

A Review of Audit Quality and Joint Provision of Audit and Non-Audit Services¹

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David Gwilliam
University of Exeter

and

Oliver Marnet
University of Exeter

and

Chie Min Teng
University of Exeter

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About the authors

David Gwilliam, BA, MA is an ICAEW member, currently a professor in the School of Business at the University of Exeter. He has studied, taught and researched aspects of the audit and the audit market for more than 25 years. He has research experience covering archival, empirical and interview based studies relating to audit and governance. He has worked on three previous studies supported by ICAEW twice as a primary researcher and once as secondary researcher. The completion of these studies led to the publication of three books (Gwilliam, 1987; Macve with Gwilliam, 1993; Brierley and Gwilliam, 2001) together with a significant number of associated publications in both professional and academic journals. In 2003 he gave the ICAEW PD Leake lecture entitled 'Audit methodology, Risk Management and Non-Audit Services: What can we learn from the recent past and what lies ahead' (Gwilliam, 2003) and has published a number of journal papers relating to non-audit services (Ezzamel, Gwilliam and Holland, 1996; Canning and Gwilliam, 1999, Ezzamel, Gwilliam and Holland, 2002).

Oliver Marnet BA, MA, PhD, currently a lecturer in the School of Business at the University of Exeter, conducts research into corporate governance and audit with a focus on the quality of decision-making of external auditors and board directors. These studies have led to the publication of one book, publications in academic journals (Marnet 2007, 2008, 2011, 2012), and submissions of comments on the European Commission's consultation on Audit Policy (EC, 2010). In 2010, he was invited to provide input to the ICSA review of the 2003 Higgs Guidance on behalf of the Financial Reporting Council, subsequently published by the FRC as the *Guidance on Board Effectiveness* (FRC, 2011), an element of the UK's corporate governance framework.

Chie Min Teng FCCA, MSc, a lecturer at the University of Exeter Business School, has more than ten years experience as a practitioner in auditing, management and accounting. His experience in the industry provided him with insights into the selection and implementation process of various types of services, both from the view of the auditor and the purchaser. His current research interest is in the area of non-audit services. This includes the development of legislation and regulations that govern the provision of non-audit services by auditors, and changes in the non-audit service market.

1.0 Executive Summary

1.1 Introduction

This executive summary is divided into 2 sections. Section 1.1 sets out the motivation and scope of the study. Section 1.2 discusses the key findings and main conclusions.

1.1.1 Motivation for this study

The primary aim of the proposed research is to investigate and 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. To reflect the need for a better understanding of the importance of non-audit services provision, and in order to further quantify, qualify and categorize these, we investigate how NAS are perceived by the public and investors, and why companies request joint provision from firms.

Against a background in which issues of audit competition, efficiency, pricing and value added are on the front stage of the audit debate and audit regulation, this research is designed to provide input relevant to these issues, input which will inform and be of use to firms, as well as the professional bodies and regulators more widely. Such an investigation provides additional insights on the magnitude and type of NAS provision to a broad spectrum of companies and stakeholders and also develops an understanding of how NAS may enhance and/or overlap with their use of audit services.

1.1.2 The scope of this study

The study focuses on the extensive body of literature directed toward significant aspects of non-audit service provision and issues associate, 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 (including reporting beyond the financial statements) and auditing.

We consider it to be directly relevant to the ongoing debate at both national and European level as to issues of competition, liability and regulation in the audit market. This paper seeks to: contextualise the issue; provide a resume of the arguments that have been advanced for and against allowing such joint provision; and concludes with a brief review of possible policy options. It seeks to do this by means of:

- a) Consideration of the change in the extent and range of non-audit service provision by accounting and auditing firms since the beginning of the previous decade;
- b) Exploration of the manner in which the perception and practice of audit has changed in recent years away from that of monitoring the accuracy of company financial reporting to that of an enabling and facilitating function within the overall risk and business management of the client, and the more recent change away from the business risk approach;
- c) Discussion of arguments for and against continuing to allow the provision of non-audit services to audit clients with a particular focus on the interaction with the change in the audit approach and the generation of two way knowledge spillovers between audit and non-audit services,
- d) A review of the current policy debate in the UK and at EU level on continuing to allow the joint provision of non-audit and audit services to audit clients, and as a business model for large firms.
- e) Conclusions and consideration of policy issues.

1.1.3 Audit quality and joint provision of audit and non-audit services

We review the relevant academic literature on impacts on audit quality from joint provision, with a particular focus on covering the past 10 years to provide an update to more recent research and provide a reflection on the changes that have impacted on the provision of audit and non-audit services. We also reflect on relevant non-academic literature, such as official reports (e.g. EC papers, FRC publications) where this contributes to an understanding of the current debate or where this shapes the environment in which audit and NAS operate.

1.2 Key findings and conclusions

The research under review provides a somewhat mixed picture on the effects of the joint provision of audit and non-audit services on auditor independence and the quality of audit. At first glance, the evidence would not appear to overwhelmingly support a blanket ban of joint provision. However, we note that the research and arguments supporting limits to the provision of non-audit services to an audit client are somewhat more substantial in comparison to arguments that support joint provision.

On the whole, the reviewed evidence tends to support arguments against the provision of non-audit services to an audit client. A diminished emphasis on joint provision also appears to be reflected in recent market trends, expressions of concerns by regulators, policy makers and various stakeholders, and regulatory responses to perceived shortcomings of audit with regard to its social and economic function.

The provision of consulting services has become an increasingly important source of revenue for the Big Four over the past decade, but there has at the same time been a significant and steady decline in the provision of non-audit services to audit clients. Data on joint provision by the Big Four may reflect a significant decline in the perceived importance or credibility of arguments that favour joint provision, as well as raised client concerns with regard to perceptions of impairment to auditor independence from the provision of non-audit services to audit clients. This supports conclusions drawn from the review of the relevant literature and policy responses which suggests that arguments for not providing non-audit services to audit clients are more convincing.

Further conclusions can be based on considerations with regard to the impact of behavioural and cognitive factors on auditor judgement and auditor independence, and their effects on the ability of auditors to conduct audit with the required degree of scepticism. The impact of cognitive bias on the quality of auditor judgement and decision-making supports the conclusion that not to provide non-audit services is a good thing. Regulators and policy makers would increasingly appear to share such an interpretation.

For reasons discussed in the text we welcome the trend reflected in market data, whilst acknowledging the possibility for specific circumstances where it could be useful for some services other than audit to be provided to an audit client. Market pressures may already have led to a decline of joint provision, although some rationale would suggest moderate provision of selected non-audit services to audit clients to provide limited benefits. The latter proviso might make it difficult to support a blanket prohibition of the provision of non-audit services to audit clients without further research which seeks to more clearly ascertain the threat to independence from specific non-audit services.

In sum, while a complete ban on audit firms carrying out non-audit work for clients whose accounts they audit may neither be justified nor advisable, we note that a combination of market trends and regulatory concerns have led to a decline in joint provision, a trend which we would like to support.

2.0 Introduction

The primary objective of this report is to provide a detailed review of the extensive academic and other literature which has investigated and analysed the manner in which accounting and audit firms have provided non-audit services to audit clients and others, and to provide insights which may be of value to policy makers and others. Issues of auditor independence and the public perception of auditor independence in connection with the provision of non-audit services (NAS) to their audit clients were recently again 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 non-audit services are provided by the auditor. Perceptions exacerbated where there is a high ratio of NAS fees to audit fees paid to a company's auditor, the scale of the issue finding reflection in proposals by the Treasury Select Committee in October 2009 (and related proposals by the European Commission in 2011 – see COM(2011) 779), to impose a blanket prohibition on the provision of non-audit services by auditors recommendations which for the time being, were not supported in the UK which essentially continued to rely on a threats and safeguards approach, clarification with regard to definitions, and specific prohibitions in respect of non-audit services included in ethical standards (see, ES 1, ES 5, revised, APB, 2011).²

The majority of existing research effort has focused on specific issues, for example is the provision of non-audit services associated with more earnings management? or with a diminished propensity to modify the audit report? But there has also been more limited investigation of wider and more holistic issues – for example analysis of changes in this market consequent to the divesting by the large firms of their 'big ticket' consultancy arms around the turn of the millennium; the spotlight shone on the joint provision of audit and non-audit services with regards to Enron and other high profile North American cases; the reaction embodied within the Sarbanes-Oxley Act (2002) in the US and the various UK government inspired post Enron reports; the new requirements for disclosure and for monitoring and approval of the provision of non-audit services by the incumbent firm; the entry into the audit and consulting market of firms primarily focused on consulting rather than on the provision of audit services; and the significant increase in the extent and

² On 28 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 external audit contract at least every ten years, applied on a 'comply or explain' basis. See: <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-publishes-updates-to-UK-Corporate-Governance-C.aspx>.

detail of reporting beyond that required by statute, reporting which is frequently accompanied by forms of assurance provided by firms.

The present review aims to focus on the literature relating to the joint provision of audit and non-audit services and the potential effects on independence and the quality of audit. In the last three decades there has been an array of literature, largely North American in orientation, on issues related to the provision of non-audit services, a literature that includes *inter alia*: Palmrose (1986), Firth (1997), Canning and Gwilliam (1999), Defond et al. (2002), Ezzamel et al. (2002), Firth (2002), Frankel et al. (2002), Beattie and Fearnley (2002), (who provide an extensive and valuable review of the then extant literature as to the relationship between the provision of a broad range of non-audit services and auditor independence), Ashbaugh et al. (2003), Ferguson et al. (2004), Kinney et al. (2004), Krishnan et al. (2005), Hay et al. (2006), Srinidhi and Gul (2007), Basioudis et al. (2008), Davis and Hollie (2008), Pott et al. (2009), Dedman et al. (2009), Beattie et al. (2009), Francis (2011), Krishnan et al. (2011).

In their detailed review of the literature on auditor independence and non-audit services, Beattie and Fearnley (2002) note that while there is little clear support for the view that joint provision impairs independence in fact, there is a reasonable consensus that joint provision adversely affects perceptions of auditor independence. Schneider et al. (2006) reach a broadly similar conclusion in their review of the literature. In a more recent review of the post-Enron changes to the NAS regulation in the UK, EU and US, Beattie et al. (2009) note the significant drop in the percentage of NAS fees to audit clients from 1997 to 2008, attributing the drop to both regulatory changes, but also to a voluntary choice by companies as a result of reputational concerns of accepting NAS from their external auditor. Beattie and Fearnley (2009) further examine the impact of regulatory changes on decisions on NAS provision and acceptance, and note that audit committees are more reluctant to procure services from their auditor due to concerns about auditor independence, in combination with the need for auditors to comply with ES 5 (APB, 2011), which restricts their ability to provide many services, and a perceived heightened deterrence from a strengthened UK audit inspection regime with regard to breaches of ethical standards or inaccurate reporting of the breakdown of NAS.

