



THE INSTITUTE  
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Dear Hazel

**Consultation on audit firms providing non-audit services to listed companies that they audit**

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the APB's *Consultation on audit firms providing non-audit services to listed companies that they audit*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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## ICAEW REPRESENTATION

### ICAEW REP 03/10

#### CONSULTATION ON AUDIT FIRMS PROVIDING NON-AUDIT SERVICES TO LISTED COMPANIES THAT THEY AUDIT

Memorandum of comment submitted in January 2010 by The Institute of Chartered Accountants in England and Wales, in response to the Auditing Practices Board's *Consultation on audit firms providing non-audit services to listed companies that they audit* published in October 2009.

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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the consultation paper *Consultation on audit firms providing non-audit services to listed companies that they audit*, published by the Auditing Practices Board (the APB).

## WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. Our membership includes auditors, numerous audit committee chairs, finance directors and members involved in investment management activities. Members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

## MAJOR POINTS

4. We believe the current regime of Ethical Standards on independence, audit committee consultation and disclosure of fees and independence arrangements works. There is no clear evidence that the provision by auditors of non-audit services to listed entities that they audit (NAS) has actually compromised audit quality and we do not believe that the provision of NAS diminishes audit quality in principle.
5. There will be specific types of NAS or specific circumstances which would render such provision unacceptable and there is always a need for ongoing review of the detail included in underlying standards and guidance. However, we believe in the basic approach consisting of threats and safeguards, selective prohibitions, review by the audit committee, which is central to the corporate governance framework in the UK, and disclosure. This provides the right, proportionate combination of flexibility to allow the provision of services by the auditor where it is in the public interest to do so without compromising independence, and robustness to ensure threats are addressed.
6. There does remain a perception issue in some groups representing investors in listed companies and this clearly needs to be addressed. We believe this perception is not about independence per se, but part of a concern about what might hamper audit quality. There are a number of measures in place to address audit quality, of which some are referred to below. As regards the perception issue, we believe this is most constructively dealt with by clearer and more relevant disclosures in annual reports of fees from NAS, and by stakeholder dialogue. We would be pleased to be involved in the latter process.
7. Global harmonisation is also a key consideration: it is a goal of governments (as evidenced by the G20 declaration and European Commission action) and investors (as evidenced by a recent global survey referred to below). The current approach is in substance in line with that adopted internationally: further divergence would be a backward step and could result in territoriality issues, discussed further below.

8. A recently released academic paper is annexed to this response. It summarises academic research into the area of NAS provision and includes results of an informative survey of finance directors, audit committee chairs and audit partners. Key points are referred to in the detailed response to the consultation paper questions set out below but we commend the whole paper as relevant to the consultation.

## RESPONSES TO SPECIFIC QUESTIONS

**Q1: (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?**

**(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?**

### Actual threats to audit quality

9. We see no evidence that the current UK 'threats and safeguards' approach, in relation to preserving auditor independence when the auditor provides non-audit services, has failed to protect audit quality. This would therefore suggest that the provision of non-audit services has not adversely affected audit quality.
10. The current approach to the provision of NAS by auditors specifically prohibits the provision of particular services where there is a clear threat to independence that cannot adequately be safeguarded against. It permits NAS where appropriate safeguards can be established, where there is appropriate discussion and the audit committee's approval process is followed, and where the fees are disclosed. This reflects audit committees' central role in strong governance arrangements on such matters and allows businesses to make their own decisions, and investors to make their own judgements.
11. As noted in the consultation paper and expanded upon in the academic paper included as an appendix to this response, there have been significant developments in the UK regulatory regime surrounding the provision of NAS. Underlying this is the basic threats and safeguards approach to NAS described above, which has been adopted in the UK for many years and is in line with that recommended by the European Commission, and adopted by the International Federation of Accountants (IFAC), the Code of Ethics of which is subject to a significant public interest oversight process.
12. The consultation paper notes that academic research has not provided evidence of a generalised link between the level of fees for NAS provided by auditors and the quality of financial information. We attach, as an appendix to this response, a further independent academic review of past research that has been published since the consultation paper was issued. This confirms the lack of any link, noting:
- 'The academic evidence has not found a systematic link between levels of NAS and factors undermining the quality of financial reporting or auditing which might suggest a lack of independence in fact.'
13. The Professional Oversight Board's 2009 Report to the Secretary of State comments on the findings of the Audit Inspection Unit (AIU). The AIU monitors auditors of listed and other economically significant entities and ensures that standards are complied with in spirit as well as form. The report does note that firms need to exercise greater care in assessing whether it is appropriate for them to provide certain NAS to audit clients but also goes on to state 'the

overall findings of the AIU's inspections during 2008/9 support the view that the quality of auditing in the UK is fundamentally sound.<sup>1</sup>

14. Even before the current independence standards, corporate governance arrangements and disclosure requirements were put in place, it is not clear that the provision of NAS by auditors had resulted in impaired auditor independence that adversely affected audit quality. In 2002 Counsel reviewed, on behalf of the ICAEW, DTI inspectors' reports from 1992 to 2002. The purpose of the review was to determine the extent to which auditor independence was considered to be an issue by the inspectors. Of the seventeen reports reviewed, only eleven referred to auditors. While NAS had been provided by the auditors in each of those cases, in only two of those is comment made by the inspectors relating to the impact of NAS on the integrity of audit services. In one of those cases the concern was with the volume of services and in the other, that the auditors had become too aligned with management. This does not in our view indicate a fundamental problem with the provision of NAS in general terms, though it does highlight the value of a monitoring programme.

