ninth Report Banking Crisis: reforming corporate governance and pay in the City', 15 May 2009, para 237.

²⁸ This previously having been prohibited by the Companies Act 2006, see s1214 ('Independence requirement').

recommendation that the Office of Fair Trading (OFT) examine grounds for the prohibition of other services to be carried out by a company's external auditor, HoL, 2011, para 87). In line with its concerns over the role of audit, audit quality, and audit market concentration, the Select Committee further recommended that the OFT should conduct an investigation into the audit market. In October 2011 the OFT announced its decision to refer concerns related to audit market concentration to the Competition Commission. This report is discussed further below.

THE COMPETITION COMMISSION'S STATUTORY AUDIT SERVICES MARKET INVESTIGATION (2012/13)

The Competition Commission was wide-ranging in its search for evidence focusing on issues relating to the audit market and audit quality. This search included: a survey of over 600 FDs, CFOs and Audit Committee Chairs; case studies, including interviews at 10 FTSE 350 companies; hearings with 10 audit firms and other interested stakeholders; the receipt of written submissions; and the commissioning of an updated literature review from an academic source.²⁹ The initial findings were published in February 2013³⁰ and were set out in summarised form as follows.

- Companies face significant hurdles in comparing the offerings of an incumbent auditor with those of alternative suppliers other than through a tender process.
- It is difficult for companies to judge audit quality in advance due to the nature of audit.
- Companies and firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship.
- Company management face significant opportunity costs in the management time involved in the selection and education of a new auditor.
- Mid-tier firms face experience and reputational barriers to expansion and selection in the FTSE 350 audit market.
- Auditors have misaligned incentives, as between shareholders and company management, and so compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ.
- Auditors face barriers to the provision of information that shareholders demand (in particular, from the reluctance of company management to permit further disclosure).

Although one of the most extensive reviews of the UK audit market in recent years – the final report published in October 2013³¹ runs to more than 300 pages – the report contains relatively little which is specific to the provision of NAS. Where they are, briefly, referred to it is in the context of whether the 'bundling' of NAS and audit by Big Four audit firms constitutes a threat to market competition. This is, however, considered largely separately from issues such as audit quality – which is a little surprising as there is a quite extensive review of audit quality issues elsewhere in the report. In the end the Commission concluded that there was no evidence of such a competitive threat and in consequence recommended that no changes be made to current guidance and regulation.

Beyond that the report notes, by means of reference to a 2009 study by Beattie et al., four factors that may have acted to decrease fees from the provision of NAS(A):

'First, the enhanced role of the AC in developing policies for purchasing NAS, following the Combined Code (2003) and Smith Report (2003), has made ACs more conscious of the importance of auditor independence and therefore reluctant to buy services from their auditor. Second, increased scrutiny from activist investors and risk of adverse publicity. Third, ES5 has restricted auditors' ability to provide many services. Fourth, the UK audit inspection regime has deterred inappropriate NAS provision by auditors. (CC, 2013, Appendix 20, para 11).'

Although, again, it does not seek to discuss or analyse these in great detail.

²⁹ See competition-commission.org.uk/our-work/directory-of-all-inquiries/statutory-audit-services

³⁰ OFT press release 21 October 2011, see webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/news-and-updates/press/2011/115-11

³¹ See competition-commission.org.uk/our-work/directory-of-all-inquiries/statutory-audit-services

In its wider conclusions relating to audit quality, the audit market and the need to lower barriers to entry, the Competition Commission explored in its Notice of Possible Remedies (February 2013) the following combination of remedies, with final findings and recommendations. These were largely reiterated in the Final Report in October 2013 (CC, 2013, Appendix 20) – but with the time period for mandatory tendering extended from 5 to 10 years:³²

- mandatory tendering every 10 years;
- expanded remit and/or frequency of Audit Quality Review team (under auspices of FRC reviews);
- prohibition of 'Big-Four-only' clauses in loan documentation;
- strengthened accountability of the External Auditor to the Audit Committee;
- enhanced shareholder-auditor engagement; and
- extended reporting requirements and shareholders' vote at the AGM on whether Audit Committee Reports in company annual reports are satisfactory.

EU GREEN PAPER³³, THE REVISED GREEN PAPER, EC PROPOSALS AND EU DISCUSSION (2011/12/13)

The concerns and activities of the EU have been associated with, and are to an extent both parallel to and instigating, domestic enquiry. Within its overall remit the EU has long maintained an interest in aspects of the audit market including issues relating to licensing of auditors, audit market concentration, auditor liability and auditor independence (for example, issues concerning rotation, NAS etc).

At EU level, concerns about the independence of audit have led to proposals with particular considerations given to requirements for mandatory audit firm rotation, tendering, and a ban on the provision of NAS to audit clients in relation to the statutory audit of public-interest entities, such as banks, insurance companies and listed companies. These measures aimed to enhance auditor independence and to make the statutory audit market more dynamic (EC, COM(2011) 778 final, COM(2011) 779 final)³⁴ with the following preliminary key reform proposals by the European Commission (November 2011).³⁵

Mandatory tendering: public-interest entities will be obliged to have an open and transparent tender procedure when selecting a new auditor. The audit committee (of the audited entity) should be closely involved in the selection procedure.³⁶

Non-audit services: audit firms will be prohibited from providing non-audit services to their audit clients. In addition, large audit firms will be obliged to separate audit activities from non-audit activities in order to avoid all risks of conflict of interest.

European supervision of the audit sector: in addition, given the global context of audit, it is important that coordination of and cooperation on the oversight of audit networks is ensured both at EU level as well as internationally. Therefore, the Commission proposes that the coordination of the auditor supervision activities is ensured within the framework of the European Securities and Markets Authority (ESMA).

Enabling auditors to exercise their profession across Europe: the Commission proposes the creation of a single market for statutory audits by introducing a European passport for the audit profession. To this end, the Commission proposals will allow audit firms to provide services across the EU and will require all statutory auditors and audit firms to comply with international auditing standards when carrying out statutory audits.

³² In view of the EU's audit reforms endorsed by EU member states on 18 December 2013 and adopted by the European Parliament on 3 April 2014, the Competition Commission announced on 17 January 2014 that it would delay the release of its package for audit reform in the UK. The Competition Commission Orders were to be redrafted in light of the results of these consultations and then subject to a further period of consultation. The new Orders were expected to begin in Q4 2014. We should note that the Competition Commission was closed down on 1 April 2014, and its functions have been transferred to the Competition and Markets Authority.

³³ The EC's Green Paper is a consultation document. Formal proposals by the EC for EU legislation can subsequently be based on such a consultation document.

³⁴ The underlying process normally followed is that the European Commission makes a proposal; the European Council and the European Parliament subsequently debate and amend before adopting a proposal. A directive (eg, COM(2011) 778 final) is addressed to the member states, and while this is binding on the member states, achievement of objectives and implementation is left to the member states. In contrast, a regulation (eg, COM(2011) 779 final) is directly applicable ie, it creates law which takes immediate effect in all the member states in the same way as a national instrument, without any further action on the part of the national authorities.

³⁵ Final amendments to the EC's proposal were originally due by November 2012 but deliberations continued into late 2013. The investigation by the UK's Competition Commission into the Big Four's dominance of the FTSE 350 audit market, meanwhile, had issued preliminary findings in February 2013, and published final findings in October 2013.

³⁶ In the UK, the FRC in September 2012 required FTSE 350 companies to put their audit contract out to tender at least once a decade or explain to shareholders why they did not do so. See frc.org.uk/Our-Work/Publications/Corporate-Governance/Audit-Tenders-Notes-on-best-practice.pdf (FRC, 2013a).

In September 2012 a draft report by the Legal Affairs Committee (JURI) (EP, 2012a) proposed significantly watered-down measures – particularly those in relation to audit rotation which JURI suggested should take place every 25 years – although there was evidence of strikingly different views within the Commission (ECON, EP, 2012b). Calls for stronger action on audit rotation and audit tendering also came from a letter sent in September 2012 representing the views of many of the largest investors in Europe.^{37 38} Specifically in respect to NAS, in April 2013 the Legal Affairs Committee announced an intent to prohibit auditors from supplying certain NAS(A) – but opposed a general prohibition.

A framework for EU audit reform was unanimously endorsed by EU member states on 18 December 2013 and adopted by the European Parliament on 3 April 2014.³⁹ EU listed companies and public-interest entities will be required to put their audit to tender every 10 years and must change their auditor after 20 years (or 24 years under a joint audit arrangement). Under the rules, audit firms face a 70% cap on the fees generated for non-audit work to public-interest entities, with certain NAS, such as tax advice and services linked to financial and investment strategy, being banned altogether. Additionally, the rules prohibit the use of restrictive clauses in contracts which limit a company's choice of auditor.

THE UK RESPONSE TO EU CONSULTATION AND PROPOSALS

Beyond this there has been the UK Government's response via the Department of Business, Innovation and Skills to the EU Green Paper on Audit, which expresses a reliance on the more explicit requirements on auditor independence provided in the Combined Code, and caveats set out in ESS of the APB on the provision of NAS (which amount to de facto prohibitions in many instances, but otherwise rule out any support for a ban on NAS provision and indicate a reluctance to support additional rules for the audit of financial institutions, a position which had not significantly changed by December 2013).⁴⁰ The UK Government has, throughout, argued against mandatory rotation of auditors, opting instead for the approach adopted by the FRC in 2012 which requires mandatory audit tendering every 10 years on a 'comply or explain basis'.⁴¹ As noted above, the Competition Commission, in its final measures of October 2013, proposed that FTSE 350 companies must put their statutory audit engagement out to tender at least every 10 years.⁴²

³⁷ See europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fTEXT%2bIM-PRESS%2b20130422IPR07532%2b0%2bDOC%2bXML%2bV0%2f%2fEN&language=EN

³⁸ The 2011 EC legislative proposals (Directive and Regulation) following on from the Green Paper are the basis of ongoing negotiations. The Parliament and the Council are the co-legislators, although in effect the EC is part of a 'trialogue' process to negotiate the final text of the legislation, which must be agreed by the Council and the Parliament. The Council has an ongoing process of discussing the proposals – a working group comprising all the member states and chaired by the EU presidency meets roughly monthly as called by the presidency and tries to agree on a compromise text. This process is ongoing at the time of writing this report. Various committees of the Parliament address this issue. The Legal Affairs Committee (JURI), which has the lead competence, and other committees, supported by the Economic and Monetary Affairs Committee (ECON), issue an 'Opinion' to feed into the JURI report. The JURI report is just a starting point – and requires a vote in the Committee to agree the final 'Opinion/Report'. There has been a vote in ECON and in the Committee on Industry, Research and Energy (ITRE). Sufficient agreement on the major issues (known as a 'general approach') will allow for triologue to start, which refers to the tripartite negotiations between the EU Council, Parliament and Commission.

³⁹ Directive 2014/56/EU amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2014:158:FULL#page=198); Regulation 537/2014 on specific requirements regarding statutory audit of public-interest entities (eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2014:158:FULL#page=79).

⁴⁰ See bis.gov.uk/assets/biscore/business-law/docs/u/10-1346-uk-government-response-ec-green-paper-on-audit, 'UK Government Response to the European Commission's Green Paper on Audit', 8 December 2010, response to question 19.

⁴¹ In October 2012 the FRC updated the Corporate Governance Code and introduced a new provision, on a comply or explain basis, requiring FTSE 350 companies to put their audit out to tender every 10 years. See frc.org.uk/Our-Work/Publications/Corporate-Governance/Audit-Tenders-Notes-on-best-practice.pdf, FRC (2013a).

⁴² See webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/media-centre/latest-news/2013/Oct/cc-finalises-measures-to-open-up-audit-market

2. Arguments for and against the provision of non-audit services to audit clients

This chapter seeks to contribute to the debate about the suitability of allowing or even encouraging the provision of NAS(A) by focusing on the strength or otherwise of the respective arguments for and against such provision. It seeks to achieve this in part thematically, by categorising specific arguments that have been adduced both for and against such provision, and in part by wider consideration of issues concerning audit evidence gathering and auditor judgement (although auditor judgement is considered more specifically in Chapter 3), which are relevant both to the NAS debate and more generally to the nature and role of audit.

The underlying methodology employed might loosely be described as qualitative rationalism but it is informed by the extensive previous literature, the evidence from the range of relevant empirical studies conducted over the past 30 years or so, and also inductive/qualitative building on previous work, using evidence from a wide range of sources including formal investigations, reviews, and enquiries.

