

What is the relationship between audit quality and non-audit services? An overview of the existing literature

Jan Bouwens¹

Professor of Accounting at Cambridge Judge Business School and Managing Director of the Foundation for Auditing Research.

Introduction

In this paper, I take stock of the literature that takes issue with the question of whether audit quality is impaired if a firm offers audit as well as advisory services to the market. I observe that the extant literature gives little evidence of a quality-reducing effect of advice on the audit. The research even seems to point towards an increase in quality, in cases where, in addition to assurance, the firm offers advisory services. This advantage can be attributed to knowledge transfer, where auditors benefit from the knowledge of their colleagues who give advice to the firms they audit. The findings indicate that audit quality has not improved with the stricter rules to separate advisory from audit services. If anything, the rules have introduced a barrier for positive spill overs to occur between assurance and advice.

Literature discussion

There is a social debate about whether it is wise to organize accountancy and advisory services within one company. The concern is that accountants are less likely to raise shortcomings in reporting because these could possibly harm the advisory business. Such damage would be directly at the expense of the audit company's income if profits from the business units are pooled and would also harm their relationship with the advisors because they would reject the auditor's harsh position toward their client. In a report commissioned by the ICAEW, Gwilliam, Min Teng and Marnet examined the question, concluding that: "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." Chief Executive Stephen Haddrill of the Financial Reporting Council, which regulates the sector in the UK, called for "an investigation into whether

¹ I wish to thank Olof Bik, Marco van de Vegte and Egbert Eeftink for the comments they gave on a previous version of this paper. I wish to thank Katie Jones and Emily Brown for their help.

KPMG, Deloitte, PwC and EY should have to spin off their UK audit arms into separate businesses” (Haddrill, 2018).

In this paper, I refer to the literature that took issue with the relation between audit quality and the provision of non-audit services. I want to start with the observation that the number of studies that have been undertaken is overwhelming and that almost without exception, they point in a different direction than that assumed in politics and debate. That is, the evidence suggests that non-audit services do not adversely affect the quality of the work of the accountant.

Three aspects are considered: (1) the extent to which the accountant allows the company to show better or worse results than the underlying economic condition warrants (e.g., the accountant allows firm management to manipulate results), (2) the willingness of the accountant to issue a qualified going concern opinion, and (3) the extent to which the accountant holds on to the conservatism principle (recognizing profit only if it is certain and taking losses even if it remains uncertain if these losses will arise).²

When it comes to the question of whether auditors are less likely to issue a qualified opinion on the going concern status, the work by DeFond, Raghunandan and Subramanyam (2002) does not give any indication of a smaller chance of qualifying the continuity of firms that take advisory services in addition to audit services. Ruddock, Taylor and Taylor (2006) find no evidence for the conjecture that auditors relax the application of the conservatism principle as a guiding principle for companies that, in addition to the audit, take other services offered under the same brand name. In other words, regardless of whether an audited company does or does not provide advisory services alongside auditing services, auditors do not make any difference between both customers in terms of result recognition. That is, independent of whether their firm does or does not offer advisory services, the auditor maintains the conservatism principle, according to which they require that costs are expensed at the time they surface as a potential cost and where they only recognize a revenue when this is realized with certainty. Antle, Gordon, Narayanamoorthy and Zhou (2006), Ashbaugh et al. (2003), Chung and Kallapur (2003), Francis and Ke (2003), and Reynolds, Deis and Francis (2004) find no result to suggest that there exists a link between the relative financial interest the audit firm has from one individual client in the office and earnings management. Lennox (2016) demonstrated that the restrictions imposed by the PCAOB in 2005 and 2006 on tax advice had no effect on audit quality

² Of all the papers I list below, there appears only one that finds a generic link between non-audit services and earnings manipulation: Frankel, Johnson and Nelson (2002). Their finding, however, proved to be based on a mis-specification (Ashbaugh, LaFond and Mayhew, 2003). If there is a problem, it comes with a very small sample of fast-growing SMEs in which the management had the full say.

measured in terms of the number of reported errors that gave rise to a financial restatement, shortcomings in filed tax returns and the going concern opinion.

Looking at the huge amount of studies, there seems to be little ground to support the claim that cases exist, for which it is shown that the accountant's independence was adversely affected because the firm he/she is part of also provides advisory services.

Is there nothing going on?

Francis (2006) believes we should be careful. We will not find a direct connection as quickly, as it is unlikely that quality issues can be readily observed. Instead, it is entirely possible that the accountant sub-consciously loses his/her independence, if they offer additional advisory services. But if that were true, we should still find such evidence in empirical studies, because the above studies do not distinguish between conscious or sub-conscious independence issues. The studies examine whether the accountant per se makes a difference between customers who do or do not receive advisory services alongside assurance.

