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# Briefing

THE IMPACT OF CHANGES TO THE  
NON-AUDIT SERVICES REGIME ON  
FINANCE DIRECTORS, AUDIT  
COMMITTEE CHAIRS AND AUDIT  
PARTNERS OF UK LISTED COMPANIES

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November 2009

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## Motivation for this Briefing

The banking crisis in the UK has resulted in the re-examination of many aspects of the regulation and reporting associated with the UK banking and financial services sector, including the role of auditors. In 2009 the House of Commons Treasury Committee reported that the Committee had received very little evidence that ‘auditors failed to fulfil their duties as currently stipulated’ (House of Commons Treasury Committee, 2009, p77). The Committee, however, reviewed the UK’s auditor independence regime, which was significantly strengthened after the Enron scandal and the collapse of the audit firm Andersen in 2002. The changed regime introduced widespread restrictions but not a total ban on the provision of non-audit services (NAS). The Treasury Committee expressed the belief 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 recommended that the Financial Reporting Council (FRC) should consult on this proposal at the earliest opportunity (House of Commons Treasury Committee, 2009, p84). Although the Committee was focused on the banking crisis, the proposal to prohibit all NAS could apply to all companies and auditors, not just to the banking sector. The Auditing Practices Board (APB), which is part of the FRC, issued a consultation in October 2009, which focuses primarily on NAS for listed companies (APB, 2009, p3).

This Briefing focuses on the impact of the post-Enron regulatory changes to the NAS regime on companies and auditors, principally by reporting relevant findings from a wide-ranging experiential questionnaire study which we carried out in 2007. The questionnaire sought views and experiences from finance directors (FDs), audit committee chairs (ACCs) and audit engagement partners (APs) of UK listed companies on recent regulatory changes including restrictions on NAS provision. This Briefing provides direct evidence of how the changes to the NAS regime affected key parties actually engaged with the financial reporting and audit process before the economic downturn. There has been no significant change to this regime since 2007, and therefore these results are relevant to the current environment.

We first summarise the key changes to the NAS regime introduced from 2002 onwards, and briefly review findings in relevant academic studies. We then provide evidence of changes to NAS fee levels since 2002, and then we report relevant findings of the 2007 experiential survey. Our conclusions on the evidence follow.

## Key changes to the UK NAS regulatory regime

In 2002 the UK government established a Co-ordinating Group on Audit and Accountancy issues (CGAA, 2003), which included members at ministerial level, to review the UK's regulatory regime following the Enron scandal and the collapse of Andersen. The group concluded that there was little clear support for the view that joint provision of audit and NAS had in fact compromised auditor independence. Nevertheless, CGAA recommended 'tougher and clearer safeguards to ensure that joint provision of audit and non-audit services does not undermine auditor independence in fact or appearance' (p29). This was to be achieved by independent setting of auditors' ethical standards and an enhanced role for audit committees in overseeing auditor independence and NAS provision.

At the same time auditor independence came under close scrutiny by regulators in other countries. In 2002 the European Commission issued a Recommendation on Auditor Independence for the EU (European Commission, 2002), which included restrictions on auditors providing certain non-audit services. In the same year The Institute of Chartered Accountants in England and Wales (ICAEW) adopted policies consistent with the Recommendation thus bringing an obligation on ICAEW members, who audit most of the UK's largest companies, to comply with it.

The EC Recommendation (2002) follows a principles-based model for auditor independence including the recognition of threats to independence posed by NAS provision. The message is that auditors should not provide NAS which 'a reasonable and informed third party' would conclude compromise independence. The threats and safeguards approach to independence requires that, where the independence risk of an activity cannot be reduced to an acceptable level, the auditor should either give up the audit engagement or decline the NAS. The Recommendation identifies the following key threats to independence from NAS provision: making management decisions (which is prohibited); self-review; advocacy; trust (ie, familiarity); and intimidation. Some safeguards are suggested to mitigate the risks but the overall tone strongly discourages provision of the following services: preparing accounting records and financial statements (prohibited for public interest entities); design and installation of financial IT systems; valuation services; internal audit; acting for a client in a legal dispute; and senior management recruitment. It also recommends that auditors should discuss NAS provision with the client company's governance body. The ICAEW policy in following this Recommendation in 2002 brought change to the pattern of NAS provision ahead of the regulatory changes initiated by the UK government.