The first section – arguments against the provision of NAS(A) – considers specific arguments which have been directed toward either the restriction of, or the complete prohibition of, such provision.

2.1 Arguments against the provision of non-audit services to audit clients

As noted earlier in this report, the primary regulatory concern has always been that the provision of NAS(A) constitutes a threat to auditor independence, particularly in terms of: enhanced fee dependence; the possibility of the auditor being required to critically appraise work carried out by other members of the accounting firm; and greater familiarity with, and psychological dependence upon, client management. Each of these threats is now considered in turn.

2.1.1 Enhanced fee dependence

In the UK and the US, auditors are normally 100% fee dependent upon their clients irrespective of whether or not NAS are supplied. The loss of an audit client will result in the loss of that stream of income which will in turn have implications for the firm and also, as is increasingly being recognised, for the fortunes within that firm of the individual managers and partners associated with that client. There are, however, logical reasons for believing that pressures on auditors to acquiesce to inappropriate client accounting procedures are greater when the accounting firm also benefits from substantial NAS revenue from that audit client. Although there is little direct confirmatory empirical evidence, there is a strong perception that the loss of an audit client is also likely to lead to the loss of the stream of associated NAS – services which are conventionally perceived to be more profitable than audit per se. In forming an opinion or not about the suitability of a client's accounting practices, an audit partner – or the team of partners which is likely to be associated with a decision to qualify or threaten qualification of a set of financial statements – is likely to be mindful of the overall fee income which the client represents to the firm.^{43 44}

Indeed, in the recent past, critics of the profession in the UK and the US have alleged that accounting firms 'low ball' tenders for audit ie, price the audit below cost for the purpose of gaining access to lucrative NAS, and quote specific examples where incoming auditors have undercut the outgoing auditors on the audit fee and then benefited from a very substantial rise in subsequent NAS fee income.⁴⁵ Of course individual cases may be driven by specific factors, and the wider empirical evidence to support this view is not necessarily compelling. Nevertheless, in

⁴³ When reviewing their association with Enron at a client retention meeting in February 2001, Andersen were clearly aware of the overall fee link when discussing the possibility of combined audit and non-audit fees rising from \$52m (\$25m audit, \$27m non-audit) to \$100m (Powers et al., 2002).

⁴⁴ The SEC heard evidence about the 'subtle but powerful psychological factors [that] skew the perceptions and judgments of persons – including auditors – who have a stake in the outcome of those judgments.' (SEC, 2000). See also Bazerman et al. (1997).

⁴⁵ Similar concerns were expressed by a number of parties giving evidence to the SEC hearings ahead of approval of its new independence rules (SEC, 2000) and indeed previously by the then chairman of the SEC, Arthur Levitt, in a speech in 1996: 'The auditing function should be the very soul of the public accounting profession, not a loss-leader retained as a foot in the door for higher-fee consulting services' (quoted in Pitt and Birenbaum, 1997 at p50 fn.109).

the opinion of the authors, it would be naïve to believe that individual auditors⁴⁶ and audit firms can entirely divorce themselves from such considerations when making operational and pricing audit decisions.

2.1.2 Review of work by other members of the accounting firm

Concerns about the auditor being put in a situation where they are effectively auditing their own work have been raised, primarily relating to situations where the audit firm has been responsible for advice on or the actual installation of client financial and related systems. The worry is essentially that the auditor will either be reluctant to probe too far into the operation and output of such systems, or if they find evidence that they are malfunctioning, will be reluctant to report this finding to client management or to a wider audience. Although concerns are normally couched in terms of the provision of financial systems, one could conceive of possible conflicts of interest arising across a range of NAS provision including, among others, internal audit, taxation, personnel selection and corporate finance. Here again empirical evidence on the scale and extent of such a problem is very limited – although there is some, at least indicative, evidence that such a threat to independence does exist. Here are some examples.

Sikka and Willmott (1993) in their review of the DTI Inspectors' report on Roadships Limited in 1976 noted that after examining the quality of audit by the auditor, the inspectors concluded:

'We do not accept that there can be the requisite degree of watchfulness where a man is checking his own figures or those of a colleague ... For these reasons we do not believe that (the auditor) ever achieved the standard of independence necessary for a wholly objective audit.'⁴⁷

As auditors of Enron, Andersen saw their role as that of providing an 'integrated audit' combining its outside audit role with extensive internal auditing and consulting services. However, the accounting and corporate governance experts testifying before the US Senate Committee on Governmental Affairs investigation of the role of the Enron directors condemned the very concept of an integrated audit:

'... not only for diluting the outside auditor's independence, but also for reducing the effectiveness of an outside audit by allowing the auditor to audit its own work at the company. Mr Sutton called it a "terrible idea" while Mr Campbell called it a "horrible practice" and I do not think it should be permitted.'⁴⁸

Another specific example where the intrusion of NAS impaired the quality of audit can be seen in Ernst & Young's less-than-successful attempt to audit ERF (a UK truck manufacturer) – which resulted subsequently in extensive litigation and an admission by Ernst & Young of a number of counts of negligence (see Gwilliam 2010). One aspect of the case was that the company accountant had for some years been falsifying the VAT returns so as to obtain repayments from the then Customs and Excise. Ernst & Young did not notice this in the course of their audits for the relevant periods and, indeed, during the course of the 1998 audit Ernst & Young had introduced to ERF two members of its firm with 'expertise' in VAT, apparently for the purpose of bringing to ERF's attention the scope of other services provided by Ernst & Young to their clients.⁴⁹ Although these personnel became aware of the pattern of reclaimed VAT, it did not appear to strike them as particularly unusual. More importantly, the audit team carried out little or no work on the VAT figure as they believed that it had been covered for audit purposes by the VAT specialists. Furthermore, in the following year they appear to have been under the impression that the specialists were continuing to be associated with ERF's VAT computations – although they were not – and again carried out no specific work on the VAT returns.

More recently, albeit with less concrete examples, concern has been expressed about the role of the large accounting firms in the mark-to-market practices which played a part in the run-up to the global financial issues which came to the fore in 2008 and 2009. It is not clear the extent to which, if any, audit firms or their consulting arms participated in the construction of the mark-to-market modelling but there are possible resonances with the Enron saga – where the involvement of Andersen in putting together the variety of accounting practices used by their client made it very difficult for them to come to the appropriate audit opinion.

2.1.3 The relationship with management

Perhaps the greatest threat to auditor independence deriving from the provision of NAS(A) lies in the implications for the relationship between client management and the auditor and the effect that this has in turn upon the audit approach. For much of the 20th century, in the UK at least,

⁴⁶ See Gwilliam (1987, p104), Trompeter (1994), Brierley and Gwilliam (2001) for discussion of incentives facing individual partners and aspiring partners within accounting firms.

⁴⁷ p9.

⁴⁸ US Senate, Report 107-70, July 2002, 'The Role of the Board of Directors in Enron's Collapse', p58.

⁴⁹ para 368.

the wider perception of the auditor was that of a quasi-judicial monitor of the accuracy of client financial reporting. Although the auditor was economically dependent upon its clients, auditor independence was strengthened by relatively low levels of competition for existing clients and the greater relative importance of the professional bodies both in the wider commercial world and in relation to the audit firms themselves. Relationships between company management and the auditor appear to have been more formal and more distant than they are today. However, greater competition between audit firms and, in particular, the desire for fee growth through the sale of NAS to the client has significantly changed the relationship between auditor and client.

Whereas in the UK the company auditor is de jure, if not necessarily de facto, appointed by the shareholders and the audit report is addressed to the shareholder, as a consultant the accounting firm acts in a capacity similar to that of any outside contractor and is essentially at the behest of company management. In setting up tax avoidance schemes for the client, or as in the case of Enron helping to construct special purpose entities designed to be at the very edge of what might be considered to be acceptable accounting practice,⁵⁰ the auditor is both providing a service to management and also comes to perceive the company client from the viewpoint of management rather than that of a dispassionate outside observer/monitor. This is likely to exacerbate a situation where the interests of the outside shareholders, to whom the auditor is reporting but who lack personification as the auditor has no direct contact or dealings with them, consciously or subconsciously become subordinate to the interests of 'the client' as personified by client management who have a clear personification and frequently a similarity of background, socialisation and training as the senior members of the audit team.⁵¹ This section has highlighted just one aspect of the wider behavioural and social environment within which audit operates – further relevant issues are discussed in Chapter 3.

2.1.4 The market for non-audit services

A final and rather separate issue relates to the possible distortion of the market for the type of consulting and other NAS provided by accounting firms in that other providers of such services allege that the entrée to clients obtained by means of statutory or other regulatory requirements for audit provides an unfair advantage to accounting firms compared with non-accounting firms. Again it is extremely difficult to adduce empirical evidence to support this contention. However, few of the services offered are specific either to accounting firms or non-accounting firms. In the absence of economic evidence on the benefits of the provision of NAS to clients (an issue discussed further below), it is unclear whether there would in fact be costs either to society or to accounting firms if such provision was prohibited. If accounting firms are indeed currently competing on a level playing field with other providers of NAS (and audit clients are purchasing NAS for genuine economic reasons) then one would expect a redistribution of the existing pool of audit client NAS between accounting firms. If the playing field is not level then other service providers would gain at the expense of accounting firms but it is far from clear that this would be economically inefficient.

2.2 Arguments for the provision of non-audit services to audit clients

In seeking to protect their freedom to provide NAS(A), the accountancy firms and the accountancy profession in both the UK and the US have, over the years, marshalled an impressive array of arguments both diverse and overlapping. A number of these are summarised below under the following headings: the wider economic benefits; enhanced audit quality; a lack of evidence of user concern; a lack of evidence of adverse economic impact; a lack of evidence of association between the provision of NAS and audit failure; the role of professionalism; reputation effects and economic sanctions; and the impact on recruitment to the accounting profession.

⁵⁰ Andersen appear to have been well aware of the limits to which Enron was pushing accounting practice. With reference to nine identified high-risk practices, a 1999 note by the engagement partner prepared for briefing the Enron Audit Committee stated: 'Obviously, we are on board with all of these, but many push limits and have a high "others could have a different view" risk profile.' (US Senate, 2002, p17).

⁵¹ 'As the auditor becomes increasingly involved with the audit client and its managers, the auditor is more likely to perceive himself as part of the management team and place less emphasis on his or her primary loyalty to investors.' (SEC, 2000).

2.2.1 Wider economic benefits

The very rapid expansion in NAS(A) may be seen as having been indicative of real economic benefits arising from the joint provision of such services because of economies of scope. These economies of scope are normally characterised as knowledge spillovers (Simunic, 1984). To intervene in the market by prohibiting the provision of NAS(A) would then reduce economic efficiency.

Although the success of accounting firms in marketing NAS to their clients in the 1980s and 1990s was undoubted and demonstrated by the rapid growth in fee income deriving from such services over that period, the exact nature of the relevant economies of scope/knowledge spillovers is perhaps less easy to establish. Antle et al. (1997) suggest that:

'Because auditing, tax work and consulting generate knowledge of clients' organizations, processes and problems, it is intuitive that there exist economies of scope in auditing and these non-audit services ... While quantitative estimates of economies of scope are not available, the success of accounting firms in competing in consulting markets is testimony to their existence.'⁵²

However, empirical research has found it difficult to pin down these advantages in terms of reduced audit fees associated with a higher level of NAS – indeed the majority of pricing studies suggest that firms which purchase a high level of NAS from their auditors pay rather more than average for their audits (Ezzamel et al., 1996). Ezzamel et al. (2002) suggested that this positive association may be explicable in terms either of client-specific differences, for example, organisational complexity, 'or of events giving rise to the purchase of more audit and non-audit services rather than in terms of direct economic linkages between the cost functions for audit and non-audit services'.⁵³ While definitive interpretation of the empirical evidence is fraught with complications, given that audit is generally considered to be a service with an inelastic demand,⁵⁴ the existence of a positive association between the pricing of audit and non-audit services provides little, if any, support for the argument that there are extensive economic benefits arising from joint provision of audit and non-audit services.

2.2.2 Enhanced audit quality

A linked argument, albeit one at a slight remove, is that the provision of NAS enhances the auditor's knowledge base and enables them to carry out a better quality audit. Whereas professional writers and the professional bodies have focused on independence as a mental construct, others, for example, Wolnizer (1987), Power (1997, 2000), have identified the need for auditors to have a knowledge base, whether pre-existing or as a result of search and evidential enquiry, which enables them to form an independent opinion on the quality of financial reporting. In the absence of such knowledge an audit is likely to degenerate into no more than an acceptance of management representation and be of correspondingly little value. As business activity becomes ever more complex as a consequence of globalisation and expansion of markets for services and products,⁵⁵ then it is the provision of NAS which both adds value to the client and provides the auditor with the essential understanding of the mode and nature of the client's activities, an understanding which will underpin the audit opinion.

