Does Selling non-Audit Services Impair Auditor Independence?

Dr. Khaled A. Hamuda  Mr. Nouraden A. Adeb

Al-Aziza High Institute, Libya

Khmuda@yahoo.co.uk  nouraldenaldeb@gmail.com

Abstract:

This paper examines whether non audit service are associated with audit auditor independence. In relation to the impact of non-audit service on audit auditor independence. The findings of the study demonstrate that auditor independence is perceived to be significantly impaired when the audit was performed by small audit firms. The local audit firms affiliated to one of the Big Four audit firms (Price Waterhouse Coopers, Deloitte, KPMG, and Ernst and Young) are still preferred by companies in the Libyan audit market due to their experience, resources, and audit technology. The findings also show that, subject to the condition that non-audit services (NAS) should be provided by a separate department (a ‘Chinese Wall’), it is widely perceived that the provision of NAS to an audit client does not impair auditor independence.

Keywords: auditor independence, audit quality, non-audit service, audit firms.

1. Introduction:

One of the most hotly debated audit independence issues has been the provision of non-audit services (NAS) by audit firms to their audit clients. Strong arguments have been made that such services create an economic bond between auditor and client, impairing an
auditor’s independence. On the other hand, equally strong opinions have been expressed that the provision of NAS increases an auditor’s knowledge of the client’s business, resulting in a more effective audit. Empirical studies of the potential relation between audit quality and NAS levels have found little if any evidence to support the former position, and some evidence to support the latter opinion. However, a recently published study by Causholli, Chambers, and Payne (2014) reports significant and robust evidence that NAS is associated with lower audit quality.

Will examine non-auditing services supplied since the early eighties by auditors. Indeed since this time the proportion of audit firms’ revenue earned from NAS has increased whilst that supplied by traditional auditing services has decreased (Sawan 2013; Abdel-Khalik 1990; Craswell 1999; Kleinman et al., 1998; Pa; Shawn and Dana 2008). How this double provision has affected auditing independence is of great importance.

2. Literature Review
Auditor independence, as a human quality, is not directly observable; it is therefore difficult to prove the existence of such a character trait (Windsor & Ashkanasy, 1995; Kleinman & Palmon, 2001). It can be argued that independence (in mind) can be maintained even if additional consulting services are provided by the auditor. Several research studies have examined the effect of NAS on auditor independence. Whether NAS should be provided for clients is something that has been debated for some period of time (see for example: Abu Bakar et al., 2005; Barkess & Simnett 1994; DeFond, Raghunandan, & Subramanyam, 2002; Sawan, 2013). The case that has been made against its provision is that where it is provided the result may be partiality and a loss of independence because the revenue that stems from NAS creates a dependency on it and on those clients who ask for such services.
Therefore, audit fees are disclosed in annual reports because the auditors are deemed to be agents of the shareholders. Where NAS becomes of significant importance to the auditor, either with reference to the totality of his work or in the case of a particular client, there is the risk that the auditor may become economically dependent on both the service and the client resulting in partiality and objectivity being compromised and in bias developing (Simunic 1984).

Firth (1997b) states that in the UK it is permissible for auditors to provide NAS to clients but the Companies Act makes clear that payment for these services must be disclosed in the annual report of the company. In Australia the provisions of Auditing Practice AU32 makes permissible the provision of NAS together with other extra services, but ‘the auditing and performing of the same work’ is prohibited (AUP 3). What this does is ensure that audit independence is seen to exist which means that the relationship between auditor and client is a transparent one. These provisions also allow for greater access to further useful information relating to financial statements for those requiring it, such as clients, shareholders and researchers.