As a result of the CGAA initiatives, a comprehensive regime for NAS approval by directors was introduced into the Combined Code for Corporate Governance (FRC, 2003a). This drew on detailed guidance for audit committees in the Smith Report (FRC, 2003b), which recommends that audit committees should establish and implement a policy for NAS purchase, taking account of auditors' ethical guidance. Where NAS is purchased, the annual report should include an explanation of how auditor independence is safeguarded. Under UK company law, shareholders have the right to remove directors from office and approve the re-appointment of auditors. Incorporation of these provisions in the Combined Code offers investors the opportunity to challenge non-compliant behaviour by exercising their votes.

In addition, a rigorous regime for regular inspection of public interest audits was introduced in 2004 by the newly established Professional Oversight Board for Accountancy (FRC, 2009).

In 2004 the Auditing Practices Board (APB, 2004) issued Ethical Standard 5 (ES 5), which addresses auditor independence issues associated with the provision of NAS. ES 5 refers to the two well-recognised aspects of auditor independence. These are: the perception of third parties about whether an auditor appears to be independent of a client (ie, independence in appearance); and whether the auditor actually behaves with objectivity (ie, independence in fact), the latter being observable only to those who are directly associated with the audit process.

ES 5 (APB, 2004) is more detailed than the EC Recommendation but uses the same threats and safeguards approach. Paralleling the Combined Code, ES 5 requires the auditor to inform the audit committee about NAS issues, including inconsistency between ES 5 and company policy regarding NAS purchasing. ES 5 largely prohibits the services referred to in the EC Recommendation adding corporate finance activities including contingent fees to the list. Apart from very limited exceptions to take account of special circumstances in a company or immateriality of the service to the financial statements, ES 5 conveys a clear message that the safeguards a firm could put in place for these services would not normally be adequate to protect independence. Subsequent revisions to the above documents have not materially changed the NAS regime.

The UK's principles-based approach (with some de facto prohibitions) accords with the approach adopted in the Code of Ethics set by the International Federation of Accountants (IFAC, 2009). Revisions to IFAC's Ethical Standards, which have not yet been introduced in the UK, introduce more restrictions. The US regime takes a different approach by setting out specific prohibitions. Section 201 of the Sarbanes-Oxley Act (US Congress, 2002) prohibits some NAS in addition to the services which are referred to in the UK and EC (eg, actuarial services). However, despite the prohibitions, the US regime does not introduce a total ban on NAS provision.

In addition to these changes, Statutory Instrument 2005/2417 was issued, requiring companies to disclose a more detailed breakdown of NAS fees provided by their auditors than had previously been mandated. The details of the disclosures are similar to the categories of NAS referred to in ES 5.

There has therefore been a major change to the UK regulatory regime for NAS, which takes a dual approach by imposing requirements on both directors and auditors. For directors, the Combined Code expects the company audit committee to engage with the decision to purchase NAS from the company auditor and the Statutory Instrument requires more detailed disclosure in the company financial statements, thus making investors aware in greater detail of what is being purchased. For auditors ES 5 sets out detailed and diverse caveats for the provision of specific NAS in certain commonly occurring circumstances, which amount to a de facto prohibition. As all listed company audits are subject to inspection by the Professional Oversight Board's Audit Inspection Unit (AIU), there is a significantly increased risk for the auditors that failure to comply with ES 5 and any errors or misstatements in the audited financial statement disclosures of NAS provision will be discovered by the AIU. Such failures could lead to public criticism of the audit firm by the AIU.

## Relevant academic studies

Academic studies on NAS provision follow two main lines of enquiry. One examines the impact of NAS provision by the incumbent auditor on independence perceptions ie, independence in appearance. The other seeks to evaluate independence in fact, using various independence proxies (for example, qualified/unqualified audit opinions and, more recently, evidence of earnings management).

Beattie and Fearnley (2002) conclude from a comprehensive literature review that 'there is very little clear support for the view that joint provision impairs independence in fact. There is a reasonable consensus, however, that joint provision adversely affects perceptions'. US-based reviews by Francis (2006) and Schneider et al. (2006) reach similar conclusions. Francis (2006) observes that share prices have been shown to be significantly lower for US companies that pay large NAS fees (eg, Francis and Ke, 2006).