Through systematic analysis and review of this literature this report aims to both make this literature more accessible to a wider audience – but also offer 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 non-audit services to audit clients and indirectly as to the wider policy debate on concentration in the auditing industry.

3.0 Context and Background

Accounting and audit firms, and in particular the large international firms have transformed in the last 40 years from organizations, 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 categorized loosely under the umbrella of knowledge services. Over the same time, there has been a perceived transformation in the role of the audit firm from that of a periodic external check on the accuracy of a company's financial statement toward a value adding function integrated within and contributing to the company's overall risk management profile and business performance. Since the 1970s, auditors have relied on the audit risk model to gain an understanding of the different components of audit risk. Comprised of inherent risk, control risk, and detection risk, audit risk refers to the possibility of the auditor issuing an inappropriate opinion on materially misstated financial statements. The 1990s saw a shift to the business risk approach, which involved a greater focus on an understanding of the business risks that could find reflection in the financial statements, with less attention to detailed procedures. A shift back to the audit risk approach might be witnessed after the Enron and WorldCom scandals of 2001-02.

Accounting firms in both the United Kingdom and the United States have always provided services other than audit both to their audit clients and others. 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 nineteenth century that audit came to be seen as the primary fee earner for accounting firms.³ 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 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 and this situation continued for much of the twentieth century.

In the United States 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 non-audit services linked more closely to the financial statements as such,

³ 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).

began to develop.⁴ The 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.'*⁵

Accounting firms in the United Kingdom 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 small⁶). Nevertheless as the large firms in particular transformed themselves into multi-national multi-service providers the growth in the range and extent of non-audit services 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 one half of its total United Kingdom fee income from services other than audit, and by the end of the decade non-audit services 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.⁷ Similar developments took place in the United States. 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 non-audit service provision, and in particular provision to audit clients, has heightened concerns as to the threat posed to auditor independence. In the United States Arthur Levitt, a former SEC Chairman, noted earlier 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.'*⁸

These concerns are not in themselves new. In the United States the Cohen Commission, which was set up in the aftermath of a series of accounting and audit failures in the early

⁴ Although Pitt and Birenbaum (1997, p.17) 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 United States.

⁵ Previts (1985) at p.94.

⁶ 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.

⁷ *Accountancy*, October 2000, p.10.

⁸ Levitt (2000).

1970s, was one of the first quasi-independent bodies to formally consider the issues involved.⁹ In 1978 the SEC required disclosure of the percentage of fees for non-audit fees relative to audit fees and disclosure across 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 non-audit services. However, these disclosure requirements were withdrawn in 1982, and it was not until 2000 that the SEC introduced the present requirements for disclosure of fees for audit services and non-audit services split by category between *Financial Information Systems Design and Implementation* and *Other*.

In the United Kingdom in 1986 a DTI 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 non-audit services to audit clients. No such legislation was introduced although the 1989 Companies Act enabled the introduction of the present requirement for disclosure of the aggregate amounts paid to auditors for non-audit services by means of statutory instrument in 1991.¹⁰ The Companies Act of 2006 empowers the Secretary of the State to issue regulations that require companies to disclose the compensation paid to their auditors. With *The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008* [Statutory Instrument (SI), 2008] as amended by SI, 2011,¹¹ all but small and medium sized companies are required to disclose in the notes to their audited financial statements the amount receivable by their auditor for the audit and all other services provided to the company.¹²

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 non-audit services 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 Buijink *et al.* (1996) note that in Europe similar disclosure requirements exist in Ireland, Norway, Denmark, Belgium and Italy.

¹¹ Regulations requiring disclosure of auditors' remuneration were originally made by the Secretary of State in accordance with powers conferred by CA 1985, s.390B, as amended by the Companies Act 2004. These regulations (*The Companies (Disclosure of Auditor Remuneration) Regulations 2005* (SI, 2005)), came into force on 1 October 2005. CA 1985, s.390B (as amended) was incorporated in CA 2006, s.494, followed by *The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008* (SI, 2008). These came into force on 6 April 2008. *Amending SI, 2008, The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011* (SI, 2011) came into force on 1 October 2011. Schedule 2A was substituted in place of Schedule 2 (updating the services, and associated remuneration, provided to audit clients by auditors which are required to be disclosed).

¹² Each type of service is specified in Schedule 2A to the 2011 Regulations (see footnote 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' is delegated to the Financial Reporting Council and subordinated independent bodies of this regulator.¹³ The ICAEW Code of Ethics (ICAEW, 2011), the largest such body, contains a number of provisions designed to prevent the offering of non-audit services 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).¹⁴ In the provision of non-audit services care must be taken not to perform management functions or 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 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 with regard to the provision of corporate finance advice where the firm acts as auditor or advisor to two or more parties involved in a takeover subject to the City Code. In addition to the provisions of the Code there are Auditing Standards requirements that the audit committee considers the scale and nature of non-audit services provided to the company by its auditor.¹⁵

In the United States the actual regulation of non-audit service provision to audit clients has not been substantively different from that in the United Kingdom although there have been structural differences, for example the creation of the Independence Standards Board in 1996 (the Board was wound up in 2001), and the more specific regulatory interest of the SEC. For many years there were slightly more stringent SEC restrictions in terms of 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. Although under the chairmanship of Arthur Levitt, the SEC proposed significantly greater proscription, the revised rules ultimately approved in November 2000 went primarily down the route of disclosure and audit committee approval with extension of prohibition only with regard to certain IT

¹³ The FRC's function include the oversight and regulation of auditing and external financial reporting; setting, monitoring and enforcing accounting and auditing standards; establishing ethical standards in relation to the independence, objectivity and integrity of external auditors; operating an independent investigation and discipline scheme for matters which raise, or appear to raise, important issues affecting the public interest; overseeing the regulatory activities of the accountancy profession (FRC, 2006, pp.2, 11, 14).

¹⁴ See Buijink *et al.* (1996) for details of income restrictions across EU countries (pp. 76-77).

¹⁵ See Statement of Auditing Standards, SAS 610 'Communication of audit matters to those charged with governance', (APB, 2001).

consultancy services, the provision of legal services and, for clients with assets in excess of \$200m, provision of more than 40% of internal audit.^{16,17}

Despite arguments by accounting practitioners which emphasise the absence of conflict of interests from the joint provision of audit and nonaudit services, others have maintained that the increased economic dependence between auditor and client impacts negatively on an auditor's ability to remain objective. The substantial growth in the provision of non-audit services to audit clients fuelled concerns by regulators and others over the impact on audit quality, and particularly on the incentives by auditors to constrain opportunistic or outright fraudulent accounting practices. As stated by the U.S. Securities and Exchange Commission (SEC) 2000 (9):

'Under any circumstances, it can be difficult for an auditor to make a judgment that works against the audit client's interest. Where that judgment may imperil a range of service engagements of the firm, of which the audit is a fairly small part, it may be unrealistic to expect that an auditor can ignore completely what the firm stands to lose by the auditor's action.'

Such concerns have motivated a number of studies examining the relation between NAS purchase and financial reporting quality. DeFond et al. (2002) infer auditor independence from audit opinions, while other studies in this research stream focus on the association between NAS purchase and earnings management activity, as proxied by estimated discretionary accruals using U.S. and UK data, with mixed results (e.g. Antle et al., 2006; Ashbaugh et al., 2003; Chung and Kallapur, 2003; Frankel et al., 2002; Gore et al., 2001; Larcker and Richardson, 2004). Ferguson et al. (2004) propose that higher levels of economic bonding between auditor and client resulting from the joint provision of NAS may reduce auditors' willingness to restrain clients' opportunistic accounting practices and, in turn, may reduce the quality of financial reporting.

Gordon (2002) refers to the phenomenon of low visibility sanctions when discussing shortcomings of the gatekeeper function of auditors. Low visibility sanctions include the non-renewal of a (non audit) contract, or not getting a consulting contract in the first place (neither action has to be publicized in proxy statements by the client firm). This is contrasted with highly visible events, such as firing the auditor, a material event that must be disclosed, and in the UK is subject to both parties' notification of the appropriate audit

¹⁶ '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).

¹⁷ Details of the rules are available on www.sec.gov/rules/final/33-7919.htm

authority.¹⁸ Even if this were not subject to disclosure, it would likely result in a considerable amount of public scrutiny and inquiry. The potential harm from such increased public scrutiny on the company can be larger than the potential harm to an auditor's reputation (in fact, this may even enhance the latter's reputation). Similar damage to the company could arise from the voluntary resignation of the auditor. Hence, a company's senior management might be less likely to press for such a visible event. Instead, it may be more likely that management makes use of a variety of low visibility sanctions. The use of this type of sanctions is made possible when the accountant (likewise, a member of the board) is receiving other forms of compensation from the firm.¹⁹ More subtle pressures can be exerted on the gatekeeper the more involved he or she is in the company. Disciplinary measures that are not subject to disclosure increase the credibility of threats against a gatekeeper who disagrees with management on a particular issue. Auditor impartiality may be severely compromised where an accountant submits to the loss of independence by agreeing to a clients' accounting interpretation. The fear is that this may lead to a race to the bottom (Gordon, 2002) where accounting firms see a competitive advantage in setting the bar of professional credibility and independence ever lower.

Arthur Andersen was described as having fallen into this trap when the firm changed over the years from being a group of independent auditors with a high ethical standing, to a profit centre unit.²⁰ In a reflection on causes for the failure of auditors to act as gatekeepers in the US, Coffee (2001), highlights the diminished legal threat due to changes in the legal liability of auditors in the United States, and notes a perceived implicit collusion where the auditor:

¹⁸ For the UK, see sections 522 to 525 of the Companies Act 2006, and recent guidance by ICAEW available at: <http://www.icaew.com/~media/Files/Technical/Audit-and-assurance/audit/auditor-cessation-statements.pdf>. FRC guidance available at: <http://www.frc.org.uk/Our-Work/Conduct/Professional-oversight/Oversight-of-Audit/Notification-of-change-of-auditor.aspx>.

¹⁹ Gordon (2002) in particular points to the bundling of auditing plus tax planning, due to what he perceives as the carryover mindset from tax planning into accounting planning. Tax planning can be a highly valued service: Enron paid virtually no corporate taxes in the five years prior to its demise, despite reporting nearly \$2bn in earnings from 1996 through 2000.