The Sarbanes-Oxley Act (SOA) of 2002 changed and clarified the parameters for the use of NAS by auditing firms within the USA. Prior to this the consulting elements of some large auditing firms had been sold off in order to avoid there being any legal liabilities resulting from conflict of interest. The SOA confers additional power on the audit committee and aims to eradicate specific potential conflicts of interest that may come about from the use of NAS. Nine activities, as listed below, may not be provided by registered auditing firms according to the SOA:

1) book-keeping or the undertaking of other services connected to the auditing of client’s accounting records or financial statements;
2) Designing and setting up systems dealing with financial information;

3) Provision of services for appraisal or evaluation, opinions concerned with fairness, and reports dealing with contributions in kind;

4) Provision of actuary services;

5) The outsourcing of services;

6) The provision of services connected with management and personnel;

7) The provision of services relating to investment, brokerage and dealership;

8) The provision of legal services or any other services that are not connected with auditing;

9) Any other service that the accounting board considers should not be provided.

Although in the UK a prohibition has not been made by the professional organisations of the supply of NAS to audit clients, account has been taken of the potential for a loss of independence if NAS supplied to audit clients giving them guidance as to how to undertake functions of management.

“There is no objection to a firm providing advisory services to a company which are additional to the audit. Care must be taken to ensure not to perform management functions or to make management decisions. It is economic in terms of skill and effort for professional accountants in public practice to be able to provide other services to their client since they already have a good knowledge of their business. Many companies (particularly smaller
ones) would be adversely affected if they were denied the right to obtain other services from their auditors”.

A number of researchers, such as (Sawan 2013; DeFond et al. 2002; Shawn & Dana 2008) have looked at both the advantages and disadvantages of auditors providing NAS to their clients. There is, for instance, a supposition that where the auditor provides NAS to the audit client a conflict of interests could arise, especially in the situation where a client’s executive personnel are taken on by an audit firm with the purpose of ensuring their success, or where a management information system is employed leading to the subsequent auditing of the accuracy and reliability of its own work. In the situation where an audit firm is acting as a consultant as well as an auditor in the carrying out of the consultant role, the temptation may arise not to report poor consulting which has been seen in the course of the audit in order to avoid any damage to reputation. Independence is threatened if any circumstance arises which makes it more likely that an auditor will not issue a truthful report after an audit investigation (Simunic 1984).

Canning & Gwilliam (1999) DeAngelo (1981b) and Wines (1994) maintain that where NAS are provided the auditor may be prepared to ignore any dubious accounting practices of the management since if questions were raised about these, it could mean the loss of further NAS work as well as of the audit fees. A further problem arises where the auditor gains client-specific rents as a result of NAS and where companies can threaten to change auditors in order to have access to a more favourable audit report. This is another instance where supplying NAS to audit clients can result in a threat to independence (Canning & William 1999; DeAngelo 1981b).
However, it is also the case that supplying NAS to audit clients may provide the auditor with greater knowledge so that it becomes more likely that problems will be discovered. This counters the risk of switching auditor since, at a given level of independence, the dependency of the client on the auditor may be increased. Abdel-Khalik (1990) considers another frequently discussed advantage of supplying NAS to audit clients, which is the potential for advantages in cost which stem from the exchange of knowledge that can take place where the auditor being used also provides NAS.

3. The Population and Sampling of the Research

An aspect of the research that impacts significantly on the quality of the data that is collected is the selection of those who will participate in the research. For this reason Denscombe (2001) strongly recommends that in order to be able to use the best population sample for the research, the researchers should be able to make their own selection. Sekaran (2003, P.265) defines population as:

“The entire group of people, events or things of interest that the researcher wishes to investigate”

For this study, the population was made up of two Libyan groups, the first being drawn from the staff of audit firms and the second being drawn from staff of industrial public companies. Within each group a further selection was made of three categories, these being auditors, managing partners and audit supervisors in the case of audit firms, and in the case of public companies, internal auditors, financial managers and accounts managers. These specific groups were chosen since earlier researches had identified that these were the most appropriate groups to use for a study of auditor independence, since their perceptions of auditor independence were highly relevant and worth consideration. These two groups are comprised of individuals who all have professional qualifications and a high degree of training and were therefore able
to make informed observations that were pertinent to this area of study. The following gives the reasons why these groups have been chosen as targets.