Such a viewpoint fitted comfortably within the portrayal of 'business risk audit' as a value-adding activity situated within the client's overall risk management strategy, with a focus on the overall control and corporate governance environment, knowledge of the business and a key assessment of management integrity (see Lemon et al. 2000), and also within the framework of assurance services and consulting as a continuum with few defining break points (see Jeppesen, 1998; Boritz and Cockburn, 1998). There is no doubt that in many cases the provision of NAS will enable the auditor to have a clearer understanding of the nature of the client's activities and financial transactions. In Enron, the fact that Andersen provided extensive NAS relating to the setting up of a number of the key off-balance-sheet vehicles which were used to manipulate the financial statements clearly provided them with knowledge of the relevant transactions⁵⁶ – but in the end this did not lead to a higher quality audit. More generally, although the interface between a wider range of service provision and enhanced knowledge of the client's business is intuitively persuasive, as suggested by Antle et al, there is little empirical evidence as to how this translates into better quality auditing.

⁵² pii.

⁵³ p13.

⁵⁴ This refers to a situation where the demand for a product or service is relatively unaffected by changes in the price of that product or service.

⁵⁵ For example, the enormous growth in the markets for financial derivatives and for contracts and trading in the future supply of energy and related services (as pioneered by Enron).

⁵⁶ See the Powers Report (Powers et al., 2002) 'Andersen billed Enron \$5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.' (p5) and 'Andersen's total bill for Raptor-related work came to approximately \$1.3 million. Indeed there is abundant evidence that Andersen in fact offered Enron advice at every step, from inception through restructuring and ultimately to terminating the Raptors.' p132.

2.2.3 Lack of evidence of user concern

Review studies by Orren (1997) and Kinney (1999) both concluded that the North American literature suggests that financial statement users, at that time at least, did not share the concerns of regulators about the effects of the provision of NAS(A).⁵⁷ This conclusion was reached notwithstanding the fact that a number of early empirical studies found that as the level of NAS provision increased, the level of user confidence in auditor independence decreased (Lindsay et al., 1987; Pany and Reckers, 1983, and Reckers and Stagliano, 1981). Moreover, subsequent studies by Beattie et al. (1999) and Canning and Gwilliam (1999) of UK and Irish financial statement users respectively both suggested that increasing levels of fees from NAS can impair the perception of auditor independence.⁵⁸ More recently Dart (2011) also suggested that UK investors expressed increasing concern about the quality of audit when there was significant provision of NAS. This mirrors an earlier US attitudinal research study conducted on behalf of the Independence Standards Board (Earncliffe Research & Communications, 2000) which did suggest concerns among North American financial statement users about the continuing evolution of auditing firms into multi-disciplinary professional services⁵⁹ and the SEC heard a depth of evidence of user concern as it deliberated ahead of its November 2000 rule changes (SEC, 2000). This study was carried out before Enron and it is likely that this cause célèbre would have given rise to a significant shift in perceptions and enhancement of concern.⁶⁰

2.2.4 Lack of evidence of adverse economic impact

Evidence that high levels of provision of NAS(A) has direct economic effects is similarly sparse. Studies into the reaction to the SEC-required disclosures between 1978 and 1982 showed little evidence of changes in the pattern of purchases of NAS (Scheiner and Kiger, 1982; Scheiner, 1984) or of any impact on shareholder auditor approval ratios (Glezen and Millar, 1985). Subsequently, Antle et al. (1997) found no evidence that the pricing of auditor liability insurance to the then Big Six firms was affected by the level of provision of NAS by the individual firms and concluded that, 'because the insurers have such an obvious and direct monetary interest in such matters, this is evidence that the supply of non-audit services has not damaged auditor independence'.^{61 62}

Early empirical work in this field was restricted by the lack of disclosure of data for audit and non-audit services in the US. Those studies using publicly-available data which took place outside the US focused primarily on the interaction between the pricing of audit and non-audit services – the majority suggesting, perhaps perversely as noted in 3.2.1, a positive interaction between the audit price and the extent of the provision of NAS. However, as noted in the Appendix, subsequent to the introduction of the US disclosure requirements there has been an upsurge in empirical interest in the US. To take just one example, an early post-disclosure study by Frankel et al. (2002) based on more than 4,000 proxy filings found a negative market reaction to proxy statements filed by firms reporting higher than expected NAS fees. The study also found there was a relationship between the level of non-audit fees and the extent of earnings management. Firms purchasing more NAS from their auditor were more likely to meet earnings benchmarks and to report large discretionary accruals. However, again as discussed in more detail in the Appendix, subsequent US studies have contested these findings. In the UK the evidence has been more mixed, for example, Gore et al. (2001) found there to be evidence that earnings management activity to avoid losses and earnings decreases was positively associated with the scale of provision of NAS for companies with (then) non-Big Five auditors but not for companies with Big Five auditors. Earnings management to meet analysts' forecasts was positively associated with the extent of NAS provision irrespective of whether the auditor was Big Five or not.

⁵⁷ Orren states 'Most studies have found that non-auditing services have minimal effects on the appearance of auditor independence. These studies also show that people with greater knowledge about the auditing profession are less concerned about the potential threat of non-auditing services on auditor independence'. (p1).

⁵⁸ Another UK study by Brand Finance (2000) found that 94% of analysts surveyed (who expressed an opinion) and 76% of company representatives surveyed (who expressed an opinion) considered that significant levels of NAS provision were likely to compromise independence.

⁵⁹ It also illustrates how quickly perceptions can change, a key finding of the study being that: 'Interviewees felt very confident and satisfied with the general standard of financial reporting in the US.' It is perhaps unlikely that had the study been conducted a year or two later the findings would have been identical.

⁶⁰ And post-Worldcom where disclosed non-audit fees of \$12m were apparently three times the audit fee of \$4m.

⁶¹ p25.

⁶² The SEC rejected this argument: 'we do not believe as urged by at least one commentator, that liability insurance premiums are a barometer of the extent to which non-audit services pose a risk to audit quality', on the grounds that a very wide range of other factors affected the setting of liability insurance premiums, (SEC, 2000).

2.2.5 Lack of evidence of association between the provision of non-audit services and audit failure

It is frequently argued that there is little, if any, direct empirical evidence linking the supply of NAS(A) with audit failure⁶³ and it was the lack of identification of such a link which in part influenced the Cohen Commission not to recommend prohibiting NAS(A). Antle et al. (1997) suggested that independence concerns are raised in a very small number of legal actions against auditors, with yet fewer specific references to NAS in these actions. Others have suggested that the establishment of such a link in individual cases is likely to be problematic because the nature of conscious or unconscious influences on an auditor's judgement is unlikely to be documented in a manner that provides incontrovertible evidence of an association.

Put simply, an auditor is not going to make a file note which says that a particular accounting treatment is acceptable because the client is such a valuable source of NAS fee income or that systems weaknesses should be ignored because the accounting firm advised on systems installation. As the US Public Oversight Board noted a year after the publication of the Cohen Report: 'specific evidence of loss of independence through MAS [management advisory services], a so-called smoking gun, is not likely to be available even if there is such a loss'.⁶⁴ (POB, 1979)

This issue was considered at length by the SEC which took the view that 'the asserted absence of conclusive empirical evidence on this point is not particularly telling',⁶⁵ and that in any case the role of the regulator was to act in a prophylactic manner and if NAS provision was considered to be a threat to auditor independence and audit quality then action should be taken before that led to actual audit failure. On this latter issue it set out its position thus:

'The Commission's obligations to protect investors requires it to act before there has been a serious erosion of confidence in our nation's securities markets. Our position is quite different from that of the CEO of an accounting firm that we should wait to adopt restrictions on non-audit services until there has been "a train wreck or stock market crash". Our mission is not to pick up the pieces of such a "train wreck" but to prevent one.'⁶⁶

2.2.6 The role of professionalism

The traditional professional view of auditor independence was that set forward by John Carey (a former AICPA Executive Director) in 1946:

'Independence is an abstract concept, and it is difficult to apply either generally or in its peculiar application to the certified public accountant. Essentially it is a state of mind. It is partly synonymous with honesty, integrity, courage, character. It means, in simplest terms, that the certified public accountant will tell the truth as he sees it and will permit no influence, financial or sentimental, to turn him from that course.'⁶⁷

An interview-based research study carried out on behalf of the AICPA (Burke, 1997) provided some support for the notion that the traditional professional values represented by this quotation continued to be important within accounting firms. He stated:

'There appears to be a strong norm both within these firms and throughout the profession, for maintaining independence as a means of providing clients with the best possible audit service and, in the larger scheme, providing financial statement users with the most accurate information with which they can make decisions. It would seem then, that auditors who uphold the norms of objectivity and independence will be recognized, to a large extent, informally by their peers and their supervisors, and to a somewhat lesser extent, perhaps, by their profession, for their contribution to supporting what are the underpinnings of our free market economy.'⁶⁸

Others are more sceptical and would argue that, as over the years the importance and influence of the professional accounting associations has diminished whereas that of the multi-national accounting firms has increased, traditional professional attitudes and values have all but disappeared (Zeff, 2003a,b). Their place has been taken by an attitudinal set with a heavy emphasis on short-term economic considerations. They would point to a culture and framework in the large firms of management by objectives focused primarily on continuous earnings growth.⁶⁹ The importance of the firms in imparting values and professional attitudes in the UK was seen in a study of large firm trainee accountants (Anderson-Gough et al., 1998) which concluded that their subjects' notions of professionalism were largely negotiated by the organisation for

63 For example, 'there is no empirical evidence to support the notion that providing non-audit services to audit clients has any adverse effect on the quality of audit.' (Letter from Deloitte & Touche to the SEC hearings September 2000, SEC, 2000).

64 POB (1979, at 34 n.103).

65 SEC (2000).

66 SEC (2000).

67 Quoted in Pitt and Birenbaum (1997, p13).

68 p5.

69 See Dirsmith et al. (1997).

which they worked and it is perhaps unlikely that this has changed significantly since. Another source which provides a review of the literature relating to issues of acculturation and socialisation within the professional firms can be found in Brierley and Gwilliam (2001).

2.2.7 Reputation effects and economic sanctions

Professional considerations apart, there are economic incentives acting to maintain auditor independence. Economic models suggest that firms will give up apparent short-term gains from non-independent behaviour to build up their reputation over the longer term, which will in turn bring future economic returns (see Watts and Zimmerman, 1981). As the firms grow in size the penalties attached to the discovery of non-independent behaviour increase because there is more reputational capital at risk (Wilson and Grimlund, 1990). Antle et al. (1997) noted that partners' financial capital in each of the then Big Six firms in the US at the end of 1996 exceeded \$3.5bn – all of which could be put at risk if a firm engaged in non-independent behaviour. They also highlight the importance of actual and potential litigation against accounting firms in providing powerful incentives for firms to avoid systemic independence violations. They conclude:

'Taking a holistic view, we have found that auditors have many incentives to protect their independence. Legal liability is significant, and any firm that would damage its independence risks an avalanche of litigation. Auditors have substantial investments in reputations, audit technology and methodology and directly in their financial stakes in accounting firms.'⁷⁰

In many ways the fate of Andersen **post**-Enron illustrates very clearly the risks attendant to non-independent behaviour. On the face of it, it is likely that the collapse of Andersen would have significantly influenced the attitudes and actions of partners in the remaining large firms whether or not the ensuing enhanced regulation was put in place. However, it is by no means clear that reliance upon economic forces alone is necessarily the most efficient mechanism for maintaining auditor independence. To a greater or lesser extent, over the last 25 years all the large firms have been drawn into accounting and auditing cause célèbres. None of these **pre**-Enron appeared to have any but the most marginal effect upon the standing and growth of the firms.

Post-Enron events also do not support the view that significant, potentially catastrophic, future risks associated with current behaviour will necessarily act sufficiently as a deterrent to business practices which predominantly focus on present gains. As an example, in 2005 KPMG narrowly avoided criminal indictment in the US (and thus possibly sharing the fate of Andersen) over fraudulent conduct involved in the sale of illegal tax shelters over previous years, by paying a \$456m penalty and meeting a number of additional conditions imposed by the US Justice Department. In fact all the large firms have been exposed to a number of actual, or alleged, high-profile auditing failures – but this has had little, if any, effect on their market dominance. At a slight remove it is also true that the nature of the audit service is such that it can take a long time, if ever, before sub-standard auditing is exposed to the light of day and in such circumstances the short-term pressures on accounting firms, and more particularly on individual partners and managers, may again result in an unacceptable level of non-independent behaviour.

