

## Issues on which the APB seeks views

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### **1 (a) Do you think that the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?**

I think that the provision of non audit services (NAS) by accounting firms to their audit clients currently impacts confidence in the independence of auditors. Based on academic literature and empirical evidence<sup>2</sup>, and experience as trainee accountant, the impact of the provision of NAS (by accounting firms to their audit clients) on the confidence in the independence of auditors has been demonstrated. In my opinion, it is important to distinguish between the effects attributed to the volume of non audit services being provided by such accounting firms and the type of non audit service<sup>3</sup>.

**The provision of non audit services in itself by such firms, does not necessarily impact the independence of auditors. However where the fees generated from such non audit services are considerably high** (in proportion to the audit fees earned by such accounting firms) **and insufficient safeguards exist to protect the auditor's independence**, this creates a situation whereby the auditor's independence is likely to be compromised – since the auditor may be denied potential lucrative contracts (in the form of fees generated from NAS) where he decides to give a qualified opinion on the financial statements being audited.

### **(b) Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have adversely affected audit quality?**

No I'm not personally aware of any instances where the provision of non audit services by accounting firms to their audit clients may have adversely affected audit quality. In some cases, the provision of non audit services by accounting firms to their clients is considered to be

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<sup>2</sup> According to an analysis (by Quick and Warming Rasmussen) of the effects of 19 different non audit services, „a negative effect“ was discovered in relation to these. Furthermore, it was demonstrated that “the type of NAS not only influences the degree to which auditor independence is perceived to be impaired,” but “that perceived auditor independence does increase if NAS are provided by a separate department of the audit firm.” See R Quick and B Warming Rasmussen, ‘ Auditor Independence and the Provision of Non Audit Services: Perceptions by German Investors (2009) International Journal of Auditing (13) 141-162 Blackwell Publishing Limited .

<sup>3</sup> According to results obtained by Ezzamel et al, the relationship between levels of audit fees and non audit services is considered to be dependent on the category of non audit services. See M Ezzamel, DR Gwilliam and KM Holland, “ The Relationship between Categories of Non Audit Services and Audit Fees: Evidence from UK Companies (2002) International Journal of Auditing (6) 13-35. They also argue that “even though the theoretical literature points to important potential links between audit and non audit fees operating through either “knowledge spill overs” or differential benefits from “recurring” non audit services, there is no reason to assume that different categories of NAS will have the same effect on audit fees.”

beneficial – particularly where adequate safeguards operate to ensure that the auditor’s independence is not compromised.<sup>4</sup> Where the level of fees (non audit fees) generated by the provision of non audit services by such accounting firm influences the firm’s ability to make objective decisions and results in a situation where the firm’s independence is impaired, then this would be detrimental to the quality and credibility of the financial statements being audited.

The provision of non audit services in itself does not result in lower quality audits where necessary safeguards operate. The existence of necessary safeguards would not only ensure that the auditor’s independence is not compromised, it would also facilitate a process whereby costs savings (through “knowledge spill overs”, differential benefits from “recurring” non audit services and economies of scale) are maximised. Where such safeguards do not operate then the provision of non audit services to clients would definitely have an adverse effect on audit quality.

The response to this question is not quite clear cut.<sup>5</sup> Some of the poorest audits which have been observed in practice, an example of which is provided by Mr Hayward of “Independent Audit”, have been undertaken by audit firms whose ability to deliver high level quality audits was impaired by their “considerable level of ignorance about the client’s activities” – “the price for having no non audit work.”<sup>6</sup>

On the other hand, it is rightly contended that even if greater knowledge could be acquired about a client – as a result of non audit services being performed for such a client, such “knowledge spill overs” would not necessarily be used in generating better quality audits- where insufficient safeguards operated to ensure that the auditor’s independence was not compromised.<sup>7</sup>

**2) .If you do consider that the provision of non-audit services has adversely affected audit quality or currently impacts confidence in the independence of auditors please identify which non-audit services are of concern. Please give the reasons for your view.**

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<sup>4</sup> See *ibid* – for instance where this enables the accounting firm to acquire greater knowledge and understanding of the client being audited.

<sup>5</sup> Ashbaugh et al also “find no systematic evidence supporting Frankel et al’s claim that auditors violate their independence as a result of clients purchasing relatively more non audit services.” See H Ashbaugh, R LaFond and B Mayhew “Do Non Audit Services Compromise Auditor Independence? Further Evidence” (2003) *The Accounting Review* (78) No 3 611-639 and also R Frankel, M Johnson and K Nelson “The Relation Between Auditors’ Fees For Non Audit Services and Earnings Management” (2002) *The Accounting Review* (77) 71-105

<sup>6</sup> See observation of Mr Hayward of „Independent Audit“ Treasury Ninth Report, May 2009 Banking Crisis: Reforming Corporate Governance and Pay in the City  
<<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51909.htm#a37>>

<sup>7</sup> Quick and Rasmussen assert that „based on the current situation in audit markets, where audit services have low margins, it could be assumed that knowledge spillovers from consulting services are not used to increase audit quality but to reduce audit costs” and that “even if knowledge spillovers increase auditor’s ability to discover a breach in the client’s accounting system, such an increase in effectiveness would be worthless if the auditor did not report the breach – owing to lack of independence.” See R Quick and B Warming Rasmussen, ‘ Auditor Independence and the Provision of Non Audit Services: Perceptions by German Investors (2009) *International Journal of Auditing* (13) at page 155

Where non audit services are performed and sufficient safeguards operate to ensure that the level of fees generated from such services do not impact the auditor's ability to remain objective and independent, then such services do not pose a threat.