### **Perceived threats to audit quality**

15. Clearly, not only actual independence needs to be considered. The perception of what many codes refer to as 'the reasonable and informed third party' is also relevant. This was considered at length post-Enron by the profession, the European Commission, IFAC, the UK government's CGAA committee, the SEC and others. The outcome was to preserve a general approach of 'permission with selective prohibition' but to have a reduced number of prohibitions for audits of entities other than those which were listed or otherwise public interest audits, reflecting the fact that in such cases, perception could be addressed, effectively on a stakeholder by stakeholder basis.
16. Nevertheless, as noted in the academic review of past research in the appendix to this response, there remains a perception concern in a few quarters about adverse effects on audit quality, though we do believe this view is actually a concern about how to determine that there has been a quality audit. A number of regulatory measures have been and are being taken to address this (see paragraph 23 below). In addition the academic review referred to above adds '...some of the services causing the most concern are now effectively prohibited'.
17. However, as auditor independence requirements are a particularly visible aspect of the audit quality process, the concern has continued to manifest itself in a perception (misplaced in our view, but nonetheless a real one) that any provision of NAS by auditors must somehow result in an independence issue. As the consultation paper notes, the Treasury Select Committee (TSC) report *Banking Crisis: reforming corporate governance and pay in the City* stated: '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.' To put this in perspective, we note that the TSC report was concentrating on the banking sector and went on to observe, as did the House of Lords Economic Affairs Committee, that auditors had actually fulfilled their duties properly. We further note that the TSC report stated that Professor Michael Power of the LSE is of the view that auditor independence is a soft target and something of a 'red herring'.
18. We do not believe these concerns are universally held, a view supported by informal discussions with a number of investor groups, who seemed to be more concerned about communication and disclosure. For example, an Investor Confidence survey in 2004 indicated that even then, only a few years after Enron, 'an overwhelming majority - 87%- of UK respondents had either a "great deal" or a "fair amount" of confidence in UK audited financial information' and that "fund managers reported an increase in the level of confidence in UK audited financial information in the past 12 months."<sup>2</sup>

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1 Report to the Secretary of State for Business, Innovation and Skills for the year to 31 March 2009, FRC 2009, para 5.20

2 Investor Confidence Survey 2004, ICAEW

19. Since then, NAS as a proportion of overall fees has fallen from 191% of audit fees to 71%, as noted in paragraph 5.4 of the consultation paper. This indicates that the combination of the current threats and safeguards approach, audit committee review and fee disclosure has resulted in audit committees choosing their auditors to perform NAS where it is most appropriate for them to do so, given the auditors' involvement, knowledge and experience. As reported in the academic paper annexed to this response, there has been a significant change in purchasing behaviour. This is especially relevant as the paper also refers to research suggesting that shareholders only perceive a threat to auditor independence at high levels of total audit and NAS fees (indicating that fee disclosure is relevant).<sup>3</sup>
20. There are many situations where it is advantageous to a business for the auditors to perform NAS. As noted in the consultation paper, there can be cost, quality and consistency benefits as the auditors are already familiar with the business and its procedures. This can also save scarce management time and speed up the work in situations where a rapid turn-around is needed. In addition, information gathered during the course of providing the NAS can make the audit more efficient. Thus where NAS can be provided without compromising audit quality, it cannot be in the public interest to start with a general prohibition as the default position.
21. It follows that prohibitions have a cost. The academic paper included as an appendix indicates the results of a number of interviews with company directors. Some of the quotes clearly illustrate this cost, for example:
- 'It is becoming increasingly difficult to get help from the auditors because of [NAS limitation]. This is ludicrously inefficient!'; and
  - 'As there are no real indications of non audit services causing audit failure the reduction in use of the audit firm for tax and accounting systems issues is an expensive nuisance.'
22. Further examples of situations illustrate the potential effect on jobs in the UK:
- the current and perhaps inevitable level of going concern problems highlights the need for companies in distress to receive assistance in obtaining finance;
  - companies facing hostile takeover bids also need assistance in preparing defence data.

In both of these situations the NAS provision is likely to be needed very rapidly and the auditors may be the only realistic provider, given their existing knowledge of the business.

## **A way forward**

23. A number of measures have been and are being taken to address the perceived concerns about audit quality in general, referred to above. These include the publication of AIU reports, further AIU reports designed for the directors of the entities audited, and the recently published Audit Firm Governance Code. We do believe that there needs to be further investor dialogue undertaken on the wider concerns about what an audit actually is and what it should be. This expectation gap is a long-standing issue but has not yet been resolved. Such dialogue could, for example, be through the Audit Quality Forum facilitated by the ICAEW.
24. In terms of the NAS issue itself, any substantive change to the current approach would be disproportionate, in that we do not believe there would be any significant change in audit quality. However, we do believe that transparency of both the amount and nature of NAS fees and the governance arrangements undertaken to ensure auditor independence should be enhanced. This is discussed in our response to question 4 below.

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3 Holland and Lane 2009

**Q2: 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?**

25. We do not consider that the provision of non-audit services has adversely affected audit quality or currently impacts confidence in the independence of auditors. Any reasonably detailed set of standards or regulations will need to be monitored continually in the light of events to ensure that developments are properly addressed. However we do not believe there needs to be any substantive amendment to the Ethical Standards in relation to the provision of NAS. The academic paper annexed to this response notes the results of a survey of institutional and private investors by Dart: 'Institutional investors were most concerned about: internal audit; valuations; investment advice; bookkeeping; and actuarial services, and least concerned about: tax; HR; legal advice; and systems design and implementation'. However, the paper goes on to note 'Provision of most of these services is already specifically referred to in ES 5 and thus actively discouraged or prohibited.'