Recent published UK studies include Basioudis et al. (2008), who find from UK 2003 data that high audit and NAS fees adversely impact going concern reporting judgements for financially distressed companies. Three recent working papers are also relevant. Siddiqui et al. (2006) find evidence of the expected significant voluntary reduction in NAS purchase among FTSE 350 companies, but no evidence that companies changed auditors to retain NAS services from their incumbent. Based on 2005 data, Dart (2009) surveys institutional and private investors about independence threats. Economic dependence in general and non-audit service provision in particular were viewed as the most serious threats. Of both groups, 43% considered NAS to be a threat. Institutional investors were most concerned about: internal audit; valuations; investment advice; bookkeeping; and actuarial services, and least concerned about: tax; HR; legal advice; and systems design and implementation. Provision of most of these services is already specifically referred to in ES 5 and thus actively discouraged or prohibited. Holland and Lane (2009) from a 1999-2006 UK market study find that shareholders only perceive a threat to auditor independence at high levels of total audit and NAS fees. They find disclosure of NAS and audit fees of relevance to investors. Humphrey et al. (2009), reviewing the response to the current financial crisis, call for greater knowledge of the global audit regulatory arena in order to understand the forces driving regulatory policy.

The academic evidence has not found a systematic link between levels of NAS and factors undermining the quality of financial reporting or auditing, which might suggest a lack of auditor independence in fact. However, the same investor perception problems remain, although some of the services causing the most concern are now effectively prohibited.



## Evidence of a changing pattern of NAS provision

POB (2009) includes data obtained from the UK's four largest audit firms about the mix of their fee income. This data is not restricted to income from listed companies.

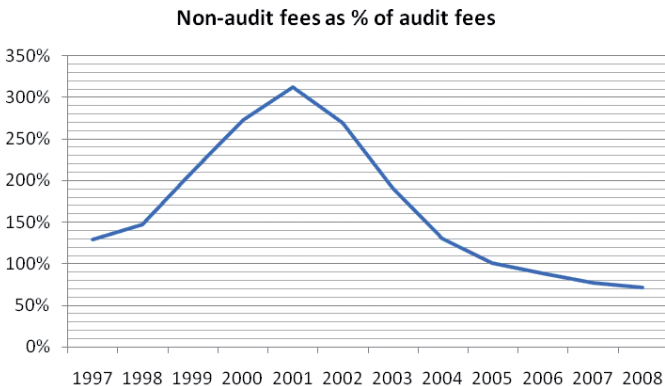
The POB data for the Big Four audit firms (POB, 2009, p57) shows that over a six-year period from 2003 to 2008, NAS income from audit clients fell steadily from 25% total income in 2003 to 17% total income in 2008. Over the whole period total NAS fees remained lower than total audit fees and also reduced as a percentage of audit fees. Fee income from non-audit clients rose steadily from 49% of total income in 2003 to 59% total income in 2008.

Data for other large firms shows a slightly less consistent pattern (POB, 2009, p58). Fee income from NAS fell over the six-year period from 19% total income to 16%, a much lower drop than shown by the Big Four, possibly because the smaller firms were providing fewer NAS before the change. NAS also remained lower than audit fees over the whole period but showed a less consistent pattern in proportion to audit fees. Fee income from non-audit clients rose between 2003 and 2004 by 7% of total income but showed a fairly consistent pattern subsequently of smaller increases.

Although factors other than changes in the NAS regulatory framework may also influence these income patterns, the evidence indicates that there has been a reduction in the value of non-audit services provided by audit firms to their audit clients. Over the same period income from non-audit clients has increased, suggesting that companies are buying more services from firms other than their auditors. It is not known to what extent other services may be purchased from suppliers other than audit firms.

Deloitte (2009) summarise data from the *Financial Director* survey of audit and NAS fees for FTSE 100 companies showing the percentage of NAS fees to audit fees from 1997 to 2007 with an additional year added by their own data collection. These results are shown in graphical form in Figure 1 and indicate a significant drop in NAS provision to audit clients from a peak of over 300% of audit fees in 2001 to 75% in 2008. When this data is considered along with the POB data it suggests that changes in the level of NAS provision to audit clients have been influenced by the changes in the regulatory framework starting from the ICAEW decision to follow the EC Recommendation in 2002.

**Figure 1: NAS as a % of audit fees for FTSE 100 companies, 1997–2008**



Source:

1997–2007: *Financial Director* survey of audit fees. 2008 survey not yet available.

2008: Extracted from company-by-company data for 98 companies in FTSE 100. For the other two (F&C Investment Trust PLC and Carnival PLC), taken directly from annual report.