**Audit firms:** who belong to the Libyan Accountants and Auditors Association (LAAA), have the right to practise as auditors and accountants, particularly, those who are registered with the General People's Committee and therefore fall under the People’s control, these firms were chosen because they are employed by the government to audit the financial statements of its corporations. In this study is to meet its objective of making an examination of a number of factors that impact on perceptions of auditor independence, it is vital to be aware of audit firms’ own perceptions of themselves in relation to each of the selected variables which may have an effect on auditor independence.

**Industrial public companies:** The choice was made of Industrial public companies because they have a wide experience of dealing with auditing firms and are the longest established and biggest firms dealing with the Libyan audit market, and therefore will hold opinions relating to auditor independence since they will have contracts with external auditors who will be responsible for the auditing of their financial statements. It is therefore of significant importance to know how the staff who are part of these companies, such as internal auditors, financial managers and account managers, perceive the external auditors’ independence, particular, these three classes were chosen because they have direct connection with the external auditors. The Libyan government currently owns about 121 industrial public companies.

4. **The process of sampling**

Once the population to be used for this study had been defined, a section of that population that could be seen as representative of the whole had to be selected, this process being known as sampling. Sekaran (2003, P.266) defined sampling as:
“The process of selecting a sufficient number of elements from the population, so that a study of the sample and an understanding of its properties or characteristics would make it possible for us to generalise such properties or characteristics to the population elements”.

Samples are used for the collection of data, rather than an entire population, because it is more manageable in terms of cost and the use of various other resources, in particular where there are a number of elements involved and they are geographically widespread. It is important to choose the right technique for sampling from among the range of methods that exist. Commenting on this, Collis & Hussey, (2003) suggest that what makes a representative and good sample is one where the results that are collected from the sample can be relied upon to apply to the population as a whole. They also state that a good sample must be:

1- chosen at random meaning that each member within the population stands a chance of being chosen;

2- of a sufficient size to enable it to meet the needs of the investigation;

3- an unbiased sample.

Sekaran (2003) maintains that there are two main ways in which a sample may be designed. The first is probability sampling which allows for each element of a population to have a chance which is known and equal of being a selected subject, and the second is non-probability where those potentially taking part do not have a known or predetermined chance of selection. In this study probability sampling was used in order for subjects from each of the target groups, that is the staff of audit firms and the staff of public companies, to be selected. The use of a random sampling method ensures that that there is an equal probability of each person in the targeted class being selected as part of the sample. This method of sampling also makes use of non-replacement
sampling so that there is no chance of choosing a specific respondent more than once. The reasons for opting to use this method are firstly that it offers greater generalisability and the sample that is most representative, and second it helps to eliminate bias which means that it is possible to make an estimation of possible sampling errors (Sekaran, 2003). Since Tripoli, the capital of Libya, Benghazi, Mosratah and Al-Zawiah are the cities where most of the financial and commercial activities of Libya take place (Khorwatt, 2006; Mahmud, 1997), these were the locations where sampling dealing with the selection of subjects from the two targeted groups took place. This was for the following reasons:

1- in excess of 80% of those audit firms registered with the General People's Committee for the People’s control and inspection are located in these cities;

2- most of the economic and business activity take place here.

3- and these four cities have more than 85% of the industrial public companies in Libya.

Saunders et al (2007) maintain that in order to have a good likelihood of obtaining a sampling distribution that is close to the norm, the sample size needs to be not less than 30%. They also make the point that where a sample is of a large absolute size there is the likelihood that it will better represent the population from which it is drawn than would be the case with a smaller sample. However, Cohen & Manion (1980) take the view that it is not possible to set down an exact number or percentage that needs to be used by all studies. It has been suggested by some authors that there are a number of considerations that need to be taken into account of when deciding on the size of the sample that is to be selected, such as the nature of the statistical analysis that is to be used, and how much variability is expected within the sample and the results; these considerations should be based on experience, the conventions that exist in a particular area of research in relation
to what is considered an appropriate sample size, as well as the size of the whole population and issues of time and costs (Collis & Hussey, 2003; Saunders et al 2007).