**Q3: 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?**

26. No. We believe the current approach applies the right combination of robustness and flexibility: it requires compliance in spirit as well as form and allows NAS only where any independence threats can be adequately safeguarded against. Provision of such services not only assists the audited entity but through better knowledge of the business, can enhance audit quality.

27. The Ethical Standard requirements on NAS are reinforced by further requirements in the Ethical Standards to restrict economic dependency, including fee limits and prohibitions on rewarding members of audit teams for selling NAS. The whole is supported by audit committee review and reporting to shareholders by the audit committee and of the fees paid. This gives shareholders the opportunity to make their own assessment of the situation.

28. It is also important to take into account the advantages of global standards harmonisation: a key aim of the G20. A recently released survey of over 400 investors worldwide shows majority support at the international and UK levels for global standards in areas including auditing and ethics. Respondents said that variations increase the cost of capital, whereas a global set of standards would, amongst other things, give greater clarity for investors on the meaning of auditor independence and reduce complexity.<sup>4</sup>

29. The threats and safeguards approach, fundamentally, is that adopted internationally by IFAC and the European Commission. Even in the U.S., the SEC in essence uses the approach of 'some NAS prohibited, the rest permitted subject to an overall independence requirement'.

30. The International Standards on Auditing being adopted within the European Union refer to the IFAC Code of Ethics. The revised version of this has broadly similar requirements to those currently included in the APB Ethical Standards although in a few areas the latter continues to go further. An increased divergence within the UK and Ireland would be at odds with this process and with the leadership role the APB has displayed so far, and could present difficulties with extraterritoriality. If it were thought to be necessary to prohibit the provision of NAS to address perception issues, such prohibition would presumably have to be applied to audits of overseas subsidiaries, abandoning the current pragmatic approach. This would complicate multi-national audits and attract adverse attention from the European Commission, which has referred the French authorities to the European Court of Justice on the grounds of unreasonable restriction of the freedom to provide services.

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4 Global Investors Study: Final Results and Final results -UK, Ipsos-MORI, August 2009

**Q4: If you think that there should be a change in the current arrangements, would you advocate:**

- complete or more extensive prohibitions on the provision of non-audit services by accounting firms to their audit clients within the Ethical Standards for Auditors;
- the imposition of other requirements through the Ethical Standards for Auditors (and if so which);
- more active corporate governance – eg so that non-audit service engagements were required to be pre-approved by the company's board of directors or audit committee;
- better (and more extensive) disclosure in financial statements?

31. It follows from our comments above that we believe that any changes in the current arrangements should concentrate on enhanced disclosure and stakeholder engagement to address the perception issue.

32. As regards active corporate governance, the notion in the consultation paper that pre-approval of all engagements over a certain size should be considered as best practice is something that the FRC would need to consider and consult on in a future revision of the Combined Code. We see no reason why the current approach should be considered inappropriate, where the audit committee makes its own decisions as to what it needs to approve and why. The Combined Code requires the annual report to include an explanation of how auditor independence and objectivity have been safeguarded, if the auditor provides NAS. Disclosure in practice varies but the best disclosure includes a clear and detailed explanation of the policies adopted and the reasons why the auditor has been chosen to provide any significant NAS. Such disclosure should be encouraged as it assists transparency and shareholder judgements.

33. As noted in our comments on question 1, we believe that there remains a lack of clarity of what an audit entails and we would be pleased to be involved in further engagement with stakeholders on this issue. In addition we understand that some audit committees may value guidance on independence considerations. We produced such a publication some years ago when what was then known as the Smith Guidance was first issued and would be happy to update this ourselves or jointly with others.

34. We do believe there should be an amendment to the company law regulation on fee disclosure to enhance clarity and consistency (also bearing in mind international requirements, as inconsistencies are unhelpful to companies with dual listings). The current regulation treats some fees which in substance are audit fees, as non-audit, and combines NAS fees into categories that are not wholly clear. As noted in the consultation paper, the ICAEW issued a Technical Release relating to the regulation, but it can only interpret the law as it stands and there needs to be clearer and probably more detailed disclosure through an amended or replacement regulation.

**Q5: 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? If your answer is yes, please provide specific examples of these benefits and indicate the magnitude of any cost savings that arise.**

35. We believe it is appropriate for an entity to be able to choose the most appropriate provider of services. In some circumstances this will be the auditor as there are genuine benefits to be derived, some of which have been referred to above. The most obvious is that through enhanced knowledge of the business which can be gained from performance of other services, audit efficiency and even audit quality can potentially be increased. Time and money can be saved by a business as a result of using a provider who is already familiar with the company



through the audit and knows many of the people in the company. Also, advice that is given has the potential to be more incisive and relevant, and provide additional value for money, because of the knowledge the auditor already has about the current situation and conditions impacting the business.