Research into actual judgement and decision-making of accountants and auditors from a behavioural perspective is reviewed in more detail in Chapter 3 – but this research would appear to indicate that, on occasion at least, consideration of long-term incentives acting to maintain auditor independence can be trumped by an emphasis on short-term gains regardless of the negative impact such a focus can have on future costs. This directly conflicts with traditional economic models which suggest that firms (and individuals) will give up apparent short-term gains from non-independent behaviour to increase returns over the future.

2.2.8 Recruitment to the accounting profession

An argument which has been advanced by professional bodies and accounting firms on both sides of the Atlantic is that if accounting firms were not in a position to provide NAS then they would be unable to recruit sufficiently skilled professionals able to deal effectively with a complex business and auditing environment. A linked argument is that it is the exposure to business practices and culture which trainee and junior auditors derive from NAS work which enhances their ability to audit effectively. Although there is no doubt that these considerations are seen as important by the large firms in the abstract at least, they are perhaps difficult to sustain. There is little evidence that accounting firms had difficulty in recruiting high-calibre personnel 35 years ago when NAS were relatively much less important than they are today.

There is likewise little evidence that accounting firms operating in the US had difficulty in recruiting high-calibre personnel after the prohibition of providing a number of NAS(A) after SOX

⁷⁰ p31.

2002. One would expect market forces to determine appropriate recruitment for the, admittedly more complex, audits of today irrespective of whether accounting firms offered NAS to their clients. Furthermore, if it is exposure to non-audit work in itself (rather than the firm-specific knowledge gained thereby which is discussed above) which leads to audit personnel becoming better auditors, this could be obtained by assignments other than for audit clients. There is no doubt scope for a wider study of the manner in which the large accountancy firms have acted as a commercial training ground for such a high proportion of graduates in the UK (and perhaps to a slightly lesser extent in the US) and the implications thereof – but it is less clear that privileging a particular profession, or set of commercial entities, in the manner suggested makes rational economic sense.

3. Scepticism and the quality of auditor judgement

This chapter widens the scope of discussion beyond the consideration of direct conflicts of interest and the well-established, but largely inconclusive, arguments on joint provision to consider the larger picture and the factors which impact on the ability of the auditor to remain impartial and apply an appropriate degree of scepticism throughout an audit (APB, 2011, 2012). Clearly this is relevant to the specific debate about the provision of NAS(A) and also allows for a holistic perspective thereon and a further degree of contextualisation around the nature of the environment in which such issues arise.

The importance of scepticism to an auditor's work and independence in mind has a long history. In his seminal judgment in the Australian case *Re Pacific Acceptance Corporation Limited v Forsyth and Others* (1970) 92 WN (NSW) 29, Moffitt J provided comprehensive guidance on auditors' duties, confirming or establishing a number of important legal principles, subsequently incorporated in widely-accepted auditing standards and guidelines. Three of his recommendations would appear to be of particular importance to the current discussion.

1. The duty to audit involves a duty to pay due regard to the possibility that fraud may have occurred. The audit plan and audit tests should be structured so that the auditor has a reasonable expectation of detecting material fraud if it exists.
2. The auditor has a paramount duty to check material matters for him or herself. However, reliance may be placed on enquiries from others where it is reasonable to do so. Nevertheless, reliance on others is to be regarded as an aid to, and not a substitute for, the auditor's own procedures.
3. The auditor's duty to report includes a duty to report to shareholders at their general meeting any material matters discovered during the audit. This responsibility cannot be shirked on the grounds that it involves an adverse reflection on the board, a director, or a senior executive, or on the pretext that public disclosure may damage the company.⁷¹

These legal principles highlight the importance of attention to the potential for fraud, the need to collect sufficient and adequate evidence to support (or reject) managerial assertions, and duty to report material matters to shareholders irrespective of concerns about the effect on the client or client's board. For these key issues, a sceptical attitude is of paramount importance to auditor judgement when reviewing audit evidence and managerial assertions.⁷² The concept of 'professional scepticism' is defined in ISA 200 (para 13) as:

'An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.'

The APB (1998) provided additional insights into what the concept of scepticism entails. It observes:

'... scepticism is a personal quality that relates to the attitude of individual auditors: it is characterised by a questioning, probing – almost suspicious – approach being applied throughout the audit' (para 3.7).

71 This principle is particularly relevant for the audits of some of the biggest UK banks before the 2008–09 global financial crisis. Auditors declined to raise doubts they clearly had at the time about the ability of their banking clients to stay in business in the foreseeable future (the going concern assertion). As we now know, the survival of some of the biggest UK banks depended on massive financial support from the public purse very shortly after receiving unqualified audit reports. While the heads of the Big Four deemed in their 23 November 2010 testimony to the House of Lords (see, publications.parliament.uk/pa/ld201011/ldselect/ldconaf/119/10112301.htm) that audit report qualifications relating to managerial going concern assertions of their financial sector clients were not appropriate nor required, given the government's assurance of unlimited support for these banks in case of need, obtained in confidence by the Big Four before signing off without qualification, the Lords strongly disagreed and noted: 'A going concern qualification was clearly warranted in several cases, even if the auditors may understandably have been reluctant to make it ... [because] they might fear to do so could cause a collapse of confidence and a run on the bank, to the detriment of the shareholders and, quite possibly, of the wider public interest.' (HoL, 2011, paras 140, 147). As noted, in reference to *Pacific Acceptance Corporation Limited v Forsyth and Others* (1970) 92 WN (NSW) 29, Moffitt J dismissed – more than four decades ago – adverse reflection on the board, a director, or a senior executive, or potential damage to the company from public disclosure of auditor concerns as valid reasons for non-disclosure of auditor concerns.

72 US research has shown that the failure to demonstrate an appropriate level of scepticism was a deficiency found in 60% of the cases where the SEC brought fraud-related actions against auditors (Beasley et al., 2001). The UK's Audit Inspection Unit in its 2009/10 annual report reported that audit firms are not always applying sufficient professional scepticism in relation to key audit judgements (AIU, 2010), concerns again highlighted in the AIU's subsequent annual reports (AIU, 2011, 2012, and that of the AQR in 2013, which replaced the AIU in 2012).

More recently, the APB initiated broader discussion on the concept (APB 2010b), and in 2011 reflected further on the importance of scepticism in conducting an audit when it stated:

'The application of an appropriate degree of professional scepticism is a crucial skill for auditors.'
(ABP, 2011, para 1)

The APB (2011) expressed particular concerns about the range of understanding of the term 'professional scepticism' within the accountancy profession. While some members of the profession consider that it requires auditors to adopt a neutral position (neither assuming the entity's management is honest or dishonest, nor that the financial statements are, or are not, materially misstated), others believe it involves a more questioning approach which may be referred to as 'presumptive doubt' (APB, 2011, paras 23–24). The latter interpretation suggests a move in the concept along an imaginary continuum from auditors assuming management's honesty towards assuming dishonesty, earlier reflected in Bell et al. (2005). In shifting along a continuum towards presumptive doubt, the APB questions whether a neutral position (or even an 'inquiring mind') is an appropriate or sufficient position for an auditor to adopt, emphasising 'an element of "doubt" [underlying] a number of requirements in Auditing Standards' (ABP, 2011, para 27).

In yet further refinement of its concerns, the APB (2012, p4) analyses factors which may affect an auditor's ability to apply the necessary scepticism when conducting an audit, making particular reference to cognitive, social and psychological issues:

'The disposition to believe or disbelieve an assertion may be conditioned by many influences. These include not only the results of inquiry but also potentially the biases of the individual (whether conscious or sub-conscious) and the individual's perceptions and assessments of their self-interest. These other conditioning influences must be filtered out if objective truth is to be attained. In the context of audit judgments, it may be helpful to understand the implications of the behavioural rules ('heuristics') underlying human decision-making and judgment processes. A number of heuristics have been proposed to help explain these processes, especially in the face of complex problems or incomplete information. It is also thought that they may, in some circumstances, introduce systematic errors or biases into these processes. What is needed to counteract this is a mechanism to encourage a structured consideration of the alternative point of view. One example of such a mechanism being applied in a financial services context is "reverse stress testing". In this form of stress testing, the directors consider what it would take to make the entity fail and then assess the evidence as to the likelihood of those circumstances arising.'

The APB's 2012 discussion aims to establish a common definition and understanding of the concept, underlining its critical role in delivering high-quality audits. In line with the FRC's increased recognition of the intrusion of cognitive bias and a wide range of social and psychological factors on decision-making and its potential effect on the quality of corporate governance decisions (see FRC, 2011), the APB recognises that common behavioural factors may diminish the scepticism applied during audit and thus affect auditors' ability to maintain independence in mind, key to the provision of an impartial, objective, unbiased, and high-quality audit.

A crucial ingredient in establishing the value of an external audit, accepting the judgements made therein, and the quality of the ultimate audit opinion, is evidence of an auditor's recognition of factors which may affect judgement during the audit and the implementation of procedures which diminish the impact of bias. An underlying assumption of much standard setting has been that the auditing process can be impartial and free of bias (Prentice, 2000a,b; Bazerman et al., 2002; Moore et al., 2003; Marnet, 2008). Presumably, this can be achieved if an auditor of 'good standing', 'watches out' for potential conflicts of interest and bias, and tries 'hard enough' to be neutral. Perceptions of repeated failures of the auditing process disturbed this idealised picture and have given rise to a degree of cynicism about the accounting profession's ability to remain impartial during audit. It would certainly be desirable for auditors to live up to the rationality ideal as outlined in the conventional model of economics. However, limitations on information and processing capacity, the use of heuristics and resulting bias are especially pronounced in the complex and variable environment in which auditors operate.⁷³ Since '... judging and deciding are inherent in every phase of the audit process...'⁷⁴ an auditor would appear to be the classic decision-maker under uncertainty. This is especially true in light of '... the general tendency to view the entirety of GAAP... as laws or rules to be interpreted and manipulated, rather than applied in a spirit of professional judgment', (Hendrickson and Espahbodi, 1991, p26).

⁷³ 'The audit process and its environment are complex and variable. An audit takes several months to complete and is itself part of an ongoing process incorporating past audits, intervening events and expectations about events that may occur subsequent to the audit.' (Gibbins and Wolf, 1982, p107).

⁷⁴ Solomon and Shields (1995, p139); also, 'auditors express opinions based on investigations that, no matter how thorough, inevitably involve subjective judgments.' (Hogarth, 1991, p277). Jiambalvo and Wilner (1985) find that there is often substantial disagreement among trained auditors regarding the proper outcome for a particular problem.

Accounting uncertainty has been found to negatively impact auditor objectivity, despite potential damage to auditor reputation from such uncertainty (Mayhew et al., 2001). Uncertainty may motivate auditors to agree with clients' interpretations (Hackenbrack and Nelson, 1996), and the tendency towards clients' interpretation has been found particularly pronounced where prior evidence was mixed (Salterio and Koonce, 1997).

Auditors tend to satisfice (Simon, 1955) – a decision-making strategy or cognitive heuristic that entails searching through alternatives until an acceptable threshold is met – rather than optimise in the sense of the rational actor. This might be inconsistent with a Bayesian application of probability, but is entirely rational from a cognitive cost-benefit perspective as it economises on the cost of analysis (Asare and Wright, 1997; Gigerenzer and Todd, 1999). Auditors use mental rules of thumb, or heuristics, to guide them, even when objective methods could be more effective (McDaniel and Kinney, 1995; Asare and Wright, 1997). Auditors have been found to use a number of specific heuristics, including the representativeness heuristic (Uecker and Kinney, 1977; Smith and Kida, 1991; Kellogg and Kellogg, 1991), anchoring and adjustment (Joyce and Biddle, 1981a,b; Bonner and Pennington, 1991; Bedard and Wright, 1994; Hirst and Koonce, 1996), and availability (Bonner and Pennington, 1991; Haynes and Kachelmeier, 1998).