²⁰ An evolution from a partnership of accounting professionals, constrained by a strong sense of professional ethics, to a profit-maximizing limited partnership organization using high-powered incentive compensation schemes is seen as one of the factors in the profession's morphing from 'watchdogs to lapdogs'. (Quote from US Congressional hearings on the role of Arthur Andersen in the failure of Enron Corp). For a discussion of the effect of changes to the legal and organizational setup of accounting firms, see Macey and Sale (2003). For a shorter account of the cultural change in the accounting profession, see Jeanne Dugan "*Did You Hear the One About the Accountant? It's Not Very Funny*", Wall Street Journal, March 14, 2002, p. A1.

'...may be able to market itself less as a faithful and diligent watchdog for the shareholders than as an accommodating and flexible friend of management.' (p.12)

Coffee (2001) emphasises the potential for economic coercion that accompanies the provision of NAS to an audit client:

'Corporate managers may find means by which they can seduce gatekeepers into acquiescence, such as by linking material amounts of other business to the auditing engagement, which business can be withdrawn if the auditor fails to acquiesce in the client's aggressive accounting policies. The more developed and material the business relationships between the client and the gatekeeper, the less the likely independence of the latter. This diagnosis leads to an obvious reform: restrict the ability of auditing firms to offer non-audit services to their clients.' (p.13)

Such concerns are in line with a recent reflection on the 2010 APB's consultation on the provision of non-audit services by auditors (APB, 2010a) which argued that audit quality is compromised in both fact and perception when the auditor carries out any non-audit service (p.11):

'The sale of other services creates fee dependency and forces auditors to align their interests with those of the audit clients.'

The passing of the Sarbanes-Oxley Act 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.

The Sarbanes-Oxley Act was enacted in part to reduce the economic dependence of auditors on individual audit clients resulting from the provision of non-audit services. Beattie et al. (2009) suggest that the post-Enron changes to the non-audit services regulatory regime in the UK have been effective to some degree, citing active engagement of the audit committee in the purchase of non-audit services from incumbent auditors, statutory requirement for the disclosure of services purchased from incumbent auditors detailed by types of service, detailed threats and safeguards framework in the form of Ethical Standard 5 issued by the Auditing Practices Board, and inspections of listed company audits by the Professional Oversight Board's Audit Inspection Unit. Using a questionnaire addressed at finance directors, audit committee chairs and audit partners, these authors find a change in the purchasing behaviour of UK listed company. The enhanced role of the audit committee has inspired a cautious approach by board directors, resulting in reluctance when approving the purchase of non-audit services from incumbent auditors. The directors are careful to ensure that they do not attract adverse publicity from the disclosure of an inappropriate level of non-audit service fees to the

incumbent auditor. Ethical Standard 5 restricts auditors from providing a wide range of services to their audit clients. In addition, the presence of the Audit Inspection Unit has deterred attempts of breaching ethical standards or inaccurate reporting of non-audit service purchase. The post-Enron prohibitions on the provision of certain NAS led to large reductions in the amount of NAS provided to audit clients. In the UK, ES 5 issued by the APB (APB, 2011) addresses independence issues associated with the joint provision of NAS which may have contributed to the observed decline of NAS provision to audit clients.

In their 2009 review, Beattie et al. summarize findings which show that NAS provision to audit clients dropped from a peak of over 300% of audit fees in 2001 to 75% in 2008, attributing the drop to both regulatory changes and voluntary choices made by companies. However, auditors were perceived to have less knowledge and understanding of client business as a result of reduced NAS provision to audit clients. A US study conducted by Pandit and Rubenfield (2011) reveals that although non-audit fees from audit clients have declined, more than 78% of the sample companies saw some increase in total auditor remuneration from the year 2002 through the year 2007. More than half of the sample paid at least 50% more in total auditor remuneration while more than 35% of the sample at least doubled their total auditor remuneration in the year 2007 compared to that in the year 2002. Whilst it would appear that the Sarbanes-Oxley Act has been effective in curbing the purchase of non-audit services from auditors through the outright prohibition of provision of a number of non-audit services to audit clients, it had at best a limited impact on decreasing the economic bonds between auditor and client, and thus does not significantly address threats to independence that arise as a result of economic dependence.

4.0 Overview of Recent Literature

The purpose of this section is to provide an overview of recent research, debate and policy responses (proposed or implemented) on the joint provision of audit and NAS to audit client, in reflection of changes to the regulatory and economic context that has taken place since the global shift to re-regulation in the form of the Sarbanes-Oxley Act (SOX) (2002), and related regulatory responses in the UK and elsewhere, since the Enron and WorldCom scandals. Key post-SOX changes in the UK financial reporting and auditing regime include the allocation of responsibilities for setting auditing and ethical standards, and the conduct of independent inspections of public interest audits to the FRC, changes to the UK Corporate Governance Code (2010), which require closer engagement between auditor and client's audit committee. The adoption of International Financial Reporting Standards (IFRS) in the EU in 2005 adds a more rules-based nuance to financial reporting than that represented by UK GAAP. The debate on financial regulation and in particular the quality of audit and the contribution of audit to corporate governance was further encouraged by the global banking and financial crisis of 2008/09.

Francis (2011) notes that there are multiple drivers of audit quality, which may explain the at times contradictory results that can be derived from a review of the literature. The following section summarizes recent research findings, prior to a subsequent discussion of key arguments, classifying these into four categories as set out below:

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

4.1 *Research suggesting that non-audit services affect perceived independence*

The overall conclusion from the literature review of Beattie and Fearnley (2002) and Schneider et al. (2006) is that, although there is little evidence indicating that joint provision will affect actual independence, there is a fair amount of evidence suggesting that joint provision will affect perceived independence.

Given that sociological research indicates cultural differences between English speaking and Nordic countries, Quick and Warming-Rasmussen (2005) examined the impact of non audit services on perceived auditor independence in Denmark using questionnaires. They found that shareholders, bank loan officers and journalists perceive lower auditor

independence in the presence of NAS provision. It was also ascertained that the type of NAS has a differing effect on the degree of independence impairment and the provision of MAS by a separate department of the audit firm does not improve independence in appearance.

In their examination of abnormal market returns for Andersen clients in the US around the indictment announcement, Krishnamurthy et al. (2006) found that the negative share price reaction was more acute when more non-audit services was provided by Andersen. This shows that the market perceives that auditor independence is at risk when the incumbent auditor also provides non-audit services.

In an Australian study, Gul et al. (2006) found a negative relationship between non-audit services provided by an incumbent auditor and the value relevance of earnings (using earnings response coefficient as the proxy). This relationship is weaker for firms that employ the then Big Six auditors. This shows that investors perceive the joint provision of audit and non-audit services to impair auditor independence but this adverse perception is somewhat mitigated by the appointment of a major audit firm. It is argued that, for major audit firms, the litigation and reputation cost will outweigh the benefits of client-specific quasi-rent.

Utilising a questionnaire design, Alleyne et al. (2006) investigated the perceptions of 66 auditors and 148 users in Barbados on the issue of auditor independence. They observed that economic dependence on audit client, provision of non-audit services, high competition, small firm size, being a sole practitioner, lengthy tenure, and the size and closeness of the Barbadian society had a negative impact on the perception of auditor independence.

Using an event study approach and by examining market model prediction errors around relevant dates, Liu and Nabar (2006) investigated the manner 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 approval of the sale by E&Y's partners and the approval of the transaction by Cap Gemini's stockholders. These findings indicate that the provision of non-audit services by incumbent auditors do affect investors' perception of auditor independence.

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.

Kumar et al. (2008) conducted a survey to measure the perception of government linked companies' shareholders in Malaysia towards the impact of non-audit service provision by incumbent auditors on independence. They found that the shareholders regard management services as the non-audit service having the most adverse impact on independence. This is followed by human resource services and advisory services.

German investors perceive that the provision of most types of non-audit services will impair auditor independence. However, perceived auditor independence is higher if the non-audit service is delivered by a separate department of the audit firm. The type of non-audit service has an impact on the degree of impairment in perceived independence (Quick & Warming-Rasmussen, 2009).

In a US study, Lai and Krishnan (2009) found that the market value of a firm is higher if financial information system-related services is purchased from incumbent auditors compared to firms that do not. This shows that despite the negative perception of non-audit services on auditor independence, the provision of financial information system-related services is seen as a value-adding activity providing a net benefit.

A recent UK questionnaire study revealed that private investors and institutional shareholders perceive economic dependence and non-audit services as more serious threats to auditor independence than long tenure (Dart, 2011).

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

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. This provides support for the adoption of a threshold concept rather than the prohibition of the supply of non-audit services by incumbent auditors.

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

Using market-based measure of disclosure quality and stock market liquidity, Ascioğlu et al. (2005) examined the impact of audit and non-audit fees on auditor independence. Based on a large sample of S&P 1500 stocks, they found little evidence to support the argument that auditor remuneration adversely affects the auditor-client relationship. However, there is evidence to suggest that the undesirable effects of auditor remuneration on market liquidity are prevalent in firms with weak corporate governance structures.

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

In a US study, Ghosh et al. (2009) found no association between perceived auditor independence, where earnings response coefficients were used as proxies, and non-audit service provision.

In an Australian study, Bugeja (2011) found no association between perceived auditor independence, where non-audit services provision were used as proxies, and takeover premiums. This indicates that the provision of non-audit services is not seen to impact audit quality.

4.3 Research suggesting that non-audit services affect actual independence

Using a sample of non-financial companies listed on the International Stock Exchange, Firth (2002) found that high consultancy fees is associated with unqualified audit reports. Although this finding provides support for the impaired independence argument, it can also be interpreted as the incurrence of consultancy fees to iron out uncertainties and disagreements prior to the audit, thus justifying the issue of a clean audit report.

In a US study, Larcker and Richardson (2004) found a positive relationship between the ratio of non-audit fees to total fees and the absolute value of accruals. However, using latent class mixture models, they discovered that the positive association only applies to

approximately 8.5% of the sample. Also, a negative relationship was prevalent between total auditors' remuneration and accruals. The latent class analysis reveals that this negative relationship is strongest for audit clients with weak governance. The overall results indicate that auditors' behaviour is constrained by reputation risk.

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 have a statistically significant negative effect on abnormal accruals in the UK. This indicates that non-audit service provision raises the quality of financial reporting. However, there is evidence that audit fees increase abnormal accruals in both the UK and US. This is coherent with behavioural theories of unconscious influence or bias in the auditor-client relationship.

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 non-audit services is high. This finding supports the hypothesis that the provision of non-audit services 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.

In a US study, Hoitash et al. (2007) examined the relationship between audit quality, using accrual estimation error metric and performance-adjusted discretionary accruals as proxies, and abnormal total auditor fees. They found a negative relationship between audit quality and abnormal total fees, indicating the adverse effects of economic bonding.

Nagy (2008) conducted a US study and found that it is less likely for an audit firm to issue a material weakness internal control report if the audit firm also provides the financial information design and implementation service. This provides support over concerns of non-audit service provision.