36. All regulation that is likely to have an onerous effect on some parties should be subject to cost benefit analysis. As noted in paragraph 21, there are costs to prohibitions. It is important to recognise, as the consultation paper does, that there are a number of non-audit services that either auditors are required to carry out under legislation/regulation, are a natural extension of the audit process or are otherwise advantageous to the business to be provided by the auditor.
37. It is clearly a pre-requisite that auditors should be independent but the ultimate aim of independence is audit quality and there are a number of other factors that contribute to that. In particular, when considering a situation in which an entity has determined that the auditor is the most appropriate provider, it is relevant that the prohibition of a service where independence can in fact be dealt with perfectly adequately through safeguards, can cost the company money and time, as a result of having to choose a service provider other than the audit firm.
38. Where NAS can be provided by the auditor without compromising audit quality and it is advantageous to a business, it cannot be in the public interest to prohibit them. The nature of the drawbacks of unnecessarily restricting NAS can be summarised in a comment in the academic paper included in the appendix:

‘Directors have complained that auditors are reluctant to give advice which the company needs because of the risk of breaching ES 5 and that it is more costly and inconvenient to have to use other suppliers for some services. Some auditors and directors have expressed concerns that auditors now have less understanding of their clients’ activities due to their more restricted engagement with other aspects of the business.’

This could result in less useful assistance being provided by the auditors on, for example, risk.

39. The balance between cost and benefit of a company having to employ different firms as providers of NAS tends to deteriorate the smaller the businesses are. However, as the definition of listed entities includes companies listed on AIM, PLUS, etc, any change would affect a wide range of sizes of business and, indeed, other types of public interest entity. Even within the context of listed entities, we would encourage a think small first approach.

#### **Q6: Are there any other views that you would like the APB to take into account?**

40. The reputational and regulatory consequences that reinforce the effectiveness of the current threats and safeguards approach should not be underestimated. The severe effects on a firm’s reputation of poor performance were graphically illustrated by the fate of Arthur Andersen post-Enron. In the regulatory sphere, as well as the AIU monitoring referred to above, with the potential disciplinary and reputational consequences that follow, there have been a number of recent developments that have the potential to enhance effectiveness further. These include audit partners signing the audit report in their own names and the criminalising in the Companies Act 2006 of ‘knowingly or recklessly’ signing a ‘misleading, false or deceptive’ audit report.
41. We note the comment in the consultation paper that there is a view that the provision of NAS by auditors may inhibit competition and choice in the audit market as a prohibition could help mid-tier firms build their brands through additional non-audit work. We see no evidence that the more widespread restrictions in place for the last few years have enhanced competition so far. There is an argument that non-audit work would be more likely to switch between the larger firms: indeed the greater resource of the larger firms could result in their gaining non-audit work from others as they seek replacement work. In addition, some large specialist companies, such

as those in financial services with significant amounts of regulatory reporting, are already heavily restricted on the choice of auditor. Further prohibition would only serve to disenfranchise shareholders and audit committees and make matters worse.

42. Last but by no means least we note that the consultation paper has a footnote suggesting the scope of NAS review may be widened beyond listed entities at a later stage. To the extent that there is a perception issue that management is willing and capable of subverting the judgment of auditors through the provision of NAS by those auditors, it arises from a disconnect between a business' owners and its management. This does not arise in unlisted entities with their much narrower range of stakeholders. Given this and the concern expressed above about the worsening cost-benefit balance for smaller entities, it would be wholly disproportionate and unjustified to apply any additional prohibition.

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## **APPENDIX**

### **Briefing**

The impact of changes to the non-audit services regime on finance directors, audit committee chairs and audit partners of UK listed companies.

**Vivien Beattie University of Glasgow**

**Stella Fearnley University of Bournemouth**

**Tony Hines Portsmouth Business School**

## **Motivation for this Briefing**

The banking crisis in the UK has resulted in the re-examination of many aspects of the regulation and reporting associated with the UK banking and financial services sector, including the role of auditors. In 2009 the House of Commons Treasury Committee reported that the Committee had received very little evidence that 'auditors failed to fulfil their duties as currently stipulated' (House of Commons Treasury Committee, 2009, p77). The Committee, however, reviewed the UK's auditor independence regime, which was significantly strengthened after the Enron scandal and the collapse of the audit firm Andersen in 2002. The changed regime introduced widespread restrictions but not a total ban on the provision of non-audit services (NAS). The Treasury Committee expressed the belief 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 recommended that the Financial Reporting Council (FRC) should consult on this proposal at the earliest opportunity (House of Commons Treasury Committee, 2009, p84). Although the Committee was focused on the banking crisis, the proposal to prohibit all NAS could apply to all companies and auditors, not just to the banking sector. The Auditing Practices Board (APB), which is part of the FRC, issued a consultation in October 2009, which focuses primarily on NAS for listed companies (APB, 2009, p3).

This Briefing focuses on the impact of the post-Enron regulatory changes to the NAS regime on companies and auditors, principally by reporting relevant findings from a wide-ranging experiential questionnaire study which we carried out in 2007. The questionnaire sought views and experiences from finance directors (FDs), audit committee chairs (ACCs) and audit engagement partners (APs) of UK listed companies on recent regulatory changes including restrictions on NAS provision. This Briefing provides direct evidence of how the changes to the NAS regime affected key parties actually engaged with the financial reporting and audit process before the economic downturn. There has been no significant change to this regime since 2007, and therefore these results are relevant to the current environment.

We first summarise the key changes to the NAS regime introduced from 2002 onwards, and briefly review findings in relevant academic studies. We then provide evidence of changes to NAS fee levels since 2002, and then we report relevant findings of the 2007 experiential survey. Our conclusions on the evidence follow.