After due consideration being given to the issues discussed above relating to the size of the sample which, in this case, will receive questionnaires, the size of the sample to be taken from each targeted population was decided to be more than 50% of the population as follows; the first segment of the questionnaire sample involved 67 public companies and 137 audit firms working in Libya. The questionnaire was given to three different classes of public company respondents, namely, internal auditors, financial managers and accounts managers; while it was also given to three different classes of audit firm respondents, namely, managing partners, audit supervisors and auditors. The total number of questionnaires distributed to the public companies was 201: 67 questionnaires of each class in the public companies mentioned above. The total number of questionnaires distributed to audit firms working in Libya was 411; 137 questionnaires to people in each position in the audit firms listed above. On the one hand, on the demand side, the three classes in public companies were chosen because they were leaders in their company’s business activities and, hence, needed a monitoring mechanism to report on their performance (Jensen and Meckling 1976). On the supply side, three classes of audit firms were considered because they were the main subjects in the issue of interest, supplying the documentation and/or information to the shareholders to evaluate for credibility (Humphrey 1997).

According to Saunders, et al (2009) maintains that there are several structures for administering questionnaires: postal questionnaire, the delivery and collection approach, interviewer administered and questionnaire by telephone. In order to receive a high level of valid responses in the present case, the delivery and collection method was selected for gathering the data. The
researcher distributed the questionnaire to the respondents and collected them again individually. This structure was meant to guarantee an adequate answer rate for the questionnaire survey. In addition, to establish contact for the interview phase later in the study, the delivery and collection method was most appropriate. Furthermore, a postal questionnaire was also sent to respondents located in far-away places outside the chosen cities. To raise the number of responses, the respondents were given the option to send their reply in a reply paid envelope, which was already included in every copy of the questionnaire that was sent out.

In the questionnaire survey, to obtain better responses, a reminder was sent to those respondents who had not yet sent in their questionnaire. This step was taken with due care and diligence, for if the researcher demonstrates inter-personal skills the respondents can become more co-operative. The total number of questionnaires completed and collected from public companies was 89; 28 (31.5%) from the internal auditors, 31 (34.9%) from the financial managers and 30 (33.6%) from the accounts managers, while the total number of questionnaires completed and collected from the audit firms was 192 questionnaires; 46 (26.8%) questionnaires from the managing partners, 52 (25%) questionnaire from the audit supervisors and 94 (48.2%) from the auditors.

5. Results and Discussion

To test the provision of non-audit services, public companies respondents were asked to point out whether they had received NAS from their audit firm and audit firm respondents were asked to point out whether they had supplied NAS to their customers.

Table 1 shows that (34.8%) of public company respondents had not received any type of non-audit services from their audit firm, whereas (65.2%) had received non-audit services from their audit firm. whereas, about (59.9%) of audit firm respondents had supplied NAS to their audit clients, while (39.1%) did not supply
any type of NAS to their audit clients. The minor inconsistency in these results can be explained by some audit firms being relatively specialised in the provision of NAS as well having a client profile containing some private as opposed to public companies.

Table 1: the percentage of Respondents who Received or supplied Non-Audit Services (NAS) in 2007

<table>
<thead>
<tr>
<th>Public Companies</th>
<th>Audit Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Received (NAS)</td>
<td>Supplied (NAS)</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Frequency (%)</td>
<td>Frequency (%)</td>
</tr>
<tr>
<td>58</td>
<td>115</td>
</tr>
<tr>
<td>65.2</td>
<td>59.9</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>31</td>
<td>75</td>
</tr>
<tr>
<td>34.8</td>
<td>39.1</td>
</tr>
<tr>
<td>Total</td>
<td>Total</td>
</tr>
<tr>
<td>89</td>
<td>192</td>
</tr>
<tr>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

In the analysis that follows, the 89 Libyan public companies and 192 audit firms that responded to the questionnaire are analysed in terms of (1) the respondents’ position and (2) type of audit firm

5.1) Respondents’ Position:

The questionnaire was sent to three different classes of public company respondents: internal auditors, financial managers and accounts managers, and to other three different classes of audit firm respondents: auditors, managing partners, and audit supervisors.