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

Using UK data, Basioudis et al. (2008) find that there is a lower likelihood for financially distressed companies with high non-audit fees to be issued a going-concern modified

audit report. Evidence supports the contention that high non-audit fees have a detrimental effect on going-concern reporting judgments for financially stressed U.K. companies. This might indicate an impairment of auditor independence as a result of joint provision.

Using data from Taiwan, Duh et al. (2009) examined the relationship between non-audit services and audit adjustments in the period before and after the Procomp scandal. They found a significant and negative relation between non-audit services and audit adjustments in 2003 (prior to the Procomp scandal) but no such association existed in 2004 (after the scandal). This demonstrates the trade-off consideration of gaining non-audit fees and avoiding litigation and reputation loss. These findings indicate that the proscription of non-audit services may not be the only way to uphold audit quality.

In a US study, Lim and Tan (2010) 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. As the provision of non-audit services will increase the economic dependence of auditors on a particular audit client, the finding suggests that non-audit service provision will impair audit quality.

Krishnan et al. (2011) examined the relationship between earnings management and non-audit services pre and post-SOX in the US. They discovered that the decline in income-decreasing earnings management was greater for companies with larger decreases in non-audit services. This indicates that the joint provision of audit and non-audit services do have an adverse impact on actual auditor independence. However, the lack of such evidence for income-increasing earnings management indicates that the regulatory and economic framework was effective to a certain extent during the pre-SOX period.

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 reveal that earnings management is positively related to non-audit fees while the propensity to issue a qualified opinion is negatively associated with non-audit service provision, indicating that non-audit services impair independence in fact. The negative relationship between earnings-response coefficients and non-audit fees indicate that perceived independence is jeopardised. However, the underlying studies used for this analysis are not homogenous.

Using US data Basioudis et al. (2012) link 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 (GC) modified audit opinions, after controlling for auditor tenure, the authors find that the relationship between non-audit fees and auditors' propensity to issue GC modified audit opinions is 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 4 as well as, smaller, industry specialized 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's independence.

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

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

In a US study, Ashbaugh et al. (2003) challenged the findings of Frankel et al. (2002) by adjusting discretionary current accruals for firm performance. As a result, they found no systematic evidence supporting the claim that the provision of non-audit services by incumbent auditor affects auditor independence.

In a US study, 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 restatements. This shows that the quality of financial reporting is not affected by the purchase of these services from incumbent auditors. However, the finding may be partly due to small sample sizes for registrants purchasing these services. Another finding from the study is that there is a positive association between unspecified non-audit service fees and restatements, indicating an impairment of auditor independence. On the other hand, tax service fees is found to be negatively associated with restatements, indicating that financial reporting quality benefits more than compensate for the negative effects of economic dependence.

In a US experimental study, Asare et al. (2005) found that the acceptance of an audit client was not affected by the potential of non-audit service provision. This implies that non-audit service provision may not be the cause of loss in auditor independence.

Using expert reports provided in Australian takeovers, Bugeja (2005) studied whether the independence on 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 non-audit service provision impairs the independence of auditors, the nature of the issue under scrutiny (whether independence will be impaired in the

presence of economic bond) remains unchanged. The results indicate that expert opinions are significantly related to the target firm's directors' recommendations regardless 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 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 non-audit services.

Lim and Tan (2008) analysed the relationship between audit quality, proxied by the propensity to issue 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 non-audit services in the US. No relationship was found between non-audit services 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 non-audit services. Non-audit service fee is also associated with a lower earnings-response coefficient (ERC), implying that investors perceive non-audit services to impair earnings quality. An important finding from the study is that audit quality (using propensity to issue going-concern opinion, propensity to miss analysts' forecasts and ERC as proxies) increases with the scale of non-audit services when acquired from specialist auditors as opposed to non-specialist auditors.

In a US study, Bloomfield and Shackman (2008) found little evidence that non-audit fees is positively associated with earnings restatement. However, 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 5 audit firms.

Using New Zealand data, Zhang and Emanuel (2008) found no evidence of a negative relationship between non-audit service 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 non-audit services do not reduce the likelihood of the issuance of qualified audit reports.

In a US study, Vînătoru 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 5 audit firms and restatements.

Ianniello (2012) examined the relationship between audit opinions and non-audit services 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 report with an emphasis of matter paragraph and non-audit services. 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.

5.0 Changes to the Provision of Non-Audit Services

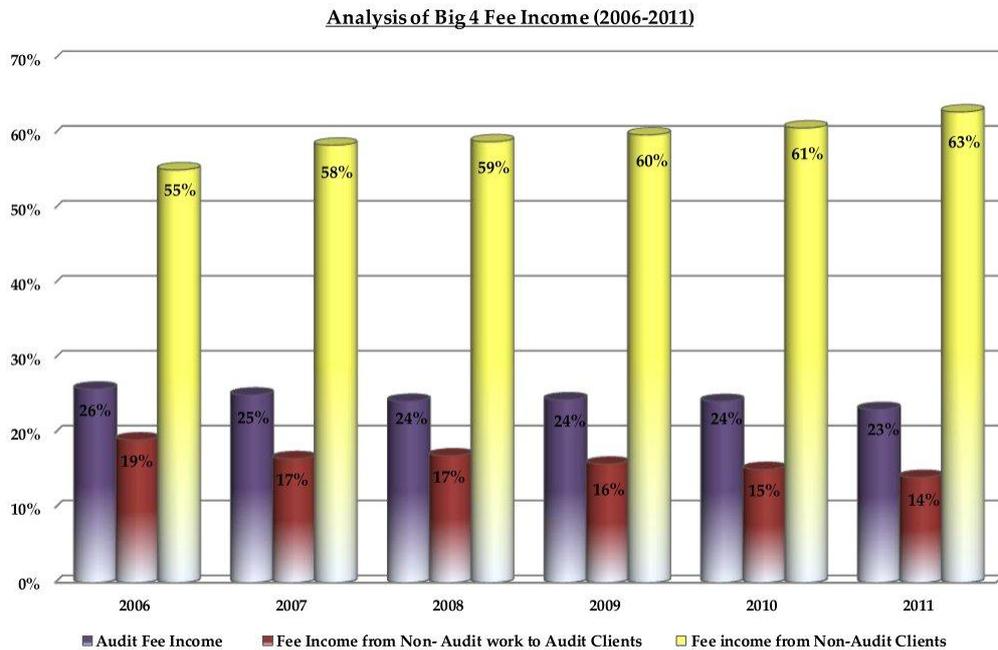
During the past decade there have been significant structural changes as certain of the very large firms have sought to dispose of all or part of their consulting businesses. Andersen Consulting (now Accenture) divorced itself from Arthur Andersen in August 2000 after a long-running and acrimonious dispute. Ernst & Young spun off its consulting business to the Paris based consulting and information technology group Cap Gemini in the same year, and KPMG floated KPMG Consulting in February 2001.

In October 2002, PwC sold its management consulting and technology services arm to IBM Global Business Services for approximately \$3.9 billion in cash and stock. However, substantial areas of non-audit activity, for example taxation services, remain in the large firms, and the question arises as to the extent to which it is the intention of these firms to build up their consulting activities anew.

Recent data provides an insight to the increasing revenue importance of consulting activities and changes in the distribution of NAS provision between audit and non-audit clients since the formal disposal of their consulting subsidiaries. Based on figures released by the Professional Oversight Board (2012), in the six years to 2011, the Big Four have experienced a steady increase in the proportion of fee income from non-audit work for non-audit clients, with the fee income from non-audit clients representing 63% of total fee income in 2011 (see Figure 1).

In contrast, Big Four fee income from non-audit work to audit clients has been declining in importance. The percentage of non-audit fee income derived from audit clients (as a proportion of total income) by the Big Four has decreased year-on-year from 19% in 2006 to 14% in 2011. The decrease was attributed to higher audit committee involvement and tighter ethical standards.

Figure 1



Professional Oversight Board, 2012

Although these figures might appear to indicate that the pressures on auditor independence from the joint provision of audit services and NAS may be diminishing, they are not sufficient to retire continuing concerns about auditor independence. The substantial continued provision of non-audit services to audit clients means that threats to auditor independence, whether perceived or actual, cannot be discounted. The summary evidence which reflects a diminished relative importance of NAS provision to audit clients is also far from conclusive since individual audit clients may still be purchasing substantial amounts of non-audit services from their auditor. Given the significant increase in the importance to firms of the provision of NAS, it would also not be an inconceivable suggestion that the prospects of lucrative fees from non-audit clients might influence the level of conflict a firm is willing to pursue during an audit, and thus gain a reputation as being a difficult or even disloyal business partner.

Key findings from a recent consultation by the APB (APB, 2010a) on NAS provision to listed companies reflect the increasing importance to accounting firms of providing these services:

- *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 are equal to or exceed 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 found that the fees for non-audit services 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 non-audit services fees to individual audited entities are broadly consistent with the overall pattern shown by total audit and non-audit services fees earned by audit firms from entities that they audit over the same period by the Professional Oversight Board (POB, 2012), as reflected in Figure 1.

6.0 Regulatory Concerns

Until about a decade ago, criticism has largely been internalized and regulatory concern muted. This has changed dramatically in consequence of events in the United States where a seemingly unending saga of revelations of corporate financial engineering and accounting machinations, the Enron and WorldCom scandals among them, has led to accounting and auditing firms being given a degree of prominence in the form of public debate previously unheard of. This aroused the interest of law makers and regulators, most notably in the United States with the passing of the Sarbanes-Oxley Act, but also in the United Kingdom and in the EU. This criticism has focused on the failure of auditors to control, identify, and report on accounting manipulation, manipulation which in some cases has rendered financial statements almost meaningless.

Debates on the recent series of perceived accounting and auditing failures in the United States²¹ and further afield²², has again brought into focus the question of whether accounting firms should continue to be allowed to provide services other than that of audit to their audit clients to limit actual or perceived threats to audit independence and resultant impact on audit quality. Most recently, the role of auditors has come under renewed scrutiny after the 2008/09 financial crisis, partly because of the profession's failure to give warning of banking collapses (see the House of Lords review into the role of Audit, HoL, 2011).

An area of particular concern continues to be the closeness of the relationship between the auditor and the client and the effect that the extensive provision to audit clients of services other than audit has had on the external auditor. Concerns about the long association between the auditor and the client has been raised in the UK by Sir David Tweedie, the former chairman of the International Accounting Standards Board, and current president of ICAS, who in April 2012 describing the estimated 48 years that a FTSE 100 auditor remains in place on average, as "pretty cosy", and expressing the view that the independence of auditors may be insufficiently protected by rules requiring lead audit partners to be changed after several years (Financial Times, April 4, 2012).