However, if it does not make any difference, can we also try for an assurance to an audit-only company? This reasoning may be problematic. In the above-mentioned studies, it is examined if the quality of the auditor's work suffers as advisory services are delivered in addition to assurance services. But there is also research into whether the audit work benefits as other services are provided alongside assurance. This work focuses on whether the knowledge gathered in the firm by providing different services is beneficial to the quality of the audit service. Such an improvement would surface if the accountant retrieves knowledge from his advisory colleagues and can apply this knowledge to enhance the quality of his/her assurance work.

Koh, Rajgopal and Srinivasan (2015) conducted an important study in this regard. They specifically looked at the situation in which it was still permitted for audit firms to provide audit services alongside advice on information systems. They find that firms that give advisory services to a company, in addition to assurance, are less likely to allow profits to be manipulated. This relationship was further enhanced if information advice was given. If we put this outcome in the light of the eradication of information services, it is unclear whether this measure has worked out favourably for the work of the audit profession. For example, it is entirely possible that it is easier to determine whether the internal controls work well, if the accountant can also obtain information from their colleague regarding the design of those controls. Weaknesses become clearer than before. In this respect it does not matter whether the firm audits and advises the same company, what is important is that firms that combine advisory with audits develop a wider range of skills that spill over. The fact that the knowledge is in the firm, helps the auditor to see weak and strong points. In addition, since advisors and auditors work according to a firm-wide set of internal rules and regulations, it is not a forgone conclusion that independence issues surface if control and advice are organized in one firm.

On the other hand, Bell, Causholli and Knechel (2015) show that for private firms the provision of advisory services is negatively associated with the quality of the audit. Audit quality was measured by looking at internal Assessments of Audit Quality by colleague accountants in the United States. Accountants provided poorer audit quality to customers who, in addition to assurance services, also obtained advice; but the result is the opposite for companies that are subject to mandatory audit. Public firms could count on higher audit quality. In the first case, the risk of a claim is smaller than in the second case. Perhaps those auditors become stricter if their independence is, in appearance, compromised (because their company also provides advisory services) and enforcement is more likely to be imposed (by the PCAOB). On the other hand, it is entirely possible that the internal controls of private firms are of a lower quality, leading mechanically to lower quality financial statements. Future research will tell.

In addition to the fact that the quality of the audit may benefit from the presence of advice in addition to assurance services, there is also an effect on the auditee. Ciconte, Knechel and Mayberry (2017) show that firms that, in addition to their assurance services provide advisory services, have a favourable influence on the operation of the company. In other words, profitability is promoted if the firm offers a broader range of services.

Discussion and conclusion

Based on the results of existing research, we can derive few arguments for firms to spin off their audit arms into separate businesses. There is a likelihood that transfer of knowledge within firms is impaired when firms are forced to deliver audit only. Very recent research from Ciconte et al. (2017) shows that corporations benefit if their auditor also offers advisory services. However, there exists some indications for possible negative quality consequences in Bell et al. (2015), who find that auditors are less alert in private firms who take non-audit services compared to public firms that take non-audit services. As Francis (2006) states, the findings do not rule out that accountants are unwittingly less strict in auditing the financial statements of firms to whom they deliver advisory services in addition to assurance services.

To conclude, the existing research would not suggest that establishing audit-only firms would enhance the audit quality.

References

Antle, R., E. Gordon, G. Narayanamoorthy and L. Zhou. 2006. The Joint Determination of Audit Fees, Non-Audit Fees, and Abnormal Accruals. *Review of Quantitative Finance and Accounting* 27(3): 235-266.

