

# [Non-audit services essay](https://assignbuster.com/non-audit-services-essay/)

“ Recent expansion of nonaudit services by public accounting firms has caused some to question whether auditors who provide nonaudit services to audit clients can remain independent of their clients”

### Introduction

The increasing level of frauds and scandals in the corporate sector have resulted in an upsurge in the regulations for audit firms whereby their independence is kept into question due to the non-audit services they offer to their audit clients (IOSCO, 2007). Many public accounting firms provide such services to their clients merely because of convenience, knowledge about the clients’ financial statements and saving extra time spent dealing with audit and non-audit services separately (Muir, 2014). However, financial statement users often perceive it as impairing the auditor’s independence (Al-Ajmi and Saudagaran, 2011). Different views exist about the impact of providing non-audit services to audit clients; they may have negative (Quick and Rasmussen, 2015), positive (Wang and Hay, 2013) or no effect on the auditor’s independence (Jenkins and Krawczyk, 2001). As such, this essay will explore whether the provision of nonaudit services affects auditors’ independence.

### Definition and Role of Non-audit Services

Adeyemi and Olowookere (2012) regard non-audit services to be any services provided by an auditor other than their code audit function. These services may include bookkeeping (Jenkins and Krawczyk, 2001), management consultancy (ICAEW, 2015), tax advisory services (Pwc, 2014), human resource consultancy (ABP, 2004) and others. Jenkins and Krawczyk (2001) found that bookkeeping has a negative impact on auditor’s independence, while management consultancy and tax advisory services have a positive impact. The differences occur because of an expectation gap between the auditing professionals and financial statement users (Jenkins and Krawczyk, 2001).

Looking at it from a marketing perspective, organisations providing additional value to their customers other than their core service are considered to be highly competitive and end up being more successful than their competitors (Hoffman, 2009). That is exactly what audit firms strive for when they offer additional services to their clients in anticipation of strengthening relationship with them (Ismail, Hasnah, Ibrahim and Isa, 2006). However, critics object on the income received from non-audit services because their impact on the objectivity of the auditor has long been considered as a potential threat for the auditing process and financial system as a whole (Adeyemi and Olowookere, 2012). Okaro and Okafor (2009) pointed out that an audit firm auditing their own work is not regarded to be independent and the objectivity of their work may be questioned at any point by financial statement users. To avoid any criticisms from their stakeholders, audit firms need to be particular about their audit quality, which is considered to be high if the stakeholders are assured to have no uncertainty and ambiguity in the financial statements prepared by the management (Krishan, Zhang and Sami, 2005).

### Negative Impact on Auditor’s Independence

#### Threat to Audit Quality

The work of an audit firm is to act as an investment guide, which helps in their clients’ valuation and predicting bankruptcy (Salehi, 2009a). Research suggests that there is a strong relationship between the credibility of the statements produced by an audit firm and the investment decision taken by the client (Salehi, 2009a). Therefore the economic development of the client is often dependent upon the credibility of the documents prepared by the audit firm, which depicts the financial standing of the client (Wahdan et al., 2005). Sori and Karbhari (2006) believe that the auditor independence may be affected by this economic bonding between the auditor and the client. In case of an increasing pressure from the client regarding consultancy in investment decisions, the auditor may unintentionally overlook the quality of the actual audit services.

Gwilliam (2010) mentioned that a classic example of audit failure was that of Ernst & Young while conducting the audit of a UK truck manufacturing company, ERF. In that case, the provision of non-audit services impaired the audit quality to such an extent that the firm had to undergo a couple of lawsuits. A part of the case constituted of the company accountant’s attempt to fabricate the VAT returns, so that the repayments from the Customs and Excise could be received. Moreover, the audit team did not work on the VAT separately; they relied upon the figures received from the VAT specialists. This compromise in the quality of audit services resulting from intrusion of additional services, negatively affected the independence of Ernst & Young.

#### Threat due to the Provision of Joint Services

Another problem arises when the audit and non-audit services are provided in conjunction with each other, whereby the focus on the actual service may be lost (Sori and Karbhari, 2006). Swanger and Chewning (2001) recommended a solution to this issue, i. e. the personnel performing the audit and non-audit services should be separate. Regulatory authorities, however, believe that it would be difficult to track performance if this solution is implemented; hence audit firms should be banned from providing any additional services to their clients (Chadbourne and Parke, 2003). Additionally, the Securities and Exchange Commission adopted rules which limit the audit firms from providing any compensation to their clients in joint services (Chadbourne and Parke, 2003).

#### Threat of Higher Non-audit Fee

Research indicates that the auditor independence is adversely affected if the fee paid for non-audit services is higher when compared with that of audit services (Frankel, Johnson and Nelson, 2002). Due to the existence of this threat, the Securities and Exchange Commission devised laws which enforced the disclosure of all fees paid to auditors by their clients (Chadbourne and Parke, 2003). Chen, Elder and Liu (2005) found an unfavourable relationship between non-audit services and the degree of acceptance the client showed to the recommendations by the auditor. This imparts that highly extensive additional services result in lower possibility of acceptance from the client, due to the equally high fee attached to them (Reynolds, Deis and Francis, 2004). Therefore, it may turn out to be hazardous for the audit firm’s independence as it would then attempt to introduce even more extensive non-audit services, further complicating legal requirements for itself.