In the United States, concerns about the effect of joint provision has led to further prohibitions and restrictions on those services that audit firms can offer to their clients. In the United Kingdom, where the approach traditionally has been to focus and rely on safeguards and controls within the audit firms rather than on specific prescriptions, the issue has recently been deliberated within a prominent discussion and evaluation of the

²¹ For example, Enron, Global Crossing, WorldCom, Xerox.

²² For example, Elan in the Republic of Ireland.

role of audit with regard to the 2008/09 financial crisis which focused on the role of audit. Culminating in the 2010 inquiry by the House of Lords Treasury Select Committee on Economic Affairs into market concentration and role of the audit industry (HoL, 2010, 2011), the narrow field of choice raised concerns about competition and the quality of audited accounts, and about possible conflict of interest between audit and consulting arms. Particular attention was directed at questions with regard to the potential for auditors to have mitigated the banking crisis of 2008/09 by alerting investors to the riskiness of the assets held by banks. The inquiry panel showed particular interest in the response by the Big Four to the going concern assertions by banks' management just prior to the crisis. It emerged that the heads of the Big Four were imminently aware of the precarious financial situation of major banks by the end of 2007 and that:

'All four of the people here [In reference to the heads of the Big Four present during the inquiry] had detailed discussions, instigated by the Big Four, with Lord Myners because of the circumstances we were in. It was recognised that the banks would only be going concerns if there was support forthcoming.'

John Connolly (Deloitte), HoL, 2010, p.27.

It emerged that the Big Four had been assured of unlimited UK government support for the banks in a letter by the then Chancellor of the Exchequer Lord Myners (in response to a request by the Big Four for clarification on the position of the UK government with regard to support of large financial institutions) indicating that the UK government remained,

'...committed to taking whatever action necessary to maintain financial stability, protect depositors and protect the taxpayer. The support the Government is providing to the financial system and the statements it has made are factors that will no doubt be taken into account in determining whether companies will continue to operate on a going concern basis.'

Letter by Lord Myners to John-Griffith Jones, KPMG (17 December, 2008), copy provided to the House of Lords

This was interpreted by the Big Four to provide sufficient evidence for the going concern assertions by banks' management and thus allow the issuance of unmodified audit opinions. Lord Lawson of Blaby expressed his astonishment to this justification (as did the Chairman):

'It seems to me that you're saying that you noticed that they were on very thin ice but you were completely relaxed about it because you knew that there would be support; in other words the taxpayer would support them, so there was no problem. That's what it seems to me you just said.'

Lord Lawson of Blaby (HoL, 2010, p.28)

Reflecting on subsequent expressions by the heads of the Big Four of the appropriateness of accepting the going concern assertion by banks' management in response to the governments' assurance on unlimited support for the industry, Lord Lipsey noted critically:

'I have an increasing Alice in Wonderland feeling about this discussion, quite frankly. I'm a naïve amateur in this field but I expect "going concern" to mean that a business can pay its debts as they fall due, but you meant something quite different. You meant the Government will dip into its pockets and give the company the money and then it can pay its debts as they fall due and you gave an unqualified audit report on that basis. If you had said, "We are satisfied that support will be available from Government that will enable it to continue as a going concern", of course you wouldn't be subject to this criticism. But instead, where your duty is to report to investors the true state of the company, you were giving a statement that was deliberately designed to mislead markets and investors as to the true state of those banks. That seems to me to be a very strange thing for an auditor to do.'

Lord Lipsey (HoL, 2010, p.37)

Expressing overall disappointment in their final report into the role of audit, the Lords failed to accept that auditors did all that was required of them, found defence of auditors with regard to audit quality disconcertingly complacent, has 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' judgment (HoL, 2011 paras. 133, 142, 144-151, 199).

In its recommendations, the Select Committee on Economic Affairs (HoL, 2011) made reference to and voiced opinions on the competition in the audit market, mandatory joint audit, mandatory tendering of audit contracts, the provision of non-audit services to audit clients, and 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 non-audit services to audit clients, the Select Committee recommended a ban on the provision of internal audit, tax advisory services, and advice to audit client risk committee (with additional recommendation that the Office of Fair Trading examine grounds for the prohibition of other services to be carried out by a company's external auditor, HoL, 2011, para. 87). In response to its considerable concerns on the role of audit, audit quality, and audit market concentration, the House of Lords further recommended that the Office of Fair Trading (OFT) conduct an investigation into the audit market. The OFT subsequently announced its decision to refer concerns related to audit market concentration to the Competition Commission on Friday 21 October 2011.

At EU level, concerns on the independence of audit, have led to the proposal to with particular considerations given to requirements for mandatory audit firm rotation, tendering, and a ban on the provision of NAS to audit clients regarding the statutory audit of public-interest entities, such as banks, insurance companies and listed companies, envisage measures to enhance auditor independence and to make the statutory audit market more dynamic (EC, 2011, COM(2011) 779 final) with details of the key suggested measures as set out below.²³

Mandatory rotation of audit firms: Audit firms will be required to rotate after a maximum engagement period of 6 years (with some exceptions). A cooling off period of 4 years is applicable before the audit firm can be engaged again by the same client. The period before which rotation is obligatory can be extended to 9 years if joint audits are performed, i.e. if the entity being audited appoints more than one audit firm to carry out its audit, thus potentially improving the quality of the audit performed by applying the "four-eyes principle". Joint audits are not made obligatory but are thus encouraged.

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.²⁴

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 Markets and Securities 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 to require all statutory auditors and audit firms to comply with international auditing standards when carrying out statutory audits.

²³ Final amendments to the EC's proposal were originally due by November, 2012, but are now not expected until 2013. The investigation by the UK's Competition Commission into the Big Four's dominance of the FTSE 350 audit market, announced delays in publications of provisional and final findings into 2013 (Accountancy Age, 17 Oct 2012).

²⁴ In the UK, the FRC on 28 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.

In this context we note the concerns earlier expressed by the Treasury Select Committee investigating the banking crisis as to the joint provision of audit and non-audit services and their call for immediate consultation on this issue by the Auditing Practices Board of the Financial Reporting Council:²⁵

'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 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.'

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

The Treasury report expressed concerns over the joint provision of audit and NAS and the potentially negative effect of NAS on firms' ability to issue an independent audit opinion and suggested banning the practice of audit firms providing NAS alongside audits and to their clients. These concerns were reflected upon during a consultation by the APB on audit firms providing NAS to listed companies they audit (APB, 2009, para. 3.2), suggesting that:

(a) the nature of some services increases the possibility that the views of the auditor will become aligned with the views of the company's management (e.g. where the auditor has extensively advised on a corporate restructuring or a strategic acquisition);

(b) the greater the volume and financial significance of the non-audit services provided by the auditor, the greater the risk that the auditor will have relationship and economic reasons not to challenge management's views and positions with the requisite degree of energy and scepticism;

²⁵ In response to the Treasury Select Committee's recommendation, the Auditing Practices Board (APB) in October 2009 issued a consultation paper (APB, 2009) on audit firms providing non-audit services to listed companies that they audit, and a subsequent feedback and consultation paper (APB, 2010a) providing a summary of responses to the earlier consultation paper and setting out explanation for proposed amendments to APB Ethical Standards for Auditors and FRC Guidance on Audit Committees. The Auditing Practices Board (APB) was established in April 2002, and replaced 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 will be carried out within the FRC by the Audit and Assurance Council, which formally replaced the APB.

(c) prohibitions on auditors providing audit services to their listed clients could enhance the opportunities for mid-sized accountancy firms to provide those services, thereby enhancing their profile and, in turn, leading to greater competition and choice in the accounting services and audit market;

(d) auditors cannot be relied upon to assess objectively whether a particular non-audit service engagement gives rise to threats to auditor independence and objectivity and apply appropriate safeguards.

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.²⁶ Following on from that the deliberations of the House of Lords Economic Affairs Committee as to the role of non-audit service provision to audit clients. Whilst not recommending a complete ban on the provision of such services the Committee did recommend a ban on the provision of internal audit and perhaps more importantly on tax advisory services and advice to the risk committee. It also recommends that the Office of Fair Trading should examine whether any other services should be banned from being carried out by a firm's external auditors.²⁷

The October 2011 decision by the House of Lords to refer the Big Four audit and accounting firms for review by the Office of Fair Trading will also have implications with respect to issues relating to the provision of non-audit services.²⁸ Even more recently – November 2011 - has been the revised draft EU Green Paper which has continued to put forward the possible separation of audit and non-audit services provided to clients within audit firms, the separation of audit services from non-audit services for large audit firms, and mandatory rotation of audit firms after a maximum engagement period.

At the House of Lords inquiry (HoL, 2010, 2011), the international financial reporting standards (IFRS), criticised as being more rule-based compared to the UK GAAP, was deemed to have restricted the exercise of prudent judgement by auditors, and impairing the true and fair view and substance over form principle. Concerns were raised specifically on the effect of mark-to-market accounting and the recognition only of incurred losses and not expected losses on the financial statements of banks. This could

²⁶ See <http://www.bis.gov.uk/assets/biscore/business-law/docs/u/10-1346-uk-government-response-ec-green-paper-on-audit>.

²⁷ House of Lords Economic Affairs Committee – Second report Auditors: Market concentration and their role. March 2011. para 87.

²⁸ OFT press release 21/10/2011, see <http://www.offt.gov.uk/news-and-updates/press/2011/115-11>.

result in inflated valuations during the boom, allowing bonuses to be paid out of profits that have not taken account of possible losses.

The House of Lords inquiry (HoL, 2010, 2011) reveals that the lack of auditor independence may not be the cause of the financial crisis. It was noted that the Big Four did highlight the issues to the Bank of England, although the warning bells should arguably have been rung earlier, and only issued unqualified audit reports upon receiving assurance that the banks will receive unlimited government support to prevent their failure. The main issue may therefore not be the joint provision of audit and non-audit services but the auditor's lack of scepticism, incompetency, and the expectation gap (see Porter et al. 2008 for a summary on the expectations gap).

Auditor's lack of scepticism is evident in various cases. PwC's inability to recognise the risky business model of Northern Rock where short-term borrowing is used to fund long-term lending is a classic example. The credit crunch resulting from the sub-prime United States market should have also alerted the auditors of the financial health of institutions in the United Kingdom. The House of Lords inquiry also expressed doubts as to whether the auditors assessed the models used for the valuation of the banks' complex financial instruments.

Incompetence may be an issue particularly with bank audits. The House of Lords inquiry revealed that the chairs of audit companies of major banks may have had no more than a vague understanding of models used in the valuation of banks' financial instruments, and that auditors may have been over-reliant on the valuations provided by audit clients. Clearly, if this were the case, the audit function would have failed in its role as the 'guardian' of the capital market.