- Ashbaugh, H., R. LaFond and B. W. Mayhew. 2003. Do Nonaudit Services Compromise Auditor Independence? Further Evidence. *The Accounting Review* 78 (3): 611-639.
- Bell, T., M. Causholli and R. Knechel. 2015. Audit Firm Tenure, Non-Audit Services and Internal Assessments of Audit Quality, *Journal of Accounting Research* 53 (3): 461-509.
- Chung, H. and S. Kallapur. 2003. Client Importance, Non-Audit Services, and Abnormal Accruals. *The Accounting Review* 78 (4): 931-955.
- Ciconte, W.A., W.R. Knechel and M.A. Mayberry. 2017. Investments in Auditor-Provided Non-Audit Services and Future Operating Performance, working paper.
- DeFond, M. L., K. Raghunandan and K. R. Subramanyam. 2002. Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions. *Journal of Accounting Research* 40 (4):1247-1274.
- Francis, J. R. 2006. Are Auditors Compromised by Non-Audit Services? Assessing the Evidence. *Contemporary Accounting Research* 23 (3): 747-760.
- Francis, J. R. and B. Ke. 2006. Disclosures of Fees paid to Auditors and the Market Valuation of Earnings Surprises. *Review of Accounting Studies* 11 (4): 495-523.
- Frankel, R. M., M. F. Johnson and K. K. Nelson. 2002. The Relation between Auditors' Fees for Non-Audit Services and Earnings Management. *The Accounting Review* 77 (Supplement): 71-105.
- Gwilliam, D., C. Min Teng and O. Marnet. 2014. How Does Joint Provision of Audit and Non-Audit Services Affect Audit Quality and Independence? A review commissioned and published by the ICAEW.
- Hadrill, S. in *The Guardian* and *the Financial Times*. 2018. <https://www.theguardian.com/business/2018/mar/16/frc-inquiry-big-four-accountancy-kpmg-deloitte-pwc-ey> and <https://www.ft.com/content/911e8184-283d-11e8-b27e-cc62a39d57a0>
- Koh, K., S. Rajgopal and S. Srinivasan. 2013. Non-Audit Services and Financial Reporting Quality: Evidence from 1978 to 1980, *Review of Accounting Studies* 18 (1): 1-33.
- Lennox, C.S. 2016. Did the PCAOB's Restrictions on Auditors' Tax Services Improve Audit Quality? *The Accounting Review* 91 (5): 1493-1512.
- Reynolds, J. K., D. R. Deis and J. R. Francis. 2004. Professional Service Fees and Auditor Objectivity. *Auditing: A Journal of Practice and Theory* 23 (1): 29-52.
- Ruddock, C., S. J. Taylor and S. L. Taylor. 2006. Non-Audit Services and Earnings Conservatism: Is Auditor Independence Impaired? *Contemporary Accounting Research* 23 (3): 701-746.

Other studies into non-audit services and audit

- Beck, P., T. J. Frecka and I. Solomon. 1988a. An Empirical Analysis of the Relationship Between MAS Involvement and Auditor Tenor: Implications for Auditor Independence. *Journal of Accounting Literature* 7: 65-84.
- . 1988b. A Model of the Market for MAS and Audit Services: Knowledge Spill overs and Auditor-Auditee Bonding. *Journal of Accounting Literature* 7: 50-64.

- Brown, J., D. Falaschetti and M.Orlando. 2010. Auditor Independence and Quality of Information in Financial Disclosure: Evidence for Market Discipline vs. Sarbanes-Oxley Proscriptions. *American Law and Economics Review* 12 (1): 39-68
- DeBerg, C. L., S. E. Kaplan and K. Pany. 1991. An Examination of Some Relationships Between Non-Audit Services and Auditor Change. *Accounting Horizons* 5 (1): 17-28.
- Dopuch, N., R. R. King and R. Schwartz. 2003. Independence in Appearance and in Fact: An Empirical Investigation. *Contemporary Accounting Research* 65: 83-113.
- Firth, M. 1997. The Provision of Non-Audit Services by Accounting Firms to their Audit Clients. *Contemporary Accounting Research* 14 (2): 1-21.
- Gleason, C. and L. Mills. 2011. Do Auditor-Provided Tax Services Improve the Estimate of Tax Expense? *Contemporary Accounting Research*, 28 (5): 1484-1509
- Glezen, G. W. and J. A. Millar. 1985. An Empirical Investigation of Stockholder Reaction to Disclosures Required by ASR No. 250. *Journal of Accounting Research* 23 (2): 859-870.
- Kinney, W. R. and R. Libby. 2002. Discussion of The Relation between Auditors' Fees for Non-Audit Services and Earnings Management. *The Accounting Review* 77 (Supplement): 107-114.
- Kinney, W. R., Z.-V. Palmrose and S. Scholz. 2004. Auditor Independence, Non-Audit Services, and Restatements: Was the U.S. Government Right? *Journal of Accounting Research* 42 (3): 561-588.
- Larcker, D. F. and S. A. Richardson. 2004. Fees Paid to Audit Firms, Accrual Choices, and Corporate Governance. *Journal of Accounting Research* 40 (3): 625-658.
- Maher M. W., P. Tiessen, R. Colson and A. J. Broman.1992. Competition and Audit Fees. *The Accounting Review* 67 (1): 199-211.
- Parkash, M. and C. F. Venable. 1993. Auditee Incentives for Auditor Independence: The Case of Non-Audit Services. *The Accounting Review* 68 (1): 113-133.
- Scheiner, J. H. 1984. An Empirical Assessment of the Impact of SEC Non-Audit Service Disclosure Requirements on Independent Auditors and Their Clients. *Journal of Accounting Research* 22 (2): 789-797.
- Scheiner, J. H. and J. E. Kiger. 1982. An Empirical Investigation of Auditor Involvement in Non-Audit Services. *Journal of Accounting Research* 20 (2): 482-496.
- Simunic, D. A. 1984. Auditing, Consulting, and Auditor Independence. *Journal of Accounting Research* 22 (2): 679-702.
- Whisenant, S., S. Sankaraguruswamy and K. Raghunandan. 2003. Evidence on the Joint Determination of Audit and Non-Audit Fees. *Journal of Accounting Research* 41 (4): 721-744.