## **Key changes to the UK NAS regulatory regime**

In 2002 the UK government established a Co-ordinating Group on Audit and Accountancy issues (CGAA, 2003), which included members at ministerial level, to review the UK's regulatory regime following the Enron scandal and the collapse of Andersen. The group concluded that there was little clear support for the view that joint provision of audit and NAS had in fact compromised auditor independence. Nevertheless, CGAA recommended 'tougher and clearer safeguards to ensure that joint provision of audit and non-audit services does not undermine auditor independence in fact or appearance' (p29). This was to be achieved by independent setting of auditors' ethical standards and an enhanced role for audit committees in overseeing auditor independence and NAS provision.

At the same time auditor independence came under close scrutiny by regulators in other countries. In 2002 the European Commission issued a Recommendation on Auditor Independence for the EU (European Commission, 2002), which included restrictions on auditors providing certain non-audit services. In the same year The Institute of Chartered Accountants in England and Wales (ICAEW) adopted policies consistent with the Recommendation thus bringing an obligation on ICAEW members, who audit most of the UK's largest companies, to comply with it.

The EC Recommendation (2002) follows a principles-based model for auditor independence including the recognition of threats to independence posed by NAS provision. The message is that auditors should not provide NAS which 'a reasonable and informed third party' would conclude compromise independence. The threats and safeguards approach to independence requires that, where the independence risk of an activity cannot be reduced to an acceptable level, the auditor

should either give up the audit engagement or decline the NAS. The Recommendation identifies the following key threats to independence from NAS provision: making management decisions (which is prohibited); self-review; advocacy; trust (ie, familiarity); and intimidation. Some safeguards are suggested to mitigate the risks but the overall tone strongly discourages provision of the following services: preparing accounting records and financial statements (prohibited for public interest entities); design and installation of financial IT systems; valuation services; internal audit; acting for a client in a legal dispute; and senior management recruitment. It also recommends that auditors should discuss NAS provision with the client company's governance body. The ICAEW policy in following this Recommendation in 2002 brought change to the pattern of NAS provision ahead of the regulatory changes initiated by the UK government.

As a result of the CGAA initiatives, a comprehensive regime for NAS approval by directors was introduced into the Combined Code for Corporate Governance (FRC, 2003a). This drew on detailed guidance for audit committees in the Smith Report (FRC, 2003b), which recommends that audit committees should establish and implement a policy for NAS purchase, taking account of auditors' ethical guidance. Where NAS is purchased, the annual report should include an explanation of how auditor independence is safeguarded. Under UK company law, shareholders have the right to remove directors from office and approve the re-appointment of auditors. Incorporation of these provisions in the Combined Code offers investors the opportunity to challenge non-compliant behaviour by exercising their votes.

In addition, a rigorous regime for regular inspection of public interest audits was introduced in 2004 by the newly established Professional Oversight Board for Accountancy (FRC, 2009). In 2004 the Auditing Practices Board (APB, 2004) issued Ethical Standard 5 (ES 5), which addresses auditor independence issues associated with the provision of NAS. ES 5 refers to the two well-recognised aspects of auditor independence. These are: the perception of third parties about whether an auditor appears to be independent of a client (ie, independence in appearance); and whether the auditor actually behaves with objectivity (ie, independence in fact), the latter being observable only to those who are directly associated with the audit process.

ES 5 (APB, 2004) is more detailed than the EC Recommendation but uses the same threats and safeguards approach. Paralleling the Combined Code, ES 5 requires the auditor to inform the audit committee about NAS issues, including inconsistency between ES 5 and company policy regarding NAS purchasing. ES 5 largely prohibits the services referred to in the EC Recommendation adding corporate finance activities including contingent fees to the list. Apart from very limited exceptions to take account of special circumstances in a company or immateriality of the service to the financial statements, ES 5 conveys a clear message that the safeguards a firm could put in place for these services would not normally be adequate to protect independence. Subsequent revisions to the above documents have not materially changed the NAS regime.

The UK's principles-based approach (with some de facto prohibitions) accords with the approach adopted in the Code of Ethics set by the International Federation of Accountants (IFAC, 2009). Revisions to IFAC's Ethical Standards, which have not yet been introduced in the UK, introduce more restrictions. The US regime takes a different approach by setting out specific prohibitions. Section 201 of the Sarbanes-Oxley Act (US Congress, 2002) prohibits some NAS in addition to the services which are referred to in the UK and EC (eg, actuarial services). However, despite the prohibitions, the US regime does not introduce a total ban on NAS provision.

In addition to these changes, Statutory Instrument 2005/ 2417 was issued, requiring companies to disclose a more detailed breakdown of NAS fees provided by their auditors than had previously been mandated. The details of the disclosures are similar to the categories of NAS referred to in ES 5.

There has therefore been a major change to the UK regulatory regime for NAS, which takes a dual approach by imposing requirements on both directors and auditors. For directors, the Combined Code expects the company audit committee to engage with the decision to purchase NAS from the company auditor and the Statutory Instrument requires more detailed disclosure in the company financial statements, thus making investors aware in greater detail of what is being purchased. For

auditors ES 5 sets out detailed and diverse caveats for the provision of specific NAS in certain commonly occurring circumstances, which amount to a de facto prohibition. As all listed company audits are subject to inspection by the Professional Oversight Board's Audit Inspection Unit (AIU), there is a significantly increased risk for the auditors that failure to comply with ES 5 and any errors or misstatements in the audited financial statement disclosures of NAS provision will be discovered by the AIU. Such failures could lead to public criticism of the audit firm by the AIU.