There may also be a gap between the auditors' perception of what is expected and that of stakeholders in general. Drawing evidence from the House of Lords inquiry (HoL, 2011), the auditors believe that their primary role is to count the score and neither to forecast next year's profit nor to look at the business model of the company. There is also a fear, specifically in bank audits, that a qualified audit opinion may cause a collapse of confidence and be detrimental to shareholders. However, the principles established over four decades ago by Moffitt, J in *Pacific Acceptance Corporation Limited v Forsyth and Others* (1970) 92 WN (NSW) 29 indicate that it is the auditor's duty to report all material matters to shareholders regardless of whether that public disclosure involves an adverse reflection on the board, a director, or senior executive, or will be detrimental to the company (or its shares).

7.0 Changes in the Nature of Audit

Whereas the dramatic growth in the provision of non-audit services up to about a decade ago can be directly observed, it is more difficult to determine the extent and nature of the evolutionary change in the audit role. The formal audit requirements in terms of the provision of an opinion as to the truth and fairness of the view presented by the financial statements has not changed but in the 1990s there was an observable shift in the perception of the capabilities and benefits of audit – a shift accompanied and to an extent led by, changes in audit approach and methodology. A simplified paradigm of the historical development of audit sees development from substantive audit via system and audit risk-based approaches to the business risk model, with a more recent reversion to an audit risk approach. The substantive approach was balance sheet oriented focusing on obtaining direct evidence to support the existence, ownership and valuation of the assets and liabilities in the balance sheet. As the size and complexity of business entities grew, and their internal control systems became more extensive and more reliable, systems-based audit, in which the confidence in the financial statement numbers was derived in part from testing the systems used to generate those numbers, came to the fore. One attraction of this approach to the audit firms was the linkage to their developing consulting activities in particular those relating to the installation and management of IT-based financial systems.

The 1980s saw the widespread adoption of audit approaches based on the audit risk model, as first set out in the US auditing standards in SAS 99, in which the overall risk of an audit failure in terms of an inappropriate opinion was modelled as the product of the likelihood of error occurring in the financial statements, the likelihood of client systems preventing or detecting that error and the likelihood of audit tests detecting any otherwise undetected error. In recent years the firms have sought to further revise and refine their audit procedures to incorporate a wider assessment of risk and have shifted the focus away from audit risk per se toward client risk and client risk management practices. The extensive rhetoric accompanying and publicising this change has portrayed it as an evolution in keeping with, and necessitated by, environmental changes in the economy and in ways of doing business. Audit had become a 'risk based, strategic systems, methodology' fit for 'the economy of the 21st Century'.²⁹

Notwithstanding the widespread acceptance of a business risk or a value-added approach to audit there is rather less agreement, or indeed evidence, as to its application

²⁹ KPMG (1999, p.4) quoted in Humphrey *et al.* (2003).

or indeed how radical a departure it is from previous audit practice.³⁰ In a study designed to add to knowledge of how the business risk approach is operationalised, Lemon et al. (2000) identify the main structural components of the business risk audit approach to be:

- a) A consideration of business risk in the general sense of the risk that the entity will fail to achieve its objectives.
- b) A greater focus on acquiring knowledge of the client's business and a more structured approach to the gathering of relevant information.
- c) A wider perception of the organizational framework away from the narrow perspective of the picture represented in the financial statements.
- d) A closer alignment with the management's view of the entity and a closer co-operation with management in the conduct of the audit and the setting of audit objectives.

In terms of evidence gathering the business risk approach may be seen as placing more emphasis on the testing of high level management controls and less on more detailed controls. These high level controls include relevant aspects of the control environment and corporate governance as well as controls over process. The extent of substantive testing is reduced (Power, 2000) but in its place analytical procedures are given enhanced prominence as being 'consistent with the auditor's desire to understand the entity's business rather than simply prove the financial statement figures'.³¹ In turn, the nature of analytical procedures has become more sophisticated with, it is claimed, the greater use of analytical software, broader-based data sets and benchmarking.

The business risk approach – and indeed the whole concept of the delivery of assurance services over and above audit – has been closely associated with the parallel rise in the provision of services other than audit. Jeppesen (1998) refers to the expansion of the scope of audit as a 'reinvention' of audit (p.525) and claims that the focus on risk and strategic objectives has led to a blurring of the traditional distinction between auditing and other services provided by the accounting and audit firm.

'To some extent auditing has become consulting and it makes increasingly little sense distinguishing between the two as the boundary between them is eroded by the 'reinvention' of auditing' (p.526), a view echoed by a North American large firm partner who stated: 'there is a continuum in the whole audit advisory services area. I don't think it's any more possible to define discrete breakpoints.' (Boritz and Cockburn, 1998, p.142).

³⁰ As Humphrey et al. (2003) note, Auditing Through a Strategic-Systems Lens: the KPMG Business Measurement Process (Bell et al., 1997) although widely regarded as an important technical expression of the new philosophy of auditing (Power, 2000) is in fact short on detail as to specific procedures introduced or modified by business risk audit methodology'.

³¹ Lemon et al. (2000)

The Enron scandal however, and resultant shifts to re-regulation of the industry (Kinney, 2005), as represented by the SOX Act (2002) in the US, and similar regulatory changes in the UK and elsewhere (Lennox, 2009), have brought about a move away from the business risk approach towards one which once again may be focused on an audit risk model.

8.0 Arguments against the Provision of Non-Audit Services to Audit Clients

As noted above, the primary regulatory concern has always been that the provision of non-audit services to auditor clients constitutes a threat to auditor independence in particular 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 are now considered in turn.

8.1 *Enhanced Fee Dependence*

In the United Kingdom and the United States auditors are 100% fee dependent upon their clients irrespective of whether or not non-audit services 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 cogent reasons for believing that pressures on auditors to acquiesce to inappropriate client accounting procedures are greater when the accounting firm also benefits from substantial non-audit service 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 non-audit services – services which are conventionally perceived to be more profitable than audit *per se*. In forming an opinion or not as to 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 unlikely not to be mindful of the overall fee income which the client represents to the firm.^{32,33}

Indeed critics of the profession in the UK and the United States have alleged that accounting firms 'low ball' tenders for audit, i.e. price the audit below cost, for the purpose of gaining access to lucrative non-audit services and quote specific examples where incoming auditors have undercut the outgoing auditors in respect to the audit fee and

³² 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, p.)

³³ The SEC heard evidence as to 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).

then benefited from a very substantial rise in subsequent non-audit service fee income.³⁴ 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 the opinion of the authors, it would be naïve to believe that individual auditors³⁵ and audit firms can entirely divorce themselves from such considerations when making operational and pricing audit decisions.

8.2 *Review of Work by Other Members of the Accounting Firm*

Concerns as to the auditor being put in a situation where they are effectively auditing their own work have been raised primarily in respect 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 non-audit service provision including *inter alia* internal audit, taxation, personnel selection, corporate finance. Here again empirical evidence as to the scale and extent of such a problem is very limited.

8.3 *The relationship with Management*

Perhaps the greatest threat to auditor independence deriving from the provision of non-audit services to audit clients lies in terms of the implications for relationship between client management and the auditor and the effect that this has in turn upon the audit approach. For much of the twentieth century, in the United Kingdom at least, 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 *vis-à-vis* 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

³⁴ 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 p.50 fn.109).

³⁵ See Gwilliam (1987, p.104) and Trompeter (1994) for discussion of incentives facing individual partners and aspiring partners within accounting firms.

particular the desire for fee growth through the sale of non-audit services to the client has significantly changed the relationship between auditor and client.

Whereas in the United Kingdom 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 in 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,³⁶ 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 whom lack personification as the auditors has no direct contact or dealings with them, consciously or sub-consciously 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.³⁷

8.4 *Bias, Scepticism and the Quality of Auditor Judgement*

An area for investigation that goes beyond a consideration of direct conflicts of interest looks at the potential impact of joint provision on the ability of the auditor to apply an appropriate degree of scepticism when performing an audit (APB, 2011, 2012). The importance of scepticism to an auditor's work has a long history. In his influential judgement 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 auditing standards and guidelines. The following three recommendations are 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.

³⁶ 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 Investigations, 2002, p.17).

³⁷ '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. 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.³⁸

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 duties with regard to reporting material matters to shareholders. With respect to these key issues, a sceptical attitude would appear to be of paramount importance to auditor judgement when reviewing audit evidence and managerial assertions. 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.'

Earlier, the APB (1998) had 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).

More recently, the APB (2011b) again reflected on the importance of scepticism in conducting an audit when it states:

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

The APB (2011b) expressed particular concerns about the range of understanding of the term 'professional scepticism' within the accountancy profession. While some members

³⁸ This principle is pertinent to the audits of some UK banks prior to the 2008-9 global financial crisis and auditors' reluctance to report doubts they had about the going concern status of the banks. While the heads of the Big 4 deemed that going concern qualifications were not appropriate nor required, given the Government's assurance of unlimited support for these banks in case of need (see in the subsequent House of Lords enquiry, the Lords 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.'* (House of Lords, 2011, paras 140, 147).

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, 2011b paras 23-24). With this interpretation, the APB suggests an almost suspicious approach while implying there to be a fine but clear line between auditors adopting a 'suspicious' rather than 'sceptical' approach to an audit. The move in the concept along an imaginary continuum from auditor's assuming management's honesty towards assuming dishonesty was reflected upon by Bell et al. (2005), who note:

'the concept of professionalism [has shifted] from neutrality toward presumptive doubt' (p. 18)

The APB too questions whether a neutral position (or even an 'inquiring mind') is an appropriate or sufficient position for an auditor to adopt and points to '*an element of doubt' [underlying] a number of requirements in Auditing Standards'* (APB, 2011b, para 27). In further refinement of its concerns, the APB (2012, p.4) analyses factors which may affect an auditor's ability to apply the necessary scepticism when conducting an audit:

"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 review of scepticism tries to establish a common definition and understanding of the concept, underlining its critical role in delivering audit quality. In line with the FRC's increased recognition of the intrusion of bias on decision-making and its impact on the quality of decisions at board level (see FRC, 2011), the APB focuses on behavioural factors which can diminish the scepticism applied during audit. The APB's interpretation of the concept of scepticism and its focus on the impact of heuristics and bias on judgement underlines the fundamental importance of independence in mind (as opposed to formal independence) of the auditor.

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 an auditor's recognition of factors which may affect their judgement 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. 2002a,b; 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 disturb this idealized picture and have given rise to a degree of cynicism with the accounting profession.

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 are especially pronounced in the complex and variable environment in which auditors operate.³⁹ Since "... *judging and deciding are inherent in every phase of the audit process...*"⁴⁰ an auditor would appear to be the classical 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, p. 26).