Auditors are subject to cognitive dissonance and escalation of commitment (Weick, 1983). Auditors display a strong tendency to seek and use confirmatory rather than disconfirmatory evidence (Waller and Felix, 1984), and to self-rationalise decisions (Peecher, 1996). Memory is critically important to avoiding audit errors, and overconfidence in their memories can lead auditors to commit reckless errors by failing to check working papers before reaching conclusions (Ramsay, 1994). General audit experience may not improve memory tasks (Johnson, 1994). Compounding this, there seems to be little correlation between auditors' confidence in their ability to make going-concern judgements, and their accuracy in actual judgements (Kida, 1984). This reflects overconfidence in their own abilities (Kent and Weber, 1998) and possibly also in self-perceptions of ethics (Cohen and Trompeter, 1998). Tax professionals (including accountants) have been found to be highly susceptible to biases toward their clients' preference (Kahle and White, 2004). Auditors' risk-taking tendencies have been found to generally conform to the predictions of prospect theory (Kahneman and Tversky, 1979) with regard to risk preferences, where a decision maker tends to be risk-averse in a gain situation and risk seeking in a loss situation (Jegers, 1991; Schisler, 1994; Cohen and Trompeter, 1998). Affective reactions can somewhat reverse this behaviour of risk avoidance (seeking) in gain (loss) contexts, indicating that such contextual variables may have a significant influence on risky behaviour (Moreno et al., 2002).⁷⁵

As the result of selective interpretation of ambiguous information that goes into a financial report, and the weight of earlier interpretations, an auditor's judgement is almost certainly biased in favour of their own and clients' interests (Bazerman et al., 1997; 2002; Moore et al., 2003).⁷⁶ Self-serving bias in an auditing setting can be exacerbated by a number of factors. These include the distance and anonymity between the potential victims of misrepresentation and the auditor, as opposed to the closeness and familiarity of the people in the client firm who could be adversely affected if a negative audit opinion were issued. Also, repercussions from a negative opinion are likely to be immediate and substantial, as opposed to the temporally distant and only potential negative repercussions from having made a misstatement, a circumstance that leads some authors to dismiss the view that the potential or actual loss of reputation is a reliable deterrent to fraudulent or negligent auditing (Prentice, 2000a).

Bias can be strictly separated from motivation, though motivation may subsequently contribute to further selective perception and skewed judgement. The mere proximity to the client is sufficient to introduce bias in perception, interpretation and judgement of the professional, which can result in audit interpretations favourable to the client (Zajonc, 1968; Moore et al., 2003). Subsequent pressures to self-justify initial acceptance of accounting interpretations (and concerns about repercussions from admitting to earlier errors in judgement) tend to lead to yet closer affiliation with the client's view. Hence, while it may only involve small steps from initial cognitive bias to self-serving motivation and finally to fraudulent behaviour, bias affect audits before any motive and intent for fraud enters the equation. This is in stark contrast to the assumption of deliberate intent by individuals of rational choice theories (see Marnet (2008) for an overview),

⁷⁵ Affect refers to the experience of feeling or emotion. The affective domain represents one of the three divisions described in modern psychology: the cognitive, the conative (natural tendency, impulse, striving, or directed effort), and the affective. Moreno et al. (2002) find that subjects reject decision alternatives which elicit negative affect in favour of alternatives which elicit positive affect. Subjects appear to consider both financial data and affective value when considering alternatives, even if this is at the cost of economic value. This indicates that decision behaviour may be the result of a complex interaction between default strategies (such as prospect theory), the decision context, and affective reaction.

⁷⁶ Bazerman et al. (2002) and Moore et al. (2003) argue that very little association with a client is required to produce biased judgements and identify a number of structural aspects of accounting which encourage biased judgement: ambiguity, attachment and approval. Socio-psychological factors including familiarity, discounting, and escalation contribute to the bias introduced by these structural aspects. Seminal research into the psychology of human judgement suggests that judgement, including that of auditors, is typically subject to heuristics and biases and that it is near impossible to sufficiently adjust for the distortions from cognitive bias, even where its existence is recognised and efforts are made to actively adjust for the effects (Kahneman and Tversky, 1979, 2000; Gilovich et al., 2002; Bazerman et al., 2002; Moore et al., 2003).

and policymaking and legal practice based on its predictions. Bias affects the perception and cognitive processing stages long before any conscious choice takes place. Traditional economic theory generally assumes that choice is a process of consciously weighing the costs and benefits of an event or decision. While this may be the intention of an individual, and can certainly form one part of the choice-making process, biased perceptions and information processing would appear to influence this process long before (as well as during) such deliberations. Impartiality is difficult to achieve, some would say impossible, as all individuals are biased towards their own interests or prejudices, heuristics are hard wired into the human mind, and judgement is affected by proximity to peers and clients. While an auditor may indeed be of very high integrity and consciously strive towards providing judgements that are 'true and fair', cited behavioural research points to the difficulty of escaping bias and heuristics that skew perception.

Current legislation may not sufficiently consider impartiality in the audit process. SOX 2002, for example, aims primarily at fraud but fails to address strongly the problem of bias.⁷⁷ It is not obvious how unconscious bias would be deterred by the threat of increased punishment (Bazerman et al., 1997; 2002; Moore et al., 2003), which is reflected in the following opinion: '... a growing consensus that the law must do something more (or different) than simply relying on its conventional strategy of vicarious corporate liability in order to induce good monitoring' (Langevoort, 2001, p2). There is no reason to assume that stronger penalties alone would deter activities where deterrence has failed in the past, as a gatekeeper can be expected to rationalise (ie, distort the objective interpretation of) their own actions to comply with accepted norms, and may downplay potential risk from penalties with a frequently observed focus on perceived short-term gains that ignores potential long-term costs. In other words, if an agent perceives him/herself to have done no harm, penalties will not be seen to apply to any of their actions.

The problem for policymakers is how to minimise the unconscious biases the auditor is subject to in everyday dealings with clients, and at the same time enhance the impact of rules on more conscious and motivated bias, and fraudulent intent.⁷⁸ The intrusion of bias in the client working relationship would appear to be inevitable, and operate even in the absence of financial incentives and motivation. This would make auditor impartiality a virtually impossible ideal (Bazerman et al., 1997, 2002; O'Connor, 2002; Moore et al., 2003), and suggests the need for instruments to actively counter bias, including periodic auditor rotation (at partner and at firm level), increased independent review of an auditor's work, and measures to diminish the financial dependence of auditor on client, in addition to procedures that challenge the quality of the decision-making process (FRC, 2011).

More recently, regulators in the UK have noted the effects of social and psychological factors on the judgement and quality of decision-making of agents in governance (see, for example the FRC's 'Guidance on Board Effectiveness', 2011).⁷⁹ In its focus on scepticism as the cornerstone of audit quality, the APB (2012) highlights that the quality of audit judgement ultimately defines audit quality – and sets out conditions necessary for auditors to demonstrate the achievement of an appropriate degree of professional scepticism. In making reference to heuristics and biases in its discussion, the APB (2012) goes significantly beyond established analyses that focus on reliance on professional conduct and standard measures of auditor independence.⁸⁰ Instead, the APB (2012) suggests that auditors critically appraise managerial assertions by actively looking out for risks of material misstatements, and encourages the design of audit procedures which consider whether there is any evidence that would contradict management assertions (rather than consider the extent to which management has provided evidence that is consistent with them). This recognises the auditor's susceptibility to heuristics and biases, and suggests the need for the systematic use of procedures designed to pre-emptively counter and mitigate the effects of bias on auditor judgement and quality of decision-making, before and during engagement and in the final review, in order to enhance the reliability of expressed audit opinion and its value to users of financial statements.

77 With regard to auditor independence, see SEC (2001), *Final Rule: Revision of the Commission's Auditor Independence Requirements*; and SEC (2003), *Strengthening the Commission's Requirements Regarding Auditor Independence*. These, among others, define and detail cooling-off periods of one year before a member of an audit team can join a client firm in certain key positions; list categories of prohibited non-audit services; mandate partner rotation; and enhance various disclosure and certification requirements.

78 Independence issues may be aggravated by increased competition in the auditing industry, particularly by the increase in importance of NAS provided by accounting firms (Macey and Sale, 2003).

79 See the 'Guidance on Board Effectiveness' (FRC, 2011), section 3 'Decision Making' on factors which can lead to flawed decision-making by individuals and groups charged with corporate governance and tentative suggestions for means to minimise the risk of poor decision-making by designing policies and procedures aimed at mitigating the impact of bias.

80 ISAs which critically depend on auditor scepticism, include, but are not exclusive to: ISA 200, 220, 240, 315, 330, 505, 520, 540, 550, 570, 700.

In summary, firms, auditing practitioners, regulators and policymakers may wish to bear in mind the persistent effects of cognitive bias when drafting and implementing audit rules and regulations aimed at enhancing the usefulness of audit reports. This is particularly relevant as fraudulent intentions and a desire to deliberately mislead are not necessary ingredients for the provision of false, incorrect, or grossly misleading audits, at least not initially, although the presence of such factors may, of course, make this more likely.

4. Conclusions and policy perspectives

4.1 Concluding remarks

This review has sought to present a broad oversight of current research and policy concerns in order to stimulate discussion about whether the provision of NAS(A) should be further restricted, as has been suggested by a range of commentators and actual or quasi-regulatory bodies – or, alternatively, whether the market should be allowed to develop freely in the absence of regulatory intervention. As noted above, the report does not claim to present a fully comprehensive analysis of the range of literature available, nor has it sought to conduct direct empirical enquiry into the views and perspectives of practitioners and stakeholders, although there is reflection on the findings of previous research studies which have sought to provide such evidence, and the study is also informed by interaction between the authors and a number of relevant stakeholders over time.

Separate discourses exist about the suitability of the provision of NAS(A). The providers of such services, and others, offer an essentially two-stranded, if interlinked, explication and justification for the provision of such services. The first strand is overarching and embedded in the rationality of the marketplace – if customers ie, the clients, do not want such services and do not see them as adding economic value, why would they buy them? The second strand, which to an extent underpins this notion, albeit indirectly, provides glimpses of why the market might value such services. This second strand of argument is set out in the following paragraph.

Changes in audit methodologies reflect, to an extent, changes in technology, relative costs, the nature of financial reporting and perceptions of the auditor's role etc. In recent years the major audit firms have, to an extent, taken the position, some more forcefully than others, that the accounting technology and internal control systems of their large clients are of a standard such that the purpose or value in conducting the type of detailed transactions- or systems-based audit that used to take place has been lessened. The audit emphasis has shifted towards a still-greater focus on the judgemental aspects of audit – the quality of these judgements will be enhanced if the auditor has greater knowledge of the business and the risks of the client. As such NAS have been seen as symbiotic in that they both assist the auditor to come to the appropriate audit judgement while at the same time providing an added-value role within the overall assessment and management of risk for the benefit of the company and its stakeholders.

The other discourse, which tends to support the restriction, if not complete prohibition of such services, acknowledges the possibility of significant gains to audit knowledge from the provision of services beyond audit but its primary emphasis is on the significant dangers in terms of enhanced threats to auditor independence, threats which may outweigh any perceived benefits from an integrated audit approach. One such example, which has been discussed more than once above, might serve to encapsulate the two different approaches. There is no doubt that the provision of extensive consulting services, in particular in relation to accounting issues, provided significant spillover benefits to Enron's auditors. Although not necessarily aware of every detail of Enron's manipulations, it is incontestable that Andersen was in possession of detailed information about the financial engineering that was taking place. Such information is likely to have been costly and time consuming to obtain if Andersen was not acting in a consulting capacity. However, few would argue that this led to a superior quality audit – as auditors Andersen willingly accepted, and very possibly proposed, a whole range of accounting treatments at the limits of US GAAP. These treatments taken together turned the financial statements into a meaningless farrago and rendered the audit opinion thereon worthless. It is true, with the benefit of hindsight, the quite extensive note disclosures – many of which appear to have been at the behest of Andersen – should have been given more attention by analysts and others, but they were not. Enron might provide some supportive evidence for the second line of argumentation discussed above, although there is scant evidence that Andersen's consulting activities went far beyond the financial statements and therefore contributed little in terms of added value, in terms of the management of risk, or in terms of limiting Enron's latter-day involvement in a whole string of projects which were cash consuming and offered negative net present value. A single example does not prove a general case, but it is understandable that from a policymaking perspective,

regulators and others interested in the quality of external audit might question whether the professionalism and/or the economic self-interest of individual auditors and audit firms can be relied upon to deliver that quality within the context of the modern approach to audit.