### **Relevant academic studies**

Academic studies on NAS provision follow two main lines of enquiry. One examines the impact of NAS provision by the incumbent auditor on independence perceptions ie, independence in appearance. The other seeks to evaluate independence in fact, using various independence proxies (for example, qualified/unqualified audit opinions and, more recently, evidence of earnings management).

Beattie and Fearnley (2002) conclude from a comprehensive literature review that 'there is very little clear support for the view that joint provision impairs independence in fact. There is a reasonable consensus, however, that joint provision adversely affects perceptions'. US-based reviews by Francis (2006) and Schneider et al. (2006) reach similar conclusions. Francis (2006) observes that share prices have been shown to be significantly lower for US companies that pay large NAS fees (eg, Francis and Ke, 2006).

Recent published UK studies include Basioudis et al. (2008), who find from UK 2003 data that high audit and NAS fees adversely impact going concern reporting judgements for financially distressed companies. Three recent working papers are also relevant. Siddiqui et al. (2006) find evidence of the expected significant voluntary reduction in NAS purchase among FTSE 350 companies, but no evidence that companies changed auditors to retain NAS services from their incumbent. Based on 2005 data, Dart (2009) surveys institutional and private investors about independence threats. Economic dependence in general and non-audit service provision in particular were viewed as the most serious threats. Of both groups, 43% considered NAS to be a threat. Institutional investors were most concerned about: internal audit; valuations; investment advice; bookkeeping; and actuarial services, and least concerned about: tax; HR; legal advice; and systems design and implementation. Provision of most of these services is already specifically referred to in ES 5 and thus actively discouraged or prohibited. Holland and Lane (2009) from a 1999-2006 UK market study find that shareholders only perceive a threat to auditor independence at high levels of total audit and NAS fees. They find disclosure of NAS and audit fees of relevance to investors. Humphrey et al. (2009), reviewing the response to the current financial crisis, call for greater knowledge of the global audit regulatory arena in order to understand the forces driving regulatory policy.

The academic evidence has not found a systematic link between levels of NAS and factors undermining the quality of financial reporting or auditing, which might suggest a lack of auditor independence in fact. However, the same investor perception problems remain, although some of the services causing the most concern are now effectively prohibited.

### **Evidence of a changing pattern of NAS provision**

POB (2009) includes data obtained from the UK's four largest audit firms about the mix of their fee income. This data is not restricted to income from listed companies.

The POB data for the Big Four audit firms (POB, 2009, p57) shows that over a six-year period from 2003 to 2008, NAS income from audit clients fell steadily from 25% total income in 2003 to 17% total income in 2008. Over the whole period total NAS fees remained lower than total audit fees and also reduced as a percentage of audit fees. Fee income from non-audit clients rose steadily from 49% of total income in 2003 to 59% total income in 2008.

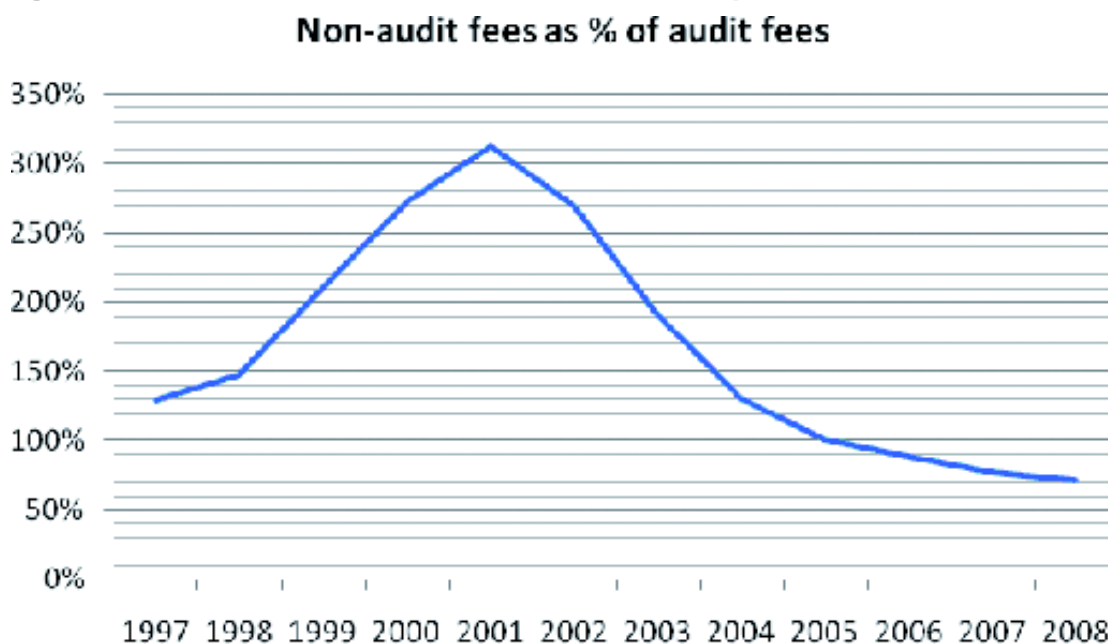
Data for other large firms shows a slightly less consistent pattern (POB, 2009, p58). Fee income from NAS fell over the six-year period from 19% total income to 16%, a much lower drop than shown by the Big Four, possibly because the smaller firms were providing fewer NAS before the

change. NAS also remained lower than audit fees over the whole period but showed a less consistent pattern in proportion to audit fees. Fee income from non-audit clients rose between 2003 and 2004 by 7% of total income but showed a fairly consistent pattern subsequently of smaller increases.