Accounting uncertainty has been found to negatively impact auditor objectivity despite potential damage to auditor reputation from this (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). This places auditors in the unenviable centre of complex interactions between a raft of heuristics and cognitive influences, which question the feasibility of an auditor's work to escape self-serving bias. Independence issues may be aggravated by increased competition in the auditing industry, particularly by the increase in importance of non-auditing services provided by accounting firms.

The intrusion of bias in the client working relationship may be inevitable, and operate even in the absence of financial incentives and motivation. This would make auditor

³⁹ "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, p. 107).

⁴⁰ Solomon and Shields (1995, p. 139); also, "Auditors express opinions based on investigations that, no matter how thorough, inevitably involve subjective judgments." (Hogarth, 1991, p. 277). Jiambalvo and Wilner (1985) find that there is often substantial disagreement among trained auditors regarding the proper outcome for a particular problem.

impartiality an impossible ideal (Bazerman et al., 1997, 2002a,b; O'Connor, 2002), and suggests the need for additional instruments to counter bias, including periodic auditor rotation (at partner and at firm level) and increased independent review of an auditors' work. As the result of selective interpretation of ambiguous information that goes into a financial report, and the weight of earlier interpretations, an auditor's judgment is almost certainly biased in favour of their own and clients' interests (Bazerman et al., 1997). 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 hurt 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 mis-statement.⁴¹

Prentice (2000a) questions the assumption that an accountant always adheres to the rational actor ideal, and dismisses the view that the potential or actual loss of reputation is a reliable deterrent to fraudulent or negligent auditing. Auditors tend to satisfice (Simon, 1955), rather than optimize. This might be inconsistent with a Bayesian application of probability, but is entirely rational from a cognitive cost-benefit perspective as it economizes on the cost of analysis (Asare and Wright, 1997; Gigerenzer and Todd, 1999). Auditors use 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 utilize 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-rationalize 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 judgments, and their accuracy in actual judgements (Kida, 1984). This reflects overconfidence in their own

⁴¹ Bazerman et al. (2002a,b) argue that very little association with a client is required to produce biased judgments and identify a number of structural aspects of accounting which encourage biased judgment: Ambiguity, Attachment, and Approval. Socio-psychological factors including familiarity, discounting, and escalation contribute to the bias introduced by these structural aspects.

abilities (Kent and Weber, 1998) and possibly also in self-perceptions of ethics (Cohen et al., 1995). Tax professionals (including accountants) have been found to be highly susceptible to biases toward the client 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).⁴²

Auditing practice and regulation should take the persistence of bias into consideration in order to increase the reliability of financial reports. This seems particularly relevant as the discussion has shown that self-serving judgments, fraudulent intentions, and deliberate misleading are not necessary for the provision of false, incorrect, or grossly misleading audits, at least not initially. Bias can be strictly separated from motivation, though motivation may (and usually does) subsequently contribute to further biased perception and judgement. The mere proximity to the client is sufficient to introduce bias in perception, interpretation, and judgement of the professional, to result in audit interpretations favourable to the client (Zajonc, 1968; Bazerman et al., 2002a). Subsequent pressures to self-justify initial acceptance of accounting interpretations tend to lead to yet closer affiliation with the client's view. Hence, while it may only involve small steps from initial bias to self-serving motivation and finally to fraudulent behaviour, bias can affect audits before any motive and intent for fraud enters the equation. This is in stark contrast to assumption of deliberate intent by individuals of rational choice theories, and policy making and legal practice based on its predictions. It must be recognized that 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.

Current legislation may not sufficiently consider impartiality in the audit process. The Sarbanes-Oxley Act of 2002, for example, aims directly at fraud, but fails to strongly address

⁴² 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.

the problem of bias.⁴³ It is not obvious how unconscious bias would be deterred by the threat of increased punishment (Bazerman et al., 1997; 2002a,b), and “... 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, p. 2). The problem for policy makers 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.⁴⁴ Impartiality is difficult to achieve, some would say impossible, as all individuals are biased towards their own interests or prejudices, and 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’, behavioural research points to the difficulty of escaping bias and heuristics that skew perception. 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 rationalize (i.e., 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.

The APB (2012) considers scepticism to be a cornerstone of audit quality – as 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 of the importance of scepticism to audit, the APB (2012) goes significantly beyond established analyses of scepticism that focus on reliance on professional conduct (see, for example, the ISAs released by the IASSB which critically depend on auditor scepticism, including: ISA 200, 220, 240, 315, 330, 505, 520, 540, 550, 570, 700).

Instead, the APB (2012) suggests that auditors critically appraise managerial assertions by actively looking out for risks of material misstatements, and to design audit procedures which consider whether there is any evidence that would contradict management assertions (rather than merely consider the extent to which management has provided evidence that is consistent with them). This recognizes auditor’s susceptibility to heuristics and biases and indicates the need for the systematic use of procedures designed to counter and mitigate the effects of bias on auditor judgement and quality of

⁴³ 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, inter alia, define and detail cooling off periods of one year before a member of an audit team can join client firm in certain key positions, lists categories of prohibited non-audit services, mandate partner rotation, and enhance various disclosure and certification requirements.

⁴⁴ By implication, this would also seem to apply to any other gatekeeper, especially, given their proximity to management, the members of a board.

decision-making, prior to and during engagement, in order to enhance the reliability on and value of expressed audit opinion.⁴⁵

8.5 *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 non-audit services 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 as 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 as to the benefits of the provision of non-audit services to clients (an issue discussed further below) then 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 non-audit services (and audit clients are purchasing non-audit services for genuine economic reasons) then one would expect a redistribution of the existing pool of audit client non-audit services 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.

⁴⁵ 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 minimize the risk of poor decisions by designing decision-making policies and processes aimed at mitigating the impact of bias.

9.0 Arguments for the Provision of Non-Audit Services to Audit Clients

In seeking to protect their freedom to provide non-audit services to their audit clients the accountancy firms and the accountancy profession in both the United Kingdom and the United States 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 non-audit services and audit failure; the role of professionalism; reputation effects and economic sanctions; and the impact on recruitment to the accounting profession.

9.1 *Wider Economic Benefits*

The very rapid expansion in non-audit service provision to audit clients may be seen as 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 spill-overs (Simunic, 1984). To intervene in the market by prohibiting the provision of non-audit services to audit clients would then reduce economic efficiency.

Although the success of accounting firms in marketing non-audit services to their clients is undoubted and is demonstrated by the rapid growth in fee income deriving from such services 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.'*⁴⁶

However, empirical research has found it difficult to pin down these advantage in terms of reduced audit fees associated with a higher level of non-audit services – indeed the majority of pricing studies suggest that firms which purchase a high level of non-audit services from their auditors pay rather more than average for their audits. Ezzamel et al. (2002) suggest that this positive association may be explicable in terms either of client specific differences, for example organizational complexity, 'or of events giving rise to the purchase of more audit and non-audit services rather than in terms of direct economic

⁴⁶ p.ii.

linkages between the cost functions for audit and non-audit services.⁴⁷ 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 function 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.

9.2 *Enhanced Audit Quality*

A linked argument, albeit one at a slight remove, is that the provision of non-audit services 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), have identified the need for auditors to have a knowledge base, whether pre-existing or as a result of search and evidential inquiry, which enables them to form an independent opinion as to 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 products⁴⁸ then it is the provision of non-audit services 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 fits 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 non-audit services 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 non-audit services in respect 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 transactions⁴⁹ - but in the outcome this did not lead to a higher quality audit.

⁴⁷ p.13.

⁴⁸ 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).

⁴⁹ See the Powers Report (Powers et al., 2002) 'Andersen billed Enron \$5.7million for advice in connection with the LJM and Chewco transactions alone, above and beyond its

More generally, although the interface between a wider range of service provision and enhanced knowledge of the client's business is intuitively persuasive there is little empirical evidence as to how this translates into better quality auditing and some have been critical of the whole concept. Sikka and Willmott (1993) in their review of the DTI Inspectors' report on Raodships 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.'*⁵⁰

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.'*⁵¹

9.3 Lack of Evidence of User Concern

Review studies by Orren (1997) and Kinney (1999) both conclude that the North American literature suggests that financial statement users do not share the concerns of regulators as to the effects of the provision of non audit services to audit clients,⁵² notwithstanding the fact that a number of early empirical studies found that as the level of non-audit services provision increased, the level of user confidence in auditor independence decreased (Lindsay et al., 1987; Pany and Reckers, 1983, and Reckers and Stagliano, 1981) and more recently studies by Beattie et al. (1999) and Canning and Gwilliam (1999) of UK and Irish financial statement users respectively both suggest that increasing levels of fees from non-audit services can impair the perception of auditor

regular audit fees.' (p.5) and 'Andersen's total bill for Raptor-related work came to approximately \$1.3million. 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.' p.132.

⁵⁰ p.9.

⁵¹ Report 107 – 70, July 2002, 'The Role of the Board of Directors in Enron's Collapse', p.58.

⁵² 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'. (p.1).

independence.⁵³ Similarly, in the United States attitudinal research conducted on behalf of the Independence Standards Board (Earncliffe Research & Communications, 2000) does suggest concerns among North American financial statement users as to the continuing evolution of auditing firms into multi-disciplinary professional services⁵⁴ and the SEC heard a depth of evidence of user concern as it deliberated ahead of its November, 2000 rule changes (SEC, 2000). It is very probable that studies carried out in the present post-Enron⁵⁵ financial reporting and auditing climate would witness a much higher degree of user concern than previously exhibited.

9.4 *Lack of Evidence of Adverse Economic Impact*

Evidence that high levels of provision of non-audit services to audit clients 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 non-audit services (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 non-audit services 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.'^{56,57}

Empirical work in this field has been restricted because of the lack of disclosure of data for audit and non-audit services in the United States. Those studies using publicly available data which have taken place outside the United States have focused primarily on the interaction between the pricing of audit and non-audit services. However subsequent to the introduction of the US disclosure requirements a 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 non-audit service fees. The study also found there to be an inverse relationship between the level of non-audit

⁵³ 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 non-audit service provision were likely to compromise independence.

⁵⁴ 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.'

⁵⁵ And post-Worldcom where disclosed non-audit fees of \$12m were apparently three times the audit fee of \$4m.

⁵⁶ p.25.

⁵⁷ 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).

fees and the extent of earnings management. Firms purchasing more non-audit services from their auditor were more likely to meet earnings benchmarks and to report large discretionary accruals. In the United Kingdom the evidence to date is more mixed. 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 non-audit services for companies with 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 non-audit service provision irrespective of whether the auditor was Big Five or not.