Researchers such as Humphrey (1997) studied samples of supply side (audit firms staff) as they are the main subjects that provide reports and/or information to stakeholders. In this study we go further classifying respondents according to their positions. Table 2 shows respondents’ positions and frequencies.

Table 2: Respondents’ Position and frequencies
Public Companies Staff | Audit Firms Staff
---|---
**Position** | **Frequency** | **%** | **Position** | **Frequency** | **%**  
Internal Auditor | 28 | 31.5 | Managing Partner | 46 | 26.8  
Financial Manager | 31 | 34.9 | Audit Supervisor | 52 | 25  
Accounts Manager | 30 | 33.6 | Auditor | 94 | 48.2  
**Total** | **89** | **100** | **Total** | **192** | **100**

In the public companies there was an even distribution of respondents between, accounts, financial management and audit whilst in the audit firms the hierarchy of responsibility was clearly evident in the data. Given the nature of the sample and on the basis of this data each partner, on average had a span of control of just over three reflecting the relatively small size of audit firms in Libya.

5.2) Variable two: The Provision of Non-Audit Services (NAS)

To obtain their perceptions of the association between the provision of NAS and auditor independence, respondents in public companies and audit firms were asked to indicate on the rating scale ranging from 1, strongly disagree, to 6, strongly agree, their views on the eight statements offered in Table 3

The analysis of the differences in responses is reported in Table 3, which shows three significant differences at the 1% and 5% levels, as measured by the Mann Whitney U test. An examination of the levels of agreement shows those of public company respondents were significantly higher than those of audit firm respondents for three statements highlighting the disadvantages of provision of non-audit services (NAS). This discrepancy in the answers is interesting, and possibly suggests that audit firm respondents see
the provision of non-audit services (NAS) from the profit viewpoint, while public companies staff sees the provision of NAS as not impairing auditor independence, but need some limitation.

Table 3: Respondents’ Perceptions’ of the Relationship between the Provision of Non-Audit Services and Auditor Independence.
In other words, public company respondents might identify some reasons for their aims in asking their external auditor to provide NAS. However, in general, the above results confirm the findings of previous studies, such as Craswel (1999) and Defond et al. (2002), that the provision of NAS does not pose a risk to auditor independence. In fact it increases the level of audit quality by giving auditors greater access to the customer’s accounting framework and more experience of the customer’s operations.

Since the responses of public companies staff and audit firms staff were not completely identical, an attempt was made to isolate the determinants of responses. Therefore, the extent to which position and type of audit firm might explain differences in public company and audit firm respondents’ responses was once again tested using Kruskal Wallis test.

The differences between the mean and median results for each question are illuminating. In the case of audit firms there appears to be no significant (out of range) difference between the median and the mean. However, for staff in public companies the difference is quite marked. In particular there appears to be a clear and firm belief that the provision of NAS to an audit client gives auditors more experience of the client’s work and more access to the client’s accounting system.

5.3) The Respondents’ Perceptions of the Relationship between the Provision of (NAS) and Auditor Independence Analysed by Position.

In Table 4 shows the analysis by position, given two significant differences at the 1% and 5% levels, between the responses of public companies staff and audit firms staff using the Kruskal Wallis test. However, for presentation and comparison purposes the following table shows combines all the significant differences of the respondents responses between the six positions, three classes of audit firms staff (Managing Partner, Auditor Supervisor,
and Auditor), and three classes of public companies staff (Internal Auditor, Financial Manger, and Accounts Manager) using the mean score of each statement for each position in that table.

The analysis by position in Table 4 shows one significant difference at the 1% level between the responses of public companies staff and audit firms staff using the Kruskal Wallis test. The level of agreement was significantly higher from internal auditors with the statement: *The provision of NAS to an audit client leads to economic dependency on that client,* than other groups. This difference in the responses is interesting, and is expected to be due to internal auditors’ greater awareness of the effect of NAS on the auditing system in the company than anyone else’s, and is considered as the “watchdog” for the corporation. This result is consistent with Firth (1997b) which found that the provision of NAS to audit clients increases the economic bonding of the auditor to the client, and hence may jeopardise independence or at least apparent independence.