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## Results from the experiential survey

### Research methodology

A questionnaire was sent in June 2007 to the FDs, ACCs and APs of domestic, officially listed UK companies (excluding AIM companies and investment trusts) seeking information about the impact of a range of recent changes to the UK regulatory framework to their working practices. The sample covered the top 250 qualifying companies by market capitalisation (as at 5 February 2007) and a systematic sample of 250 from the remaining qualifying companies. To eliminate multiple selections of ACCs, the final sample sent out to this group was reduced to 446.

To identify APs acting as engagement partners for qualifying companies and to facilitate the distribution of the questionnaire, we were assisted by 11 large audit firms. The firms identified 439 listed company APs who were asked to respond with reference to their largest listed company client which met the criteria of the study.

Table 1 shows the response rates and profile of each group showing response rates of 30% from FDs, 29% from ACCs and 50% from APs. The company size characteristics of the three groups are broadly comparable, although the ACC group contains a slightly higher proportion of FTSE 250 companies. The respondents represent a mix of industry sectors.

**Table 1: Analysis of respondent groups by company size**

	FDs n=147		ACCs n=130		APs n=219	
	No	%	No	%	No	%
FTSE 100	42	28.6	31	23.8	52	23.7
FTSE 250	48	32.7	57	43.8	85	38.8
FTSE Small-Cap	43	29.3	37	28.5	75	34.2
Fledgling	13	8.8	3	2.3	4	1.8
Not filled in	1	0.7	2	1.5	3	1.4
<b>Total</b>	<b>147</b>	<b>100</b>	<b>130</b>	<b>100</b>	<b>219</b>	<b>100</b>
Including US listing	17	11.6	8	6.2	23	10.5

**Note:** For the purposes of this Briefing we identify and report on the responses to the survey relating specifically to the regulatory changes associated with the provision of NAS.

### The parties involved in overseeing auditor independence in the approval of NAS provision and fees

The Combined Code expects the company audit committee to oversee auditor independence and approve any purchase of NAS from the auditor. ES 5 requires the auditor to communicate with the audit committee regarding NAS issues. In practice, auditor related decisions may be made by individuals ie, the ACC or the FD, by the audit committee (AC) or by the main board (MB). Table 2 shows which parties the respondents reported as being involved in decisions about three key processes associated with NAS and auditor independence: overseeing auditor independence; agreeing any NAS to be purchased from the auditor; and agreeing the fee for NAS.

**Table 2: Parties involved in overseeing auditor independence, NAS purchase and NAS fee agreement decision**

	Overseeing auditor independence*	% respondents reporting who was involved in agreeing NAS fees to be bought from the auditor*	% respondents reporting who was involved in agreeing NAS fees to be paid to the auditor*
Does not take place	0.4	0.8	0.8
FD only	0.2	6.7	<b>23.4</b>
ACC only	3.6	2.0	0.8
AC only	<b>32.7</b>	<b>13.1</b>	9.5
Main board only	1.6	2.2	1.6
FD and ACC	4.4	10.5	10.7
FD and AC	7.8	<b>17.0</b>	<b>15.5</b>
FD and MB	0.0	3.4	4.5
ACC and AC	<b>16.4</b>	3.4	1.8
ACC and MB	0.2	0.2	0.0
AC and MB	1.0	0.6	0.2
FD and ACC and AC	<b>26.5</b>	<b>32.5</b>	<b>25.8</b>
FD and ACC and MB	0.2	1.4	1.0
FD and AC and MB	0.8	1.4	0.8
ACC and AC and MB	1.4	0.2	0.0
All 4 parties	2.8	4.6	3.6
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

**Notes:**

For each activity, the three most frequently reported groups of parties involved in the key activities are shown in bold.

\*Responses missing from each respondent list 3, 2, and 3 respectively.

The responses show that the involvement of listed company main boards in overseeing auditor independence and in NAS purchasing decisions is very limited. However, audit committees and the audit committee chairs are heavily involved in the process, with the FD also playing a significant role. The most interesting finding is that 23.4% of respondents report that the FD agrees the level of fee for NAS and 6.7% report that the FD alone agrees the NAS provision. It is not necessarily surprising that FDs agree the NAS service fee as this role may be delegated by the audit committee within its NAS purchasing policy.