9.5 *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 non-audit services to audit clients with audit failure⁵⁸ and it was the lack of identification of such a link which in part influenced the Cohen Commission not to recommend prohibiting non-audit service provision to audit clients. Antle et al. (1997) suggest that independence concerns are raised in a very small number of legal actions against auditors with yet fewer specific reference to non-audit services 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 are 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 non-audit services 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 following 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.'⁵⁹ (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',⁶⁰ and that in any case that the role of the regulator was to act in a prophylactic manner and if non-audit service provision was considered to be a threat to auditor independence and

⁵⁸ 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)).

⁵⁹ POB (1979, at 34 n.103).

⁶⁰ SEC (2000).

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'.⁶¹

9.6 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.'⁶²

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 are still important within accounting firms today. 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.'⁶³

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. 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.⁶⁴ The importance of the firms in imparting values and

⁶¹ SEC (2000).

⁶² Quoted in Pitt and Birenbaum (1997, p.13).

⁶³ p.5.

⁶⁴ See Dirsmith *et al.* (1997).

professional attitudes in the United Kingdom at least can be 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 which they worked.

9.7 *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 so as 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) note that partners' financial capital in each of the (then) Big Six firms in the United States at the end of 1996 exceeded \$3.5 billion - 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.'*⁶⁵

In many ways the fate of Andersen *post* Enron illustrates very clearly the risks attendant to non-independent behaviour. It is likely that the collapse of Andersen will significantly influence the attitudes and actions of the remaining large firm partners irrespective of any further regulation that may be 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 twenty five years all the large firms have been drawn into accounting and auditing cause celebres. 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 (and 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, KPMG, in 2005, narrowly avoided criminal indictment in the United States (and

⁶⁵ p.31.

thus sharing the fate of Andersen) over fraudulent conduct involved in the sale of illegal tax shelters over prior years, by paying a \$456 million penalty and meeting a number of additional conditions imposed by the US Justice Department. 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 (see Prentice, 2000a,b for summaries of this literature) appear to indicate that 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 so as to increase returns over the future.

9.8 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 non-audit services 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 non-audit service 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 twenty five years ago when non-audit services were relatively much less important than they are today.

There is likewise little evidence that accounting firms operating in the United States had difficulty in recruiting high calibre personnel after the prohibition of providing a number of non-audit services to audit clients post the 2002 Sarbanes-Oxley Act. One would expect market forces to determine appropriate recruitment for the, admittedly more complex, audits of today irrespective of whether accounting firms offered non-audit services 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 United Kingdom (and perhaps to a slightly lesser extent in the United States) 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.

10.0 Conclusions and Policy Perspectives

10.1 *Concluding remarks*

This initial review has sought, within the constraints imposed, to present a broad overview of current research and policy concerns in order to stimulate the discussion of the provision of non-audit services to audit clients. This report by no means represents a complete analysis of the vast academic and other literature and the policy discussion on the topic under review. Within the scope of this review, little reflection was possible on the views of practitioners and stakeholders.

Changes in audit methodologies reflect to an extent changes in technology, relative costs, the nature of financial reporting, and perceptions as to the auditor's role, etc. The major audit firms take the position, some more forcefully than others, that the accounting technology and internal control systems of their large clients are such that there is little purpose or value in conducting the type of detailed transactions or systems-based audit that used to take place. In the meantime, audit reinvented and repositioned itself to fit more comfortably into an added value role within the overall assessment and management of risk for the benefit of the company and its stakeholders. This in turn gave prominence to the provision of additional services over and above audit to the client – services initially proposed to enhance the quality and efficiency of audit by adding to the information available to the auditor.

Unfortunately such an approach carries significant dangers in terms of enhanced threats to auditor independence, threats which may outweigh any perceived benefits from an integrated audit approach. There is no doubt that the provision of extensive consulting services provided significant spillover benefits to Enron's auditors. Although not necessarily aware of every detail of Enron's manipulations, it is incontestable that Andersen were in possession of detailed information, as to the financial engineering that was taking place. Such information is likely to have been costly and time consuming to obtain if Andersen were not acting in a consulting capacity. However, few would argue that this led to a superior quality audit – as auditors Andersen willingly accepted a whole range of accounting treatments at the limits of US GAAP which 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 accorded more attention by analysts and others, but they were not. One is inevitably drawn to the conclusion that as an example of the business risk audit approach Andersen's audit of Enron failed both in terms of contributing to the client's overall risk management profile and in the more prosaic role of coming to an appropriate opinion on the financial statements offered to the capital markets and to other stakeholders. From a

policy making perspective if the quality of external audit is thought to be important the question is whether the professionalism and/or 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.

Some place their confidence in professional values to ensure that auditors will deliver that quality. An interview-based research study within professional firms carried out on behalf of the AICPA (Burke, 1997) concluded, for example, that:

'There appears to be a strong norm both within the firms and throughout the profession, for maintaining independence as a means of providing clients with the best possible audit service and, in the large 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.' (p.5)

Others are 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. 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 (Dirsmith et al., 1997; Brierley and Gwilliam, 2001). The importance of the firms in imparting values and professional attitudes in the United Kingdom at least can be 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 organization for which they worked.

Professional considerations apart there are economic incentives acting 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) noted that partners' financial capital in each of the (then) Big Six firms in the United States at the end of 1996 exceeded \$3.5 billion – all of which could be put at risk if the firm engaged in non-independent behaviour. They also highlighted the importance of actual and potential litigation against accounting firms in providing powerful

incentives for firms to avoid systemic independence violations. Antle et al. (1997) 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.' (p. 31)

It is unfortunate, however, that the assumption that people will 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.⁶⁶ 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 the objectivity and independence of the auditor (Prentice, 2000a,b; Bazerman et al. 2002a,b; Marnet, 2007). As noted in a review on the importance of scepticism to an auditor's work, by the APB (2012), cognitive biases (whether conscious or sub-conscious) are likely to affect 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. 2002a,b). A diminished degree of scepticism, 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 non-audit services.

In many ways the fate of Andersen post Enron illustrates very closely the risks attendant to non-independent behaviour. It is likely that the collapse of Andersen has influenced and will continue to influence the attitudes and actions of partners in the remaining large firms, irrespective of any further regulation that may be put in place. However, it is by no means clear that reliance upon economic forces alone is the most efficient mechanism for maintaining auditor independence. To a greater or lesser extent over the past 30 years all the large firms have been drawn into accounting and auditing cause celebres. None of these pre-Enron appeared to have any but the most marginal effect upon the standing and growth of the firms, although Laventhol & Horwath, then the seventh

⁶⁶ See Jolls et al. (1998), Thaler (2000) and Rabin (2002) and for an overview of this literature.

biggest US accounting firm was forced into bankruptcy in late 1990, as the result of settlement of litigation claims (Stiner, 2010). 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. One clear policy implication is that if it is not thought worthwhile to grasp the nettle and severely restrict (as recommended by Canning and Gwilliam, 2002), or broadly prohibit the provision by auditors of non-audit services to their audit clients (as implemented by the Sarbanes-Oxley Act of 2002; and suggested by the European Commission in 2011), 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 studies have attempted to determine whether the joint provision of audit and non-audit services affect auditor independence but, as noted earlier, findings to date have been mixed and inconclusive, although evidence suggesting perceived independence to be impaired from joint provision is fairly robust, and on balance the evidence suggesting negative effects on audit quality from joint provision appears to be more appealing. Perhaps it is time to accept evidence from research on human judgement formation which suggests that joint provision inevitably impairs auditor independence, and that the only failsafe solution to avoiding potential conflicts of interest is the prohibition of all consultancy services to audit clients. This would remove a major source of self-serving bias.

But the issue perhaps 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 on the resourcefulness of individuals in finding ways around restrictions placed upon them. Rather than continuously asking questions on which we arguably already have obvious answers to, a future research agenda might wish to explore the embedment of integrity in an auditor's work, to ask 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? and how can integrity be enhanced?

10.2 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 tendering⁶⁷; extending the range of proscribed services; complete prohibition of the provision of non-audit services to audit clients; or even complete prohibition of the provision of non-audit services by firms offering statutory audit services.

If it is believed that the workings of the market will ensure that firms only deliver non-audit services to their audit clients 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 non-audit services, for example internal audit, to their audit clients and in a greater reluctance by clients, responsive to the concerns of the capital markets, to purchase of non-audit services from their auditor. However, the current crisis of confidence in the profession at least does raise significant doubt if 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 exasperated given that services are constantly evolving and being redefined (Jeppesen, 1998).

Given the concerns as to 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

⁶⁷ We note the September 2012 amendment to the UK Corporate Governance Code by the FRC requesting FTSE 350 to put their audit contract out to tender at least once a decade on a 'comply or explain' basis.

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 provision to audit clients (SOX, 2002), with increasing concerns about the impact of NAS on the quality of audit within the UK and Europe (See, for e.g., 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.

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 through the backdoor, even where such services are not provided to audit clients. The continued ability for management to apply low visibility sanctions to an accounting firm is likely to remain an important factor given the tremendous rise in the importance of the provision of NAS, irrespective of whether these are provided to an audit client (in fact increasingly less so) or to a non-audit client (increasingly more so). If an audit firm were perceived by client management to be overly critical of managerial assertions, particularly were it seen as a faithful and diligent watchdog for the shareholders rather than an accommodating and flexible friend of management, this could have obvious repercussions on the likelihood of retaining or gaining a lucrative service contract. In reflection, observed market trends could be indicative of two problems: First, the continued fee dependence of the audit firm on the audited company's management, and secondly, an increasing susceptibility to economic coercion and low visibility sanctions due to the rising importance to accounting firms of the provision of consulting services, *per se*.

Caution must be expressed in attributing how much of the downfall for example of Enron – which was essentially a poorly managed company – can be 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 with regard to the financial crisis of 2008/09 (although the House of Lords' inquiry and associated report was rather critical, HOL 2010, 2011). Nevertheless, in circumstances where the costs of prohibiting the provision of non-audit services to audit clients are at best unclear and - if other providers of similar services are to be believed – there may indeed be no substantial costs, it is difficult to see that the appropriate regulatory response should not be to prohibit or stringently control the provision of non-audit services to audit clients.

There are likely to be practical issues to be considered 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 non-audit services provided to their audit clients 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 non-audit services to audit clients.⁶⁸ 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 non-audit services to client companies cannot be unequivocally demonstrated, the logical regulatory response is likely to be to prohibit the joint supply of such services to audit clients.

⁶⁸ According to Ridyard and DeBolle (1992) this is clearly the case in France and Portugal and perhaps in Italy (p.67), see also Stevenson (2002). Further analysis and examination of practice in these countries, where auditors are prohibited from providing non-audit services to audit clients, would be instructive, as would be an analysis of the impact of the Sarbanes-Oxley Act of 2002.

11.0 References

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