Linked in to both discourses are issues about whether professional values will in themselves be sufficient to ameliorate, or even obviate, concerns over lack of independence and the impact on audit quality, and here again there are differing views. As we have seen, some commentators do place their confidence in professional values to ensure that auditors will deliver that quality (Burke, 1997). Others remain more sceptical and argue that as, over the years, the importance and influence of the professional accounting associations has diminished, a trend that accelerated with the re-regulation of audit in the wake of the Enron scandal, traditional attitudes and values have all but disappeared. There is little doubt about the importance of the firms in imparting values and professional attitudes. Again we have referred earlier in this report to the large-scale study of major firm trainees in the UK (Anderson-Gough et al., 1998) which concluded that their subjects' notions of professionalism were largely negotiated by the organisation for which they worked. This finding is supported by a wide-ranging review of the relevant literature, primarily US in origin (Brierley and Gwilliam, 2001) – a review which suggested that traditional notions of professionalism were competing with more short-term economic incentives in terms of earnings growth, client retention and individual career aspirations.

Professional considerations apart, to return to the underlying economic arguments, we have noted there are economic incentives that act to maintain auditor independence. Economic models suggest that firms will surrender apparent short-term gains from non-independent behaviour so as to build upon their reputation over the longer term, which in turn will bring greater future economic returns (Watts and Zimmerman, 1981). As the firms grow in size the penalties attached to the discovery of non-independent behaviour increase because there is more reputational capital at risk (Wilson and Grimlund, 1990). Antle et al. (1997) too highlighted the importance of actual and potential litigation against accounting firms in providing powerful incentives for firms to avoid systemic independence violations. They concluded:

'Taking a holistic view, we have found that auditors have many incentives to protect their independence. Legal liability is significant, and any firm that would damage its independence risks an avalanche of litigation. Auditors have substantial investments in reputation, audit technology and methodology and directly in their financial stakes in accounting firms.' (p31)

It is unfortunate, however, that the assumption that people will consistently behave in ways that maximise the mathematical construct of expected utility is at odds with a large body of evidence from psychology and behavioural research – much of which is discussed in the context of audit in Chapter 3.⁸¹ Applications of the latter approach to the work of auditors and other agents in corporate governance demonstrate that individuals and firms can systematically behave in ways which run counter to their own best interests and to the rational model of traditional economics underlying much of existing regulations and legal decisions (Prentice, 2000a,b; Coffee, 2001, 2003; Marnet, 2008).

Auditors' judgement has been found to be affected by heuristics and biases, which invariably influence their decision-making and impact on their objectivity and independence (Prentice, 2000a,b; Bazerman et al., 2002; Moore et al., 2003; Marnet, 2007). As noted in a review of the importance of scepticism to an auditor's work by the APB (2012), cognitive biases (whether conscious or subconscious) are likely to affect an individual's perceptions and assessments, and interfere with the attainment of objective judgement, particularly in the face of complex problems or incomplete information which require judgement under uncertainty. Cognitive bias has the potential to introduce systematic errors to decision-making during audit (Bazerman et al., 2002; Moore et al., 2003). A diminished degree of scepticism (APB, 2012), and associated impacts on the quality of audit, is just one manifestation of the effect of bias on judgement induced by a greater stream of revenues from the joint provision of NAS.

In many ways the fate of Andersen post-Enron illustrates very closely the risks attendant to non-independent behaviour. As noted above, it is likely that the collapse of Andersen would have influenced the attitudes and actions of partners in the remaining large firms irrespective of the subsequent changes in regulation. But again, as has been discussed above, it is by no means clear that reliance upon economic forces alone is the most efficient mechanism for maintaining auditor independence. As noted, all the large firms have been drawn into accounting and auditing causes célèbres, to a greater or lesser extent over the past 30 years, with any but the most marginal effect upon the standing and growth of the firms pre-Enron, although Laventhol & Horwath, then the seventh biggest US accounting firm, was forced into bankruptcy in late 1990 as the result of settlement of litigation claims (Stiner, 2010). The raft of actual or potential claims against large

81 See Jolls et al. (1998), Thaler (2000) and Rabin (2002) for an overview of this literature.

accounting and audit firms post-Enron may have had some reputational effects but it is difficult to identify a clear economic impact from these either at the individual firm level or across categories of firms.⁸² The nature of the audit service is such that it can take a long time, if ever, before sub-standard auditing is exposed to the light of day and in such circumstances the short-term pressures on accounting firms, and more particularly on individual partners and managers, may again result in an unacceptable level of non-independent behaviour. It is also the case that the legal environment within which the accounting and auditing firms have operated and continue to operate, in the UK at least, has not been a particularly hostile one (Gwilliam, 2004).

Although it is not within the scope of this study to delve deeply into the extensive literature which focuses on issues of auditor liability – and associated issues related to indemnity insurance – a possible policy implication is that if it is not thought worthwhile to grasp the nettle and severely restrict (as recommended by Canning and Gwilliam (2002), among many other commentators) or broadly prohibit the provision by auditors of NAS(A) (as implemented, partially, by SOX 2002; then suggested by the European Commission in 2011 and implemented, partially, in the EU's audit reforms adopted in April 2014), then this might point to the necessity of establishing a legal environment within which parties that have suffered as a result of inadequate auditing have a realistic chance of redress through the courts.

Numerous empirical studies, both quantitative and qualitative, have attempted to determine whether the joint provision of audit and non-audit services affects auditor independence but, as noted earlier, and again in the Appendix, findings to date have been mixed and inconclusive. There is fairly robust, but not unchallenged, evidence suggesting perceived independence to be impaired by joint provision but less robust evidence on how this impacts on the actuality of audit performance. The authors' perspective, which too is capable of challenge, is that it is time to accept evidence from research on human judgement formation which suggests that joint provision will inevitably impair auditor independence to a degree. In such circumstances the only fail-safe solution to avoid actual or potential conflicts of interest would be the prohibition, or very significant restriction, of the provision of NAS, thereby removing the perception and possibly the actuality of self-serving bias.

However, there are arguments which suggest that the costs of such loss of independence may on occasion be outweighed by economic benefits and the authors would accept that there are specific situations when the provision of such NAS might be beneficial from an economic perspective. Here there are nuances. An immediate post-Enron prohibition from SOX 2002 – and one which has de facto, if not de jure, been followed in the UK – was the prohibition of the audit firm supplying internal audit services to an audit client. Ironically in the 2,000-plus pages of the Batson report – much of which is highly critical of Andersen – there is not a word of criticism of the conduct of the internal audit function.⁸³ More generally, and from the perspective of the guidance on the audit use of work derived from the activities of internal audit, one would assume that the majority of firms would be more confident of competence and the relevant skill set when that function was conducted by their own staff.

Taxation, probably the largest source of non-audit income for large accounting and audit firms, is a similarly complex area. There are clear advantages to the audit function if it is confident that taxation charges and provisions have, effectively, been determined by experts within their firm. However, here again there are conflicts of interest, well documented in recent years, regarding the role of tax advisers in minimising tax liabilities on occasion at the edge of, or indeed past, that which is legal. The relatively minor, albeit slightly entertaining, case of the Ernst & Young VAT advisers sent into ERF demonstrates that there is the possibility of the audit team placing an over-reliance on supposed internal expertise.

Beyond the removal of potential sources of bias and the mitigation of the impact of bias on judgement through proactive procedures, the issue lies deeper yet. Rules and regulations can be tightened but the continuous emergence of financial scandals, despite countless changes in regulations and legislation, provides evidence of the resourcefulness of individuals in finding ways around restrictions placed upon them.

⁸² As we noted earlier, KPMG, in 2005, narrowly avoided criminal indictment in the US (and thus possibly sharing the fate of Andersen) over fraudulent conduct involved in the sale of illegal tax shelters over previous years, by paying a \$456m penalty and meeting a number of additional conditions imposed by the US Justice Department. This does not appear to have damaged KPMG's reputation or financial performance.

⁸³ See 'Final Report of Neal Batson Court-Appointed Examiner', available at enron.com/media/Final_Report_Neal_Batson.pdf

Rather than continuously asking questions to which we arguably already have answers, a future research agenda might wish to explore the embedment of integrity in an auditor's work, and ask these questions.

- What influences the behaviour of individuals?
- What factors will encourage honest behaviour?
- What factors will stimulate dishonest behaviour?
- How do factors related to upbringing, past experiences, peer pressures, societal norms, education and training affect the integrity of an individual?
- How can integrity be enhanced?⁸⁴

4.2 Policy options

The spectrum of possible policy options is a wide one including: continuation with the present arrangements; further disclosure of the nature and type of services provided; arrangements for compulsory tendering;⁸⁵ extending the range of proscribed services; complete prohibition of the provision of NAS(A); or even complete prohibition of the provision of NAS by firms offering statutory audit services.

If it is believed that the workings of the market will ensure that firms only deliver NAS(A) to the point at which the marginal benefit to society of such provision is equal to the marginal cost in terms of the threat to independence, then the case could be made for no further regulatory intervention. There has been significant market change post-Enron, both in terms of accounting firms voluntarily withdrawing from the provision of certain types of NAS(A) (for example, internal audit) and in a greater reluctance by clients, responsive to the concerns of the capital markets, to purchase NAS from their auditor. However, the current crisis of confidence in the profession at least does raise significant doubt about whether the position has indeed been optimal in recent years, and in the present political climate one would need a strong belief in market efficiency to advocate that no action should be taken.

Extending the range and type of proscribed services in line with those of the SEC and considered by the European Commission is another option. It is, however, difficult to determine, within the framework of the arguments outlined above, which particular services carry the greatest threat to auditor independence. It is also likely that any attempt to categorise services in terms either of traditional association with audit, for example, taxation services, or linked assurance services necessary to ensure compliance with statutory or other regulatory requirements will be fraught with difficulty. This difficulty is exacerbated given that services are constantly evolving and being redefined (Jeppesen, 1998).

Given the concerns about the effect on independence, the underpinning argument for allowing audit firms to provide services other than audit to their clients in today's commercial environment might indicate that to interfere in the workings of the market would impose economic costs, and that these costs outweigh any possible costs attendant upon non-independent behaviour by auditors. However, the costs of intervention are difficult to quantify and are indeed based on an intuitive perception that there must be economies of scope from the joint provision of audit and non-audit services. In contrast, in North America at least, the perceived costs of non-independent audit behaviour are salient and resulted in prohibition of a wide range of NAS(A) (SOX, 2002), with increasing concerns about the impact of NAS on the quality of audit within the UK and Europe (see, for example, EC, COM(2011) 779). We also note that a combination of market trends and regulatory pressures have led to a considerable decline in joint provision. In this regard it is interesting that the Chinese Institute of Certified Public Accountants (CICPA) wishes to encourage Chinese audit firms to develop NAS in order to expand their skill set, enhance their business awareness and compete with foreign firms (and especially the Big Four). They understand the independence debate (eg, in the EU) but consider that to be a problem 'for the future' once the Chinese profession has developed sufficiently (Deng and Macve, 2013).

Despite the significant structural changes and the formal disposal of all or part of their consulting services by the very large firms in the previous decade, the renewed significant rise of the revenue importance of consulting services to accounting firms might imply a continued and increasing dependence on consulting – although, as noted above, the engine of growth for the revival of consulting services has been via provision other than to audit clients. However, the very fact

⁸⁴ To answer this last question, we refer the reader to an ICAEW report which aims to analyse the meaning of integrity and discover means to promote and encourage integrity in organisations. See, *Real Integrity: Practical Solutions for Organisations Seeking to Promote and Encourage Integrity* (2012), written by Baxter, Dempsey, Megone and Lee (available at icaew.com/en/products/accountancy-markets-and-ethics/real-integrity-briefing).

⁸⁵ We note the September 2012 amendment to the UK Corporate Governance Code by the FRC requesting FTSE 350 companies to put their audit contract out to tender at least once a decade on a 'comply or explain' basis.

that audit firms are still in the market for the provision of NAS does give rise to the possibility that client management may still be able to apply low-visibility sanctions to an audit firm as to whether they would or would not seek, subject to audit committee approval, to engage their auditors in such activities.⁸⁶ If an audit firm was perceived by client management to be overly critical of managerial assertions, particularly if it was seen as a faithful and diligent watchdog for the shareholders rather than an accommodating and flexible friend of management, this could have possible repercussions on the likelihood of retaining or gaining a lucrative service contract.

Caution must be expressed in determining policy on the basis of individual causes célèbres. For example, how much of the downfall of Enron – which was essentially a poorly managed company – should have been laid at the feet of auditors, although there is little doubt that their inaction delayed possible remedial intervention and had significant effects on the determination of the respective gains and losses of the various stakeholders. A similar caution may be expressed on the role of audit in the financial crisis of 2008/09 (although the House of Lords' enquiry and associated report was rather critical, HoL, 2010; 2011). Nevertheless, in circumstances where the costs of prohibiting the provision of NAS(A) are at best unclear and – if other providers of similar services are to be believed – there may indeed be no substantial costs, there are strong arguments which would suggest that the appropriate regulatory response should be to continue to direct and encourage the existing market trends toward the significant restriction of and the reduction in the provision of such NAS.