## Changes to NAS purchasing resulting from regulatory change

Respondents were asked whether regulatory change had prevented or discouraged their company (or in the case of auditors, their client) from purchasing NAS from their auditors. Table 3 shows that 62% of FDs, 48% of ACCs and 49% of APs replied positively, providing more evidence that the purchase of NAS from incumbent auditors by companies has been seriously discouraged as a result of regulatory change. A Chi-squared analysis of respondent attributes showed no link to industry sector from those responding positively, but a strong link to company size. In total, 263 (53%) of respondents replied positively, with the percentage rising to 73% for FTSE 100 companies. This suggests that the NAS changes affected the larger companies more than the smaller ones, and is supported by the evidence of the significant drop in NAS purchase by FTSE 100 companies. FTSE 100 companies with a US listing would also have been affected by Sarbanes-Oxley prohibitions on NAS provision. It is not possible from this data to assess the impact of the 2005 change to iFRS on audit fees or NAS provision, although considerable technical effort would have been required to bring it about. However, the proportion of NAS to audit fees in 2005 for FTSE 100 companies continued to fall.

**Table 3: Parties reporting that regulatory change has prevented or discouraged NAS purchase**

Response	FDs		ACCs		APs		Combined	
	No	%	No	%	No	%	No	%
Yes	93	62.4	62	47.7	108	49.3	263	53.7

## NAS which companies no longer buy from their auditors

Respondents were asked to provide information about any NAS they no longer bought from their auditors as a result of regulatory change. The result shows that 65 FDs, 19 ACCs and 82 APs cited a total of 26 different types of service which were no longer purchased. These have been classified into five groups: tax; accounting/compliance; mergers, acquisitions and transactions; systems and other consulting; and company staff related. A total of 320 citations were made. These services are shown in Table 4 (see page 11).

**Table 4: Analysis of NAS reported as no longer purchased by companies**

	NAS given up			
	FDs	ACCs	APs	Total
<b>Tax</b>				
Tax advisory	26	17	31	74
Tax planning	6	4	5	15
Personal and expatriate tax advisory	5		5	10
Tax compliance	3	1	2	6
VAT advice	3		1	4
Tax preparation			3	3
Contingent fee-based advice			2	2
<b>Sub total</b>	<b>43</b>	<b>22</b>	<b>49</b>	<b>114</b>
<b>Accounting/compliance</b>				
Accounting/disclosure assistance	19	6	11	36
Internal audit	4	2	9	15
Valuation of intangibles/options	2	1	5	8
SOX effectiveness reports			3	3
Payroll preparation	3			3
Internal control advice			2	2
Regulatory compliance	1		1	2
Pension audit	1			1
Actuarial advice			1	1
<b>Sub total</b>	<b>30</b>	<b>9</b>	<b>32</b>	<b>71</b>
<b>Mergers, acquisitions and transactions</b>				
Due diligence and investigation	9	12	11	32
Corporate finance/transactions	7	9	7	23
Contingent fee-based transactions			3	3
<b>Sub total</b>	<b>16</b>	<b>21</b>	<b>21</b>	<b>58</b>
<b>Systems and other consulting</b>				
Consulting and non-specified	14	9	7	30
Financial systems and IT related	6	6	8	20
Broking	1			1
<b>Sub total</b>	<b>21</b>	<b>15</b>	<b>15</b>	<b>51</b>
<b>Company staff related</b>				
Share options and remuneration advice	3		13	16
Staff secondments from audit firm	2		4	6
Recruitment	1	1	1	3
Training services			1	1
<b>Sub total</b>	<b>6</b>	<b>1</b>	<b>19</b>	<b>26</b>
<b>Total</b>	<b>116</b>	<b>68</b>	<b>136</b>	<b>320</b>

**Note:**

These comments are drawn from 65 FDs, 19 ACCs and 82 APs who responded to this question, which asked respondents to volunteer the data.

The greatest change is reported in the taxation area with tax advisory and tax planning work being given up, along with some personal and expatriate tax advice for staff. Assistance and support with accounting/compliance work has also significantly reduced. There is limited reporting of it from ACCs. ACCs report a higher level of transactions work being given up in proportion to the others. It may be that these activities, being a corporate strategy issue, are more likely to come to the attention of an audit committee than assistance with accounting or compliance work. It is also possible that ACCs would be aware that other NAS had been given up but would be less familiar with the detail of what they were. There are other staff-related issues, particularly secondments. The reduction in systems and consulting work may be related to the large firms selling off some of their IT consulting activities. This offers further evidence of a significant change in buying behaviour and reflects some of the NAS that the EC Recommendation and ES 5 and Sarbanes-Oxley either prohibit or discourage.

Some of the above respondents cited services they preferred to purchase from their auditor but no longer did because of regulatory change. The largest number of citations is tax-related with relatively few in other areas.