Although factors other than changes in the NAS regulatory framework may also influence these income patterns, the evidence indicates that there has been a reduction in the value of non-audit services provided by audit firms to their audit clients. Over the same period income from non-audit clients has increased, suggesting that companies are buying more services from firms other than their auditors. It is not known to what extent other services may be purchased from suppliers other than audit firms.

Deloitte (2009) summarise data from the *Financial Director* survey of audit and NAS fees for FTSE 100 companies showing the percentage of NAS fees to audit fees from 1997 to 2007 with an additional year added by their own data collection. These results are shown in graphical form in Figure 1 and indicate a significant drop in NAS provision to audit clients from a peak of over 300% of audit fees in 2001 to 75% in 2008. When this data is considered along with the POB data it suggests that changes in the level of NAS provision to audit clients have been influenced by the changes in the regulatory framework starting from the ICAEW decision to follow the EC Recommendation in 2002.

**Figure 1: NAS as a % of audit fees for FTSE 100 companies, 1997–2008**



Source:

1997–2007: *Financial Director* survey of audit fees. 2008 survey not yet available.

2008: Extracted from company-by-company data for 98 companies in FTSE 100. For the other two (F&C Investment Trust PLC and Carnival PLC), taken directly from the annual report.

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## **Results from the experiential survey**

### **Research methodology**

A questionnaire was sent in June 2007 to the FDs, ACCs and APs of domestic, officially listed UK companies (excluding AIM companies and investment trusts) seeking information about the impact of a range of recent changes to the UK regulatory framework to their working practices. The sample covered the top 250 qualifying companies by market capitalisation (as at 5 February 2007) and a

systematic sample of 250 from the remaining qualifying companies. To eliminate multiple selections of ACCs, the final sample sent out to this group was reduced to 446.

To identify APs acting as engagement partners for qualifying companies and to facilitate the distribution of the questionnaire, we were assisted by 11 large audit firms. The firms identified 439 listed company APs who were asked to respond with reference to their largest listed company client which met the criteria of the study.

Table 1 shows the response rates and profile of each group showing response rates of 30% from FDs, 29% from ACCs and 50% from APs. The company size characteristics of the three groups are broadly comparable, although the ACC group contains a slightly higher proportion of FTSE 250 companies. The respondents represent a mix of industry sectors.

**Table 1: Analysis of respondent groups by company size**

	FDs n=147		ACCs n=130		APs n=219	
	No	%	No	%	No	%
FTSE 100	42	28.6	31	23.8	52	23.7
FTSE 250	48	32.7	57	43.8	85	38.8
FTSE Small-Cap	43	29.3	37	28.5	75	34.2
Fledgling	13	8.8	3	2.3	4	1.8
Not filled in	1	0.7	2	1.5	3	1.4
Total	<b>147</b>	<b>100</b>	<b>130</b>	<b>100</b>	<b>219</b>	<b>100</b>
Including US listing	17	11.6	8	6.2	23	10.5

**Note:** For the purposes of this Briefing we identify and report on the responses to the survey relating specifically to the regulatory changes associated with the provision of NAS.

### **The parties involved in overseeing auditor independence in the approval of NAS provision and fees**

The Combined Code expects the company audit committee to oversee auditor independence and approve any purchase of NAS from the auditor. ES 5 requires the auditor to communicate with the audit committee regarding NAS issues. In practice, auditor related decisions may be made by individuals ie the ACC or the FD, by the audit committee (AC) or by the main board (MB). Table 2 shows which parties the respondents reported as being involved in decisions about three key processes associated with NAS and auditor independence: overseeing auditor independence; agreeing any NAS to be purchased from the auditor; and agreeing the fee for NAS.

**Table 2: Parties involved in overseeing auditor independence, NAS purchase and NAS fee agreement decision**

	Overseeing auditor independence*	% respondents reporting who was involved in agreeing NAS fees to be bought from the auditor*	% respondents reporting who was involved in agreeing NAS fees to be paid to the auditor*
Does not take place	0.4	0.8	0.8
FD only	0.2	6.7	<b>23.4</b>



ACC only	3.6	2.0	0.8
AC only	<b>32.7</b>	<b>13.1</b>	9.5
Main board only	1.6	2.2	1.6
FD and ACC	4.4	10.5	10.7
FD and AC	7.8	<b>17.0</b>	<b>15.5</b>
FD and MB	0.0	3.4	4.5
ACC and AC	<b>16.4</b>	3.4	1.8
ACC and MB	0.2	0.2	0.0
AC and MB	1.0	0.6	0.2
FD and ACC and AC	<b>26.5</b>	<b>32.5</b>	<b>25.8</b>
FD and ACC and MB	0.2	1.4	1.0
FD and AC and MB	0.8	1.4	0.8
ACC and AC and MB	1.4	0.2	0.0
All 4 parties	2.8	4.6	3.6
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

**Notes:**

For each activity, the three most frequently reported groups of parties involved in the key activities are shown in bold.

\*Responses missing from each respondent list 3, 2, and 3 respectively.