There are likely to be practical issues to consider in the implementation of such a policy, in terms of determining what within the spectrum of audit and assurance services constitutes 'audit' and what constitutes 'non-audit'. It may also be necessary to take action to ensure that the NAS(A) provided by accounting firms today are not in future provided by entities with strong economic and commercial ties to the accounting firm auditor – a scenario that is, in the past at least, alleged to have been prevalent in certain of those countries which have prohibited the provision of NAS(A).⁸⁷ These issues, however, are largely beyond the scope of this review, the essential conclusion of which is that if the quality of audit per se is thought to be important to the workings of capital markets and society more generally, then in circumstances where the benefits of the joint provision of NAS to client companies cannot be unequivocally demonstrated, the logical regulatory response is likely to be to prohibit, or at the least significantly restrict, the joint supply of such services to audit clients.

⁸⁶ Both Coffee and Gordon separately refer to termination of non-audit consulting services as a 'low-visibility' means of sanctioning auditors. See Coffee, J.C. (2002), 'Understanding Enron: It's the Gatekeepers, Stupid', 57 *Business Law*, at 1411–12; Gordon, J.N. (2002), 'What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections', 69 *University of California Law Review*, at 1237–38.

⁸⁷ According to Ridyard and DeBolle (1992), this is clearly the case in France and Portugal and perhaps in Italy (p67), see also Stevenson (2002). Further analysis and examination of practice in these countries, where auditors are prohibited from providing NAS(A), would be instructive, as would be an analysis of the impact of SOX 2002.

Appendix – overview of recent literature

The purpose of this section is to provide a brief overview of recent literature addressing issues directly or indirectly related to the topic of NAS(A). It does not seek to provide a fully comprehensive review of this literature – much of which has been covered quite extensively in previous studies, for example, in the UK those of Beattie and Fearnley (2002) and Beattie (2012) – but rather to build upon these studies and, where appropriate, seek to highlight aspects of recent studies which are considered to be of relevance to the issues discussed above. It has, however, encompassed a search of 'Business Source Complete', a business research database covering over 3,300 journals. This search has focused on studies which consider the interaction between auditor independence and the extent of NAS.

Analysis of the literature is broadly thematic with a focus on just two categories:

- research suggesting that NAS affect actual and perceived independence; and
- research suggesting that NAS do not affect actual and perceived independence.

However, it is necessary to caution that literature reviews are in themselves subjective, both in terms of the literature chosen for review and the manner in which it is analysed and discussed. It is also true that, notwithstanding the perceived internationalisation and harmonisation of accounting and audit worldwide, there are still very distinct cultural and economic differences between countries (eg, China, as referred to above) – and the outcomes of individual country studies need to be considered in that light. The main body of work, particularly large-scale empirical work, uses US data – but here again it is necessary to recognise that although there is much that is similar between the UK and the US commercial environments, they are not identical and empirical findings need to be appropriately contextualised both in place and time. It is also the case that aspects of the methodology, both generic and specific, used in many of the large-scale empirical studies have been questioned by a number of econometricians and statisticians and this needs to be borne in mind when interpreting the findings of these studies.

Research suggesting that non-audit services affect actual and perceived independence

Here the overall conclusions from previous literature reviews, for example, those of Beattie and Fearnley (2002) and Schneider et al. (2006) are that, although there is little direct evidence indicating that joint provision will affect actual independence, there is a preponderance of evidence suggesting that joint provision will affect perceived independence. The outcomes of more recent studies – a number of which are referred to below – are generally in line with these earlier conclusions.

EMPIRICAL STUDIES: US AND UK

In their examination of abnormal market returns for Andersen clients in the US around the date of announcement of the indictment of Andersen for allegedly destroying relevant records, Krishnamurthy et al. (2006) found that the negative share price reaction was more acute when more NAS were provided by Andersen. This would suggest that the market perceives that auditor independence is at risk when the incumbent auditor also provides NAS.

Using an event study approach and by examining market model prediction errors around relevant dates, Liu and Nabar (2006) investigated the manner in which stock prices of Ernst & Young's (E&Y's) US audit clients reacted to the sale of the accounting firm's consulting arm to Cap Gemini. They found that the audit clients' abnormal stock returns were positively related to two events: the date of approval of the sale by E&Y's partners and the date of approval of the transaction by Cap Gemini's stockholders. These findings might be interpreted as suggestive of a market perception that the provision of NAS by incumbent auditors does affect investors' perspectives of auditor independence and related economic issues.

In another empirical US study, Lai and Krishnan (2009) provided indicative evidence that the market value of a firm is higher if financial information system-related services were purchased from incumbent auditors, compared to the market value of firms that did not purchase such services. Of course this finding runs contrary to the received wisdom that the provision of such services is in itself entirely negative and indeed could be interpreted as suggesting that the provision of financial information system-related services – which is now not allowed in the US – was seen as a value-adding activity providing a net benefit.

The difficulties of interpretation can be seen in relation to Nagy's 2008 US study which found that it is less likely for an audit firm to issue a 'material weakness in internal control' report if the audit firm also provides the financial information design and implementation service. Whether this finding provides support for those who consider such NAS provision is likely to materially impair auditor independence or those who would argue that such provision is likely to lead to greater internal control and system reliability is an open question.

FEE-RELATED STUDIES

A significant extent of research effort has been directed toward examining – or perhaps searching for – relationships between fees (both fees for audit and for non-audit services) and the nature of audit and the level of audit independence. Again these studies have led to mixed results and, again in certain instances, there may be considerations about the framing of the research questions, the nature of the statistical analysis, and the interpretation of the results obtained. However, the findings of a number of recent studies are reported below.

Using US data, Larcker and Richardson (2004) found a positive relationship between the ratio of non-audit fees to total fees and the absolute value of accruals (often considered a useful proxy for earnings management). But they also reported that the positive association only applied to approximately 8.5% of the sample they studied and that there was an overall negative relationship between total auditors' remuneration and accruals. Further analysis suggested to the authors that this negative relationship was strongest for audit clients with weak governance, and that auditors' behaviour is constrained by reputation risk. Perhaps a more robust finding might have been that such results are very difficult to interpret. Indeed, Ball (2013) and Stubben (2010) cast doubt on the validity of much of the research based on discretionary accruals, with particular criticisms aimed at the use of accrual models to detect simulated and actual earnings management.

Using UK and US data, Antle et al. (2006) modelled the joint determination of audit fees, non-audit fees, and abnormal accruals in a system of simultaneous equations. They found that non-audit fees had a statistically significant negative effect on abnormal accruals in the UK, which on the face of it they interpreted as suggesting that NAS provision is associated with higher quality financial reporting – although they cautioned that other studies both in the US and the UK had offered conflicting evidence.

In another US study, Hoitash et al. (2007) examined the relationship between audit quality and abnormal total auditor fees. They found a negative relationship between audit quality (proxied by discretionary accruals) and abnormal total fees, indicating to them the adverse effects of economic bonding.

Using US data, Basioudis et al. (2012) linked NAS with tenure and going concern reporting as a proxy for audit quality. Examining whether high non-audit fees and auditor tenure jointly affect auditors' propensity to issue going concern modified audit opinions, after controlling for auditor tenure, the authors found that the relationship between non-audit fees and auditors' propensity to issue going concern modified audit opinions was negative, but that this relationship only holds for auditors with long tenure (longer than or equal to four years). Such a relationship was found for Big Four as well as smaller, industry-specialised auditors. This would indicate that auditors' unwillingness to report client going concern problems as a result of long tenure and high non-audit fees poses threats to auditor independence.

Based on evidence from a sample of 1,479 financially distressed US companies in the period 2004 to 2006, Blay and Geiger (2013) identified that both current and future auditor's remuneration (consisting of audit and non-audit fees) is negatively related to a going concern modified opinion. One strand of interpretation that they consider is that as the data is after the SOX 2002 implementation period, this finding provides evidence that the prohibition of certain types of NAS may have elevated the need to retain the limited services the incumbent auditor currently provides, thus increasing the pressure on auditor independence rather than the opposite.

Using data of US firms audited by the then Big Five auditors for the period 2000-2001, Lim et al. (2013) found that, as non-audit fees increased, audit quality (measured by discretionary accruals and earnings-response coefficients) reduced. However, this only held for clients with low institutional ownership. This indicates that, while non-audit service provision affects actual (as proxied by discretionary accruals) and perceived (as proxied by earnings-response coefficients) auditor independence, institutional investors are an effective safeguard.

Using UK data, Basioudis et al. (2008) found that there was a lower likelihood for financially distressed companies with high non-audit fees to be issued a going concern modified audit report. This might indicate an impairment of auditor independence as a result of joint provision – but, again, it is important to caution that the interpretation of such results (and indeed of the nature of the modified report) is fraught with difficulty.

Using a sample of UK listed companies, Holland and Lane (2012) studied the impairment of independence in appearance by analysing the relationship between levels of total relative fees (ratio of the combined audit and non-audit fees due to the company's auditor expressed as a proportion of the audit firm's UK income) and market value. They adopted a non-linear model and found that perceived independence is only impaired at high total relative fee levels. There is a positive association between total relative fees and market value at lower levels. The authors suggest that this finding provides support for the adoption of a threshold concept for the level of non-audit services rather than the complete prohibition of the supply of non-audit services by incumbent auditors, a view consistent with CICPA's current policy in China referred to above.

Using meta-analysis procedures, Habib (2012) statistically aggregated results across 45 studies, correcting for statistical artefacts like sampling and measurement error. He found that the level of client-specific non-audit fees results in lower financial reporting quality. A decomposition of the financial reporting quality proxies reveals that earnings management is positively related to non-audit fees, while the propensity to issue a qualified opinion is negatively associated with NAS provision, indicating that NAS impair independence in fact. The negative relationship between earnings-response coefficients and non-audit fees indicate that perceived independence is jeopardised. However, it should be noted that the underlying studies used for this analysis were far from homogenous over sample size, methodology, location or time.

RECENT PERCEPTION-BASED STUDIES

Using a behavioural research methodology, Colbert et al. (2008) conducted an experiment to examine the reactions of US lending officers to the disclosure of financial information system design and implementation service (FISDIS) fees, and tax service fees. They found that tax service fees, but not FISDIS fees, affect the lenders' perception of auditor independence.

A recent UK questionnaire study revealed that private investors and institutional shareholders perceive economic dependence and NAS as more serious threats to auditor independence than long tenure (Dart, 2011). It also indicated that perceptions of auditor independence did not differ between gender but those without accounting qualifications (as compared to those with accounting qualifications) and private investors (as compared to institutional investors) tend to be more concerned about auditor independence.

STUDIES BEYOND THE US AND THE UK

In an empirical study using Australian data, Gul et al. (2006) found a negative relationship between NAS provided by an incumbent auditor and the value relevance of earnings (using earnings response coefficient as the proxy). However, the relationship was weaker for firms that employed the then Big Six auditors. The inference made was that investors perceive the joint provision of audit and non-audit services to impair auditor independence but this adverse perception is mediated by and, indeed, mitigated by the appointment of a major audit firm. The perspective of the authors is that for major audit firms the litigation and reputation cost will outweigh the benefits of client-specific quasi-rent.

Using Australian data, Hossain (2013) found that audit quality (using discretionary accruals and propensity to issue a going concern opinion as the relevant proxy for quality) is affected by the provision of NAS. However, this relationship only existed before regulatory reforms enacted in the Australian Corporate Law Economic Reform Program Act 2004. This Act, in line with – albeit placing in a clear statutory context – developments in countries such as the US and the UK, requires disclosure of specific categories of non-audit fees, mandatory rotation of audit partners every five years and the requirement for a statement by the audit committee on the appropriateness of the provision of NAS by the incumbent auditor.

Noting that sociological research indicates cultural differences between English speaking and Nordic countries, Quick and Warming-Rasmussen (2005) examined by means of a questionnaire study the impact of NAS on perceived auditor independence in Denmark. The results indicated that shareholders, bank loan officers and journalists perceive lower auditor independence in the presence of NAS provision. They also suggested that the type of NAS conducted has a differing effect on the degree of independence impairment and also – an interesting finding given the importance placed by firms and regulators on ‘Chinese walls’ – that the provision of NAS by a separate department of the audit firm does not improve independence in appearance.