Furthermore, the analysis by position in Table 4 shows also one significant difference at the 5% level between the responses of public companies staff and audit firms staff using the Kruskal Wallis test. The statement: *Providing NAS to audit clients by a separate department gives the auditor more credibility and independence.* The highest significant mean score which agreed with it was (4.48) from Audit supervisors. While the Managing partners had the lowest level of agreement with mean value (3.45), they were expected to achieve the lowest mean score, because a separate department of non-audit services would entail an increase in the number of workers and worker payment.
<table>
<thead>
<tr>
<th>Position</th>
<th>Provision of (NAS)</th>
<th>Auditor Independence</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>5</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>6</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>7</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>8</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

Table 4: The Respondents' Perceptions of the Relationship between the Provision of (NAS) and Auditor Independence Analysed by Position.
Audit supervisors’ highest mean score for this statement is consistent with Canning & Gwilliam (1999) who point out that perceptions of auditor independence are significantly decreased when NAS are supplied to clients by workers involved in the audit rather than by either a separate division within the audit firm or by another auditor, because the separate department will be perceived as a new auditor to the client.

5.4) The Respondents’ Perceptions of the Relationship between the Provision of (NAS) and Auditor Independence Analysed by the type of audit Firm.

(Local Audit Firms, Local audit firm affiliated to Arabic and International audit firm, and Local audit firm affiliated to one of the big audit firms)

The table 5, shows an analysis by types of audit firm undertaken to determine differences in the distribution of responses between the three types of audit firms (Local Audit Firms, Local affiliated to Arabic and International audit firm, and Local affiliated to one of the big audit firms) using the Kruskal Wallis test. No significant differences were found at either the 1% level or 5% levels of significance.

5. Summary and Review of Findings

According to the perceptions of the association between the provision of non-audit services and auditor independence, both the public company respondents and audit firm respondents perceived that the provision of non-audit services (NAS) does not harm the independence of the auditors; but does give them more experience of the client’s work and more access to the client’s accounting system. Whereas both categories of respondents perceived that the prohibition of non-audit services (NAS) to an audit client is only to maintain the perception of auditor independence, both groups of respondents felt that providing non-audit services (NAS) to an
audit client by a separate department gives the auditor more independence and credibility.

Table 5: Respondent Perceptions of the Relationship between the Provision of NAS and Auditor Independence According to the type of Audit Firms

<table>
<thead>
<tr>
<th>Type of Audit Firms</th>
<th>Provision of NAS</th>
<th>Auditor Independence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm A</td>
<td>Yes</td>
<td>4.8</td>
</tr>
<tr>
<td>Firm B</td>
<td>No</td>
<td>4.0</td>
</tr>
<tr>
<td>Firm C</td>
<td>Yes</td>
<td>4.5</td>
</tr>
<tr>
<td>Firm D</td>
<td>No</td>
<td>3.9</td>
</tr>
<tr>
<td>Firm E</td>
<td>Yes</td>
<td>4.3</td>
</tr>
<tr>
<td>Firm F</td>
<td>No</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Legend:
- Satisfied
- Neutral
- Dissatisfied

Note: The perceptions are averaged out of a scale of 1 to 5, where 1 is the lowest and 5 is the highest satisfaction level.
Generally, the results supported the results of other studies such as: (Sawan 2013; Abu Bakar et al., 2005; Craswel (1999), DeAngelo, 1981a, Defond et al. (2002), Dopuch et al. (2001).

The study also shows the positive effect of the provision of non-audit services (NAS) on the level of audit quality. But to avoid any negative impact on auditor independence, from providing such these services, the LAAA must identify and prohibit those services that could negatively impact on auditor independence such as that mentioned by Sarbanes Oxley Act (SOA) of 2002. In addition, to protect the perception of auditor independence there should be a distinction between the department of consulting services and the department of auditing services. Furthermore, the ratio of non-audit services fees must be lower than audit services fees. In the event, the amount and the type of audit and NAS must be disclosed in the annual financial statements for public companies and audit firms to the LAAA.

Bibliography


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