### **Respondents' views on the impact of NAS change on purchasing behaviour**

Respondents were also asked to comment on the changed regulatory framework. In all, 47 FDs, 32 ACCs and 92 APs made 178 comments. A qualitative analysis of the comments shows they fall into two categories – 115 comments were made about the impact of regulatory change on NAS purchase and 63 comments about the impact on the auditor/client relationship and audit quality. The results of this qualitative analysis are shown in Table 5a and Table 5b in descending frequency of citation.

**Table 5a: Analysis of respondent narrative comments re the impact of NAS regulatory changes\***

Impact of regulatory change on NAS purchase	FDs	ACCs	APs	Total
Audit committees/board feel external pressure to keep NAS fees down	5	2	19	26
Audit committees/board have clear policies on NAS purchase	5	1	14	20
Companies generally buying much less from auditor	3	1	14	18
More tendering and competition for services	5	2	8	15
Audit firms now have policies on NAS provision			6	6
More discussion and scrutiny in company before NAS purchased	4		1	5
Regulation has changed behaviour	1		3	4
No change to services bought		4		4
Only employ auditor where regulations allow and auditor is best provider	4			4
Prefer to use auditor for some services		3		3
Approval procedures create barriers to NAS provision			3	3
SEC rules/influence cause restrictions		1	2	3
NAS restrictions can limit choice of service provider		1	1	2
Greater transparency about what is being done			1	1
Regulation has consolidated best practice		1		1
<b>Total</b>	<b>27</b>	<b>16</b>	<b>72</b>	<b>115</b>

**Note:**

\*These comments are drawn from 47 FDs, 32 ACCs and 92 APs who responded to this question which asked respondents to volunteer the data.

**Table 5b: Analysis of respondent narrative comments re the impact of NAS regulatory changes\* continued**

Impact of change on auditor/client relationship and audit quality	FDs	ACCs	APs	Total
Overall less efficient for company	9	2	6	17
Auditors no longer business advisor – more remote	3	2	4	9
Less value in audit service for company	2	2	4	8
Auditor/client relationship now more formal/adversarial	2		4	6
Auditors know less about client business	2		4	6
Audit firms cautious about providing/offering services	5			5
Auditing less satisfying for audit staff		1	3	4
Some restricted NAS is not a threat to independence		2	1	3
Auditors now more focused – better	1	1		2
Firm has split staff between audit and other service provision			2	2
Restrictions do not enhance audit quality			1	1
<b>Total</b>	<b>24</b>	<b>10</b>	<b>29</b>	<b>63</b>
<b>Total from Table 5a</b>	<b>27</b>	<b>16</b>	<b>72</b>	<b>115</b>
<b>Total</b>	<b>51</b>	<b>26</b>	<b>101</b>	<b>178</b>

**Note:**

\*These comments are drawn from 47 FDs, 32 ACCs and 92 APs who responded to this question which asked respondents to volunteer the data.

The most frequently cited issue regarding the impact of regulatory change, predominantly by APs, is the impact of market pressures on companies to keep the NAS fees down to a certain level. One AP commented about the pressure from active investors:

‘Pressure by activist investor groups and misunderstanding of UK ethical standards for auditors are leading audit committees to stop auditors providing services which are perfectly legitimate and in the interests of shareholders.’ (AP 197)

One FD referred to the need to explain to activist investors why they are using the auditor for NAS:

‘Our principal subsidiary works in a heavily regulated sector and this inevitably requires both routine and non-routine reports. It would be impractical to allocate this work to anyone other than the financial auditor. However, we do ensure that additional work is carefully considered and properly explained when material in the context of “normal” audit work. External reviewers (such as PIRC, ABI, NAPF, etc) will often raise the level of non-audit work but usually accept the explanation.’ (FD 319)



Another FD commented on the market-driven need to keep NAS in proportion to audit fees:

'Now more aware of limit on value of NAS vs AS.' (FD 6)

Others referred to market pressure keeping NAS down, because some users and investors believe there is a link between high NAS fees and auditor independence:

'Certain commentators adopt a tick-box approach to analysis of accounts. As an eg, the ratio of non-audit fees to audit fees being greater than 1:1 so the auditor cannot be independent which is generally a flawed conclusion.' (AP 520)

'There has been general "pressure" in the UK to reduce.' (ACC 65)

The second most frequently cited influence on the drop in NAS purchasing is audit committee policies. The Combined Code requires audit committees to have a policy on NAS purchase and our respondents indicate that this is both rigorous and restrictive in keeping NAS down to a reasonable level because of the independence perception. A number of ACCs made this clear, for example:

'If there were requirements for substantial non-audit work, the regulatory change will prevent my company from purchasing (we have a policy).' (ACC 224)

'(Auditors) simply not considered for any service outside a tight definition.' (ACC 89)

FDs also commented on the restriction imposed by the audit committee:

'We basically now try to buy "nothing else" from the auditors although we recently used them for Class I circular work as there is no real alternative. The Audit Committee would like us to do pretty much no tax work but we don't think this is practical from the Co. side. We recently developed a formal policy in this area which is a pragmatic solution for all.' (FD 136)

'The Audit Committee has made it clear that it wishes to minimise "Other Services" to our auditor, to reduce the risk of a breach of independence.' (FD 58)

APs were also very conscious of the audit committee policies, some of which go beyond the regulatory requirements in the policy to keep NAS down:

'Yes – not because they breached rules, but because the audit committee wanted to reduce non-audit fees.' (AP 328)

'In recent years the audit committee has become more sensitive to the % of audit to non-audit fees. The concern appears to be one of perception, not of independence.' (AP 176)

Interestingly, another barrier to using the auditor for other services was the internal company administrative process. One AP refers to this:

'Need for approval biases the non-board tax director towards other suppliers where audit committee approval is not required.' (AP 188)

There is evidence that more tenders are being held for NAS and some respondents indicated that they would only use the auditors if they were clearly the best supplier and it was within the company policy. However, one FD believed competition had improved the services the company received, but at a price:

'The regulatory changes which resulted in us purchasing other services from non-audit sources has introduced us to new service providers. I find their expertise to be better than the similar teams in our auditors. We therefore have benefited from the change. For the auditors, the change has meant that they are far less involved in our business and this has been a serious negative for them. For us, we have to spend time and money briefing them on the activities that have occurred, which is wasteful.' (FD 281)

The comments about how NAS purchasing decisions are made indicate that there has been a major change in behaviour. A significant influence in keeping NAS levels down has been market pressure from active investors which preparers believe emanates from independence concerns if the level of NAS is high in relation to the audit fee. In order to avoid criticism from investors, some audit committees are restricting the proportion of NAS to audit fees and in some cases going beyond the strict regulatory requirements. Market forces and audit committee policies are having a significant influence on NAS purchasing by companies.

### **Respondents' views about the impact of the NAS change on the auditor/client relationship and audit quality**

Table 5b summarises comments about some consequences of the NAS change. The number of these comments is lower than the comments on the changed purchasing behaviour but nevertheless some potentially serious issues emerge. There are complaints about inefficiency and additional costs arising because companies are not able to get the help from their auditors that they wish to have. An FD and ACC explain:

'It is becoming increasingly difficult to get help from the auditors because of [NAS limitation]. This is ludicrously inefficient!' (FD 446)

'As there are no real indications of non-audit services causing audit failure, the reduction in use of the audit firm for tax & accounting systems issues is an expensive nuisance.' (ACC 195)

Another emerging concern is that the auditors have less knowledge and understanding of the business because they carry out less NAS for the client. One FD explains:

'Now that they do not do non-audit work, they are less conversant with our business.' (FD 281)

This view is echoed by APs, who believe it is now more difficult to offer more general business advice to their client and audit is perceived as adding less value to the business:

'Restrictions on non-audit services mean the firm does less and therefore [we] have fewer opportunities to add value: This leads to a client perception that audit adds less value.' (AP 286)

Another AP offers a more worrying outcome to the NAS independence concerns:

'Management use, "audit independence", as an excuse not to tell us what is going on, on a timely basis. Relationship more adversarial.' (AP 318)

One ACC has a concern about staff not gaining the wide-ranging experience that they previously were, whereas an FD believed that auditors were becoming paranoid about regulation:

'It is clear that the non-audit services fee issue, whilst theoretically something which should be monitored vs independence, is weakening the experience of audit firm staff. Over time, I believe this is detrimental compared with allowing more widespread use of auditors for non-audit services and managing any potential conflicts.' (ACC 224)

'This excessive legislation is simply making them paranoid. This affects the level of service they are prepared to give – eg, preparing accounts.' (FD 190)

This concern is echoed by APs. For example:

'I think a pretty good case could be made that in the longer term regulatory creep will have an adverse impact on audit quality. The reasoning being the "narrower" the role of the auditor becomes (or he/she is precluded involvement in more and more advisory services), the more boring the job becomes, and the harder it will be to retain talented people within the profession.' (AP 328)