The same authors (Quick and Warming-Rasmussen, 2009) conducted a similar questionnaire-based survey of German investors and again the results indicated that the provision of the great majority of fields of NAS acts to impair perceived auditor independence. However, they noted that the provision of NAS by a distinct and separate arm of the audit firm acted to lower perceptions of reduced auditor independence.

Using a sample of major German listed companies for the period 2004–2011, Krauss and Zülch (2013) found that audit quality (proxied by discretionary working capital accruals) is negatively associated with non-audit fees. This implies that NAS provision by the incumbent auditor impairs auditor independence. Breaking down their findings they suggest that the audit-related component of non-audit fees is the driver of this relationship.

Using a questionnaire design, Alleyne et al. (2006) investigated the perceptions of auditors and financial statement users in Barbados as they related to auditor independence. The results suggested that the level of economic dependence of the audit firm on the audit client, the provision of NAS, the extent of potential competition, small audit firm size, being a sole practitioner, and lengthy audit tenure all had a negative impact on the perception of auditor independence. They also found that the size of the economy and the closeness of Barbadian society were relevant factors influencing perceptions, thereby perhaps reinforcing the issues raised above as to the importance of cultural and economic issues.

Kumar et al. (2008) conducted a survey to measure the perception of government-linked companies’ shareholders in Malaysia towards the impact of NAS provision by incumbent auditors on independence. They found that the shareholders regard management services such as the NAS as having the most adverse impact on independence. Shareholders also expressed concerns about the effect of the provision of human resource services and advisory services on audit independence.

Using a survey questionnaire, Al-Ajmi and Saudagaran (2011) examined the perceptions of auditors, bank-loan officers, and financial analysts in Bahrain on issues relating to auditor independence. They found that economic reliance on audit clients, provision of NAS, competition, and tenure of audit service were considered the most serious threats to auditor independence.

Another questionnaire survey, conducted by Adeyemi and Olowookere (2012), noted that investors in Lagos State (taken as a representation of Nigeria) perceive the provision of NAS to adversely affect auditor independence.

An empirical study focusing on publicly-listed New Zealand companies reporting in 2011 (Wang and Hay, 2013) offered evidence that NAS provision to audit clients mitigated the issuance of a qualified or modified audit opinion. This is suggestive of the fact that, despite the regulatory developments and changes in the profession over the recent decade, auditor independence might still be impaired in such circumstances. However, an interesting nuance is that the results were very largely obtained for companies audited by auditors other than the Big Four.

Based on a sample of listed companies in Taiwan – a country with a lower litigation risk for auditors compared to common-law countries – for the period 2002–2006, Liao et al. (2013) found that, at high levels of NAS provision, a negative relationship exists between non-audit fees and the degree of accounting conservatism. However, this is mitigated in firms that have higher board independence.

Using the Stouffer combined test (a meta-analysis technique) to aggregate results across 73 published studies from 1982–2011, Habib (2013) ascertained that there is a negative relationship between non-audit fees and modified audit opinion. This suggests that the provision of NAS has a negative impact on auditor independence. However, this relationship is only found in non-US studies.

Using a sample of listed companies in New Zealand, Cahan et al. (2008) did not find an association between NAS fee growth rate or length of time of the NAS relationship and discretionary accruals. However, discretionary accruals are positively related to the interaction of time-period measures of NAS relationships and client importance. This shows that independence may be compromised when a strong economic bond develops through the continuous delivery of NAS over a period of time to significant audit clients.

In a study of Taiwanese firms, Chin et al. (2007) found that earnings forecasts reviewed by the incumbent auditors tend to be more optimistically biased and inaccurate when the ratio of NAS is high. This finding supports the hypothesis that the provision of NAS impairs auditor independence. As in this case, where the rules of review-level assurance for management earnings forecasts are less stringent, the manifestation of independence impairment is more likely given the lower liability risk.

Ianniello (2012) examined the relationship between audit opinions and NAS in Italian listed companies and did not find a statistically significant association. However, this result needs to be interpreted with caution as there were only 10 qualified audit opinions in the sample. Other findings include a positive association between unqualified audit reports with an emphasis of matter paragraph and NAS. Although this implies that there is an impairment of auditor independence, it is worthwhile bearing in mind that these cases may not warrant a more severe opinion.

Research suggesting that non-audit services do not affect actual and perceived independence

US AND UK STUDIES

In a US study, DeFond et al. (2002) found that auditor independence, surrogated by auditors' tendency to issue going concern audit opinions, was not affected by the provision of NAS by incumbent auditors.

Ashbaugh et al. (2003) challenged the findings of Frankel et al. (2002) by adjusting discretionary current accruals for firm performance. Incorporating these adjustments resulted in a finding that there was no systematic evidence to support the claim that the provision of NAS by incumbent auditors affects auditor independence.

Kinney Jr. et al. (2004) did not find a statistically significant relationship between fees for financial information systems design and implementation services or internal audit services and financial restatements. They interpreted this as evidence that the quality of financial reporting is not affected by the purchase of these services from incumbent auditors, although they cautioned that the sample of SEC registrants purchasing these services was small. However, they did find an association between unspecified NAS fees (these are fees for NAS other than financial information systems design and implementation services; audit-related, assurance and business advisory services; internal audit services; and taxation services) and restatements, which indicated to them the possibility of an impairment of auditor independence. Again the evidence was mixed as they found that tax service fees were negatively associated with restatements, which might be considered as suggestive of financial reporting quality.

Using as a dependent variable a market-based measure of disclosure quality and stock market liquidity, Asciglu et al. (2005) examined the impact of audit and non-audit fees on auditor independence. Their study encompassed a large sample of S&P 1500 stocks and found relatively little evidence to support the perspective that auditor remuneration per se adversely affects the auditor-client relationship. However, they did report indicative evidence of an association between auditor remuneration and market liquidity in circumstances where client firms had weak corporate governance structures.

In a US study, Bloomfield and Shackman (2008) found little evidence that non-audit fees are positively associated with earnings restatement. However, the total auditor's fee is positively related to earnings restatement. They also found that audit firm industry specialisation is negatively associated with restatements while a positive relation is prevalent between restatements and the then Big Five audit firms.

Lim and Tan (2008) analysed the relationship between audit quality – proxied by the propensity to issue a going concern opinion, magnitude of discretionary current accruals, propensity to meet or miss analysts' forecasts, as well as the market's reaction to earnings surprises – and NAS in the US. No relationship was found between NAS and the propensity to issue going concern opinion, magnitude of discretionary current accruals, and propensity to meet analysts' forecasts (coded as the tendency for actual earnings minus analysts' forecasts to be within zero to positive one cent). However, the propensity to miss analysts' forecasts (coded as the tendency for actual

earnings minus analysts' forecasts to be within negative two cents) is negatively associated with the provision of NAS. NAS fees are also associated with a lower earnings-response coefficient (ERC), implying that investors perceive NAS to impair earnings quality. An important finding from the study is that audit quality (using propensity to issue a going concern opinion, propensity to miss analysts' forecasts and ERC as proxies) increases with the scale of NAS when acquired from specialist auditors as opposed to non-specialist auditors.

In a US study, Vinătoru and Calotă (2009) did not find an association between non-audit fees and restatements. However, total auditor's remuneration is significantly related to restatements. The study also revealed that there is a negative relationship between audit firm industry specialisation and restatements, and that a positive association exists between the then Big Five audit firms and restatements.

In another US study, Ghosh et al. (2009) found no statistical association between perceived auditor independence, where earnings response coefficients were used as proxies, and NAS provision.

In a US study, Lim and Tan (2010) assessed how auditor specialisation and fee dependence interacted with auditor tenure in determining audit quality. They found that the positive relationship between audit tenure and audit quality is stronger if the audit work is carried out by specialists and when economic dependence is lower. This shows that longer audit tenure will increase audit quality if the audit is being carried out by industry specialists and where the fee dependence on the client is low. This implies that if the NAS fee significantly increases the auditor's economic dependence on the client, audit quality will be adversely affected.

Krishnan et al. (2011) examined the relationship between earnings management and NAS pre- and post-SOX 2002 in the US. Their results indicated that income-decreasing, but not income-increasing, earnings management was positively associated with the subsequent reduction in NAS fees. This suggests that the fear of litigation and/or reputational loss was stronger than the temptation to allow income-increasing earnings manipulation in return for higher non-audit fees.

OTHER STUDIES

In an experimental study using US subjects, Asare et al. (2005) found that the acceptance of an audit client was not affected by the potential of NAS provision. They considered that this implied that NAS provision may not be causal in terms of the loss of auditor independence.

Iyer and Reckers (2007) conducted a behavioural experiment involving 47 audit seniors from a Big Four accounting firm to examine the interactive effect of NAS provision and auditors' perception of management integrity on assessments of risk of material misstatement. Although they found that NAS provision did not affect risk assessment, they ascertained that the risk of material misstatement arising out of suspect management integrity was significantly associated with whether the auditor provided material amounts of NAS. This demonstrated to the authors that while NAS provision may not in itself affect auditor independence, it has the ability to affect audit quality by moderating the effect of other audit evidence.

STUDIES BEYOND THE UK AND US

Using expert reports provided in Australian takeovers, Bugeja (2005) studied whether the independence of a non-audit service (provision of expert reports) will be impaired if rendered by the target firm's auditor. Although this is somewhat the reverse of the typical study, whether NAS impair the independence of auditors, the nature of the issue under scrutiny (whether independence will be impaired in the presence of an economic bond) remains unchanged. The results indicate that expert opinions are significantly related to the target firm's directors' recommendations regardless of whether the expert provides other services to the target firm. However, capital market reaction is significantly lower if the report is provided by the target firm's auditor. This indicates that although actual independence remains intact, the market perceives that the expert report is of lower quality.

In an Australian study, Bugeja (2011) found no association between perceived auditor independence (proxied by takeover premium) and NAS. This indicates that the provision of NAS is not seen to impact audit quality.

In a New Zealand study, Hay et al. (2006) found no relationship between the nature of audit opinion nor the tenure of auditor, and non-audit fees. The evidence does not indicate that independence of mind is impaired by the provision of NAS.

Using New Zealand data, Zhang and Emanuel (2008) found no evidence of a negative relationship between NAS provision and earnings conservatism. This provides support that actual independence is not affected.

Fuentes and Pucheta-Martinez (2009) conducted a Spanish study and found that the joint provision of audit and NAS does not reduce the likelihood of the issuance of qualified audit reports.

Sawan et al. (2013) used a mixed-methods approach consisting of questionnaires and semi-structured interviews to examine the perception of oil companies and audit firms in Libya on the provision of NAS by the incumbent auditor. The majority of respondents did not agree that the provision of NAS will result in economic dependency and conflict of interests for the auditor. On the contrary, it is believed that NAS provision will improve audit quality through knowledge spillover. However, it is perceived that the auditor is more credible if the NAS are provided by a separate department.

Using discretionary accruals as a proxy for audit quality, Svanström (2013) explored the relationship between NAS and audit quality. Based on a sample of 420 privately held small and medium-sized enterprises in Sweden, he found a negative relationship between discretionary accruals and non-audit fees in general, and accounting services in particular. This indicates that the provision of NAS by the incumbent auditor does not necessarily impair auditor independence.

Ratzinger-Sakel (2013) used going concern modifications as a proxy for audit quality to study the relationship between audit quality and NAS in Germany. Based on a sample of financially-stressed manufacturing companies during the period 2005–2009, no significant relationship between the level of non-audit fees and the propensity to issue a going concern opinion was found. This suggests that market-based incentives, such as reputational loss, may have mitigated the possible adverse impact of economic dependence on auditor independence. However, there is some evidence that Big Four as opposed to non-Big Four audit firms are less likely to issue a going concern opinion if the level of non-audit fees is relatively high, but this is only evident for highly financially-stressed clients. This observation may be due to the lower litigation risk and liability cap in Germany.

CONCLUSION

The studies referred to above, and indeed those covered in earlier literature studies, reveal a diversity of both research approach and of research results. As is noted above, great caution needs to be taken in the analysis and interpretation of both direct data-driven empirical studies and those which use experimental or questionnaire methodology. Essentially the picture is a mixed one – some of the studies are indicative of an association between the provision of NAS and auditor judgement which might be seen as questionable. Others do not find such an association. As also noted above, this Appendix does not hold itself out to be a fully comprehensive review of the relevant literature – but rather to build on previous survey studies so as to enable further insights into the relevant issues to be obtained.

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