#### Threat from Relationship with Management

Perhaps the greatest detrimental effect which non-audit services have on auditor’s independence is related to the relationship between the auditor and client management and the way it affects audit approach (Gwilliam, Teng and Marnet, 2014). Despite its economic dependence on its clients, the audit firm’s independence is greatly strengthened by lower levels of competition to cater to its clients (Quick and Rasmussen, 2015).

### Positive Impact on Auditor’s Independence

#### Strengthening Audit Quality

Wang and Hay (2013) provided evidence for a positive relationship between provision of non-audit services and auditor’s independence, indicating that these additional services help the audit firms distinguish themselves from their competitors, whereby they portray their uniqueness in front of their clients. Some authors support this claim by saying that the auditor’s objectivity is strengthened by non-audit services because they help them form a better understanding of their clients (Jenkins and Krawczyk, 2001). Proponents of this view explain that the audit quality is indeed enhanced by the provision of non-audit services, because the auditors are then able to develop a better understanding of their clients’ industry, competitive position, strategies, business model and the risks they face (Ernst & Young, 2013). Gwilliam, Teng and Marnet (2014) mentioned that because of economies of scope, the joint provision of audit and non-audit services has economic benefits for both the auditor and the client. It is mainly because of knowledge spillovers. Limiting the audit firms from providing non-audit services would result in economic inefficiency.

Ernst & Young (2013), for example, takes advantage of its non-audit services through knowledge spillovers; i. e. it uses the financial information gained from auditing its clients to provide advisory and consultancy services to the same clients related to their investment decisions, recruitment, strategic direction and other such internal matters.

While there are concerns regarding clients paying higher fee when they opt for a joint provision of both types of services (Frankel, Johnson and Nelson, 2002), there is another school of thought which directs financial statement users to initially compare the frequency of usage of both audit and non-audit services before jumping to any such conclusions (Ezzamel, Gwilliam and Holland, 2002). This imparts that firms paying higher may be using more of non-audit services than actual audit services.

An example of the positive effect of non-audit services could be gauged from the recent guidelines by the Financial Reporting Council (FRC, 2015), which introduced the revised Auditing Standards ensuring that the auditors are able to get some consultancy and advice regarding provision of non-audit services. Along with explaining its regulations, it also claims to provide guidance to audit firms on how they can use these supplementary services to their advantage, remaining within the ethical code of conduct. Even in case of pressure from the client regarding non-audit services, the auditor must first ensure its stakeholders that it produces completely transparent financial statements and should not get involved in suspicious practices, such as the KPMG case, where the company’s accountants were doubted to be involvement in tax dodging, which they finally had to publicly admit. They then avoided the lawsuits by paying a huge penalty and accepting the conditions imposed by the US Justice Department (Gwilliam, Teng and Marnet, 2014).

#### Positive Reputation Effects

Supporters of non-audit services do not contradict with the laws related to these services; they in fact believe that if the services are provided with the appropriate measures to safeguard auditor’s independence, they will end up being favourable for both the auditor and the client (Ernst & Young, 2013). Advocates of this viewpoint also found that the income received as a result of providing non-audit services helps in enhancing auditor’s reputational capital, which is the firm’s goodwill in the market (Wang and Hay, 2013). Thus, to sustain their goodwill, audit firms would keep themselves from surrendering to their clients. Evidence from economic models suggests that audit firms may be willing to forgo short-term increases in earnings from non-independent behavior in anticipation of building a better reputation in the long run, leading to higher economic returns (Gwilliam, Teng and Marnet, 2014). Firms would, therefore, abide by the rules as they prove to be a powerful tool to safeguard against any independence violence.

#### Enhancement in Audit Training

Some researchers believe that if auditing personnel are involved in providing non-audit services, they will not be able to perform the audit tasks in a complex business environment (Sori and Karbhari, 2006). On the contrary, proponents of non-audit services argue that by performing these additional services, junior auditors and audit trainees learn many skills which then help them become more competent accountants, which favourably impacts the audit firm’s independence and audit quality (Gwilliam, Teng and Marne, 2014).

### No Impact on Auditor’s Independence

Some researchers believe that there is no relationship between provision of non-audit services and auditor independence (Jenkins and Krawczyk, 2001). Reviewing 20 years of literature, Salehi (2009b) did not find enough evidence about investors being concerned with non-audit services. Quick and Rasmussen (2009) also discovered that there is a lack of evidence supporting the claim that non-audit services are the reason behind impairment of auditor’s independence. Tepalagul and Lin’s (2014) study revealed that providing consultancy services to audit clients does not really affect the perceptions of the financial statement users about auditor’s credibility and independence; it in fact helps in enhancing the organisation’s internal control systems.

### Conclusion

There are many reasons due to which an auditor’s reliability and independence may be compromised, one of which is often said to be the additional non-audit services provided by audit firms to their clients. Some researchers believe that these services pose to be a threat to the audit quality and independence by joint provision of both service types, higher non-audit fee and relationship with management. There are others who believe that these services positively influence auditor independence, whereby the audit quality is strengthened and the audit firm enjoys better reputational capital and enhanced audit training. There are still other researchers who found non-audit services to have no impact on the auditor’s independence. Numerous examples of firms are present supporting either of the three viewpoints; it all depends upon the auditor’s strategic moves by which it strives to safeguard its independence and the reliability of its work. The doubts financial statement users have about auditors’ performance can be handled well by standardized processes and transparency of information provided by audit firms.

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