'Reduced special work from existing audit client = less knowledge of client and more formal relationship. This last point affects more junior audit staff most. Work is less fun. Harder to attract and retain good staff. Hopefully it will have improved standards of "bad" auditors though I have my doubts. The main controls to ensure good audits are: Bright people, knowledge of clients, time and peer review.' (AP 318)

A small number of respondents express a contrary view, believing that the changes have helped by providing more focus for auditors and taking the pressure away to sell other services:

'The reduction in the provision of non-audit services by the auditor has increased audit focus and commitment.' (ACC 49)

'The clear rules on non-audit services have made the role of audit partner as auditor not salesman much clearer.' (FD 350)

These comments provide evidence of some unintended negative consequences associated with NAS restrictions emerging from the current regime. Auditors may have less understanding of the business and are less engaged with the client. This may undermine the value for audit, not just to the company, but to the shareholders as well and over time auditors may have less overall business experience. A further concern is that auditors are reluctant to provide what companies consider to be necessary help, because of concerns about breaching ES 5 and being caught out. Two respondents believed that the change has improved the auditor/client relationship. There is no suggestion from respondents that regime change is needed.

## Conclusion

The CGAA (2003) set out an agenda for a tougher and more restricting NAS regime to protect both the appearance and fact of auditor independence following the Enron scandal. Following these changes there has been a substantial drop in NAS fees paid to audit firms particularly by the larger companies. At the same time audit firm fees from non-audit clients have increased, suggesting that companies have changed service suppliers in response to the regulatory changes.

Our evidence indicates that there are four main drivers of these changes, two from the company perspective and two from the audit firm perspective. The enhanced role of the audit committee in developing a policy for NAS purchase, which was introduced by the Combined Code (2003) and the Smith Report (2003) has made audit committees more conscious of the importance of auditor independence and therefore reluctant to buy services from their auditor. The second, less visible driver, is the risk to the directors of a challenge from activist investors and from adverse publicity where the level of NAS appears too high or the services disclosed appear inappropriate. Evidence from other academic studies suggests that high NAS fees can also damage share prices eg, Francis and Ke (2006).

For the auditors the requirement to comply with ES 5 has restricted their ability to provide many services regardless of client need, and we find evidence of a wide range of services which firms no longer provide to their audit clients. Furthermore, the UK's rigorous audit inspection regime has created an environment where breaches of ethical standards or inaccurate reporting of the breakdown of NAS are likely to be discovered, providing a further deterrent to NAS provision by the auditors.

It is therefore clear that the post-Enron reforms brought in by the CGAA have been successful in restricting the level of NAS and engaging the interest of audit committees and investors in considering auditor independence and NAS. Despite being principles-based, the regime has in effect introduced de facto prohibitions to auditors providing a wide range of NAS. Dart (2009) finds that investors are concerned about independence in appearance in relation to NAS provision, but our evidence suggests the provision of the services which most concern investors has already been restricted. The academic literature has not found a systematic link between NAS provision and factors in financial reporting or auditing which might suggest a lack of independence in fact, although the perception issue remains, particularly at a high total fee level (Holland and Lane, 2009). This perception is mitigated in the UK by the current regulatory environment and engagement of investors with NAS fee levels. Investors are also better informed about the type of NAS being provided by auditors via the enhanced disclosure requirements brought in by Statutory Instrument 2005/2417.

Some directors believe the changes have been a good thing and have focused auditors much more on their key tasks. However, there is also emerging evidence of inefficiencies in the current regime. Directors have complained that auditors are reluctant to give advice which the company needs, because of the risk of breaching ES 5 and that it is more costly and inconvenient to have to use other suppliers for some services. Some auditors and directors have expressed concerns that auditors now have less understanding of their clients' activities due to their more restricted engagement with other aspects of the business.

The evidence from this Briefing indicates that the UK's current market-based approach underpinned by regulation based on clear principles has brought about significant reductions in the level of NAS supplied by audit firms to their clients. By limiting the opportunities for NAS provision, these safeguards have therefore contributed significantly to reducing the perceived risk to auditor independence arising from high levels of NAS provision. No regime is perfect and there is always room for improvement, but further changes need to be considered in the light of the effectiveness of the current regime in reducing the amount of NAS provision. It is not obvious from our evidence that a total ban is needed. Furthermore, the already emerging unintended consequences to the efficiency and effectiveness of the financial reporting and auditing process arising from the existing restrictions on NAS delivery are likely to be exacerbated by a total ban or by further restrictions on NAS provision.

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