As stated by the Pensions Investment Research Company (PIRC),<sup>8</sup> in relation to the majority of cases for UK listed banks, “ the considerable level of fees paid by such banks to their auditors for non audit work creates a situation which would not only facilitate a conflict of interest, but also affect the auditor's independence and impair objectivity.”

Services identified by Quick and Rasmussen as having the potential to generate self review threat include internal control systems, book keeping, tax advisory, legal advisory, actuarial services, accounting information systems, internal audit, valuation, personnel lending, corporate management, risk management and financial services.<sup>9</sup>

**3) In the light of your answers to questions 1 and 2, do you think that there needs to be a change in the approach taken by APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit? Please give reasons for your view.**

The level of non audit services provided by the major accounting firms (the Big Four) needs to be curtailed. Such standards should also facilitate mid tier firms in undertaking more non audit services (specific services).

**4) Proposals for a change in the current arrangements,**

i) More extensive prohibitions on the provision of non audit services by major accounting firms to their audit clients within the Ethical Standards for Auditors;

A complete prohibition of the provision of non audit services is not proposed given the benefits which NAS are capable of generating (“knowledge spillovers” and “differential benefits from recurring non audit services”). However, mid tier firms should be encouraged to undertake a greater level of non audit services than is the case at the present – whilst limiting the level of non audit services provided by the Big Four. The measures (below) under (ii), (iii), (iv) should serve as additional safeguards in ensuring that the level of non audit fees generated by audit firms (major and smaller firms) do not reach a point where the auditor's independence faces the risk of being compromised.

ii) The imposition of other requirements through the Ethical Standards for Auditors

- Ethical Standard 1 paragraphs 46 and 59

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<sup>8</sup> See paragraph 234 of Treasury Ninth Report, May 2009 Banking Crisis: Reforming Corporate Governance and Pay in the City

<sup>9</sup> „All non audit services investigated were considered to have the potential to create self review threats, familiarity threats and intimidation threats.

- Ethical Standard 3 paragraphs 12, 18 and 19
- Ethical Standard 4 paragraphs 16, 25 and 29
- Ethical Standard 5 paragraphs 56, 63, 78,88, 95 and 127

iii) More active corporate governance – e.g. so that non-audit service engagements were required to be pre-approved by the company's board of directors or audit committee.

iv) Better (and more extensive) disclosure in financial statements.

In relation to (iv), I think the existing arrangements (which includes the Companies Disclosure of Auditor Remuneration Regulations 2005) are adequate. Furthermore, as stated in the Treasury Select Committee's Ninth Report, "Banks will be required to report, in greater detail, their risk positions under new regulations introduced by Basel II" – referred to as Pillar III disclosures.<sup>10</sup>

**5). In setting the standards relating to auditor independence, do you believe regard should be had to the perceived benefits that are derived by companies from the provision of non-audit services by their auditors?**

Perceived benefits arising from the provision of non audit services (as mentioned earlier) should be taken into consideration – hence the reasons for proposals which do not favour a complete prohibition of non audit services. By encouraging mid tier firms to undertake a higher level of non audit services, this would not only foster greater competition within the audit market, but should also consequentially improve the quality of audits.<sup>11</sup>

**6). Are there any other views that you would like the APB to take into account?**

Dual role of accountant – whereby he assumes the roles of a reporting accountant and also a competent person, needs to be addressed. Section 166 of the Financial Services and Markets Act (FSMA) 2000 deals with the powers of the FSA to obtain a report by a skilled person (reporting accountant) to assist the FSA in performing its functions under FSMA 2000. Under sections 167 and 168 of the FSMA, the FSA also has the powers to appoint competent persons to carry out investigations. The question relating to independence arises not only because i) The role is usually performed by auditors of the regulated firm – even though such skilled persons are usually approved by the FSA, but also because ii) Both roles of auditors of the regulated firms and skilled persons employed by the FSA (reporting accounting) are “separate roles which still overlap occasionally.”<sup>12</sup>

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<sup>10</sup> See paragraph 229 Treasury Ninth Report, May 2009 Banking Crisis: Reforming Corporate Governance and Pay in the City

<sup>11</sup> For more information on this, please see paper on “Regulating the International Audit Market and the Removal of Barriers to Entry: The Provision of Non Audit Services by Audit Firms and the 2006 Statutory Audit Directive” <http://mpa.ub.uni-muenchen.de/18624/> and [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1504703](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1504703)

<sup>12</sup> For more information on this, see D Singh „The Role of Third Parties in Banking Regulation and Supervision” Journal of International Banking Regulation Volume 4 No 3, 2003 at page 9. “The use of skilled persons’ reports has been controversial and concerns have been expressed in relation to the FSA using a skilled person’s report instead of devoting its own resources in investigating a matter.”

This is probably the reason why the FSA is making less use of auditors – in comparison to its predecessor (the Bank of England) – given the potential conflicts of interest which could arise in its use of skilled persons. However, the FSA should be making greater use of external auditors and exploiting the knowledge which could be acquired from the use of such specialists.