The responses show that the involvement of listed company main boards in overseeing auditor independence and in NAS purchasing decisions is very limited. However, audit committees and the audit committee chairs are heavily involved in the process, with the FD also playing a significant role. The most interesting finding is that 23.4% of respondents report that the FD agrees the level of fee for NAS and 6.7% report that the FD alone agrees the NAS provision. It is not necessarily surprising that

FDs agree the NAS service fee as this role may be delegated by the audit committee within its NAS purchasing policy.

## Changes to NAS purchasing resulting from regulatory change

Respondents were asked whether regulatory change had prevented or discouraged their company (or in the case of auditors, their client) from purchasing NAS from their auditors. Table 3 shows that 62% of FDs, 48% of ACCs and 49% of APs replied positively, providing more evidence that the purchase of NAS from incumbent auditors by companies has been seriously discouraged as a result of regulatory change. A Chi-squared analysis of respondent attributes showed no link to industry sector from those responding positively, but a strong link to company size. In total, 263 (53%) of respondents replied positively, with the percentage rising to 73% for FTSE 100 companies. This suggests that the NAS changes affected the larger companies more than the smaller ones, and is supported by the evidence of the significant drop in NAS purchase by FTSE 100 companies. FTSE 100 companies with a US listing would also have been affected by Sarbanes-Oxley prohibitions on NAS provision. It is not possible from this data to assess the impact of the 2005 change to IFRS on audit fees or NAS provision, although considerable technical effort would have been required to bring it about. However, the proportion of NAS to audit fees in 2005 for FTSE 100 companies continued to fall.

**Table 3: Parties reporting that regulatory change has prevented or discouraged NAS purchase**

Response	FDs		ACCs		APs		Combined	
	No	%	No	%	No	%	No	%
Yes	93	62.4	62	47.7	108	49.3	263	53.7

## NAS which companies no longer buy from their auditors

Respondents were asked to provide information about any NAS they no longer bought from their auditors as a result of regulatory change. The result shows that 65 FDs, 19 ACCs and 82 APs cited a total of 26 different types of service which were no longer purchased. These have been classified into five groups: tax; accounting/compliance; mergers, acquisitions and transactions; systems and other consulting; and company staff related. A total of 320 citations were made. These services are shown in Table 4 (see next page).

**Table 4: Analysis of NAS reported as no longer purchased by companies**

	NAS given up			
	FDs	ACCs	APs	Total
<b>Tax</b>				
Tax advisory	26	17	31	74
Tax planning	6	4	5	15
Personal and expatriate tax advisory	5		5	10
Tax compliance	3	1	2	6
VAT advice	3		1	4
Tax preparation			3	3
Contingent fee-based advice			2	2
<b>Sub total</b>	<b>43</b>	<b>22</b>	<b>49</b>	<b>114</b>
<b>Accounting/compliance</b>				

Accounting/disclosure assistance	19	6	11	36
Internal audit	4	2	9	15
Valuation of intangibles/options	2	1	5	8
SOX effectiveness reports			3	3
Payroll preparation	3			3
Internal control advice			2	2
Regulatory compliance	1		1	2
Pension audit	1			1
Actuarial advice			1	1
<b>Sub total</b>	<b>30</b>	<b>9</b>	<b>32</b>	<b>71</b>
<b>Mergers, acquisitions and transactions</b>				
Due diligence and investigation	9	12	11	32
Corporate finance/transactions	7	9	7	23
Contingent fee-based transactions			3	3
<b>Sub total</b>	<b>16</b>	<b>21</b>	<b>21</b>	<b>58</b>
<b>Systems and other consulting</b>				
Consulting and non-specified	14	9	7	30
Financial systems and IT related	6	6	8	20
Broking	1			1
<b>Sub total</b>	<b>21</b>	<b>15</b>	<b>15</b>	<b>51</b>
<b>Company staff related</b>				
Share options and remuneration advice	3		13	16
Staff secondments from audit firm	2		4	6
Recruitment	1	1	1	3
Training services			1	1
<b>Sub total</b>	<b>6</b>	<b>1</b>	<b>19</b>	<b>26</b>
<b>Total</b>	<b>116</b>	<b>68</b>	<b>136</b>	<b>320</b>

**Note:**

These comments are drawn from 65 FDs, 19 ACCs and 82 APs who responded to this question, which asked respondents to volunteer the data.

The greatest change is reported in the taxation area with tax advisory and tax planning work being given up, along with some personal and expatriate tax advice for staff. Assistance and support with accounting! compliance work has also significantly reduced. There is limited reporting of it from ACCs. ACCs report a higher level of transactions work being given up in proportion to the others. It may be that these activities, being a corporate strategy issue, are more likely to come to the attention of an audit committee than assistance with accounting or compliance work. It is also possible that ACCs would be aware that other NAS had been given up but would be less familiar with the detail of what they were. There are other staff-related issues, particularly secondments. The reduction in systems and consulting work may be related to the large firms selling off some of their IT consulting activities. This offers further evidence of a significant change in buying behaviour and reflects some of the NAS that the EC Recommendation and ES 5 and Sarbanes-Oxley either prohibit or discourage.

Some of the above respondents cited services they preferred to purchase from their auditor but no longer did because of regulatory change. The largest number of citations is tax-related with relatively few in other areas.

### Respondents' views on the impact of NAS change on purchasing behaviour

Respondents were also asked to comment on the changed regulatory framework. In all, 47 FDs, 32 ACCs and 92 APs made 178 comments. A qualitative analysis of the comments shows they fall into two categories – 115 comments were made about the impact of regulatory change on NAS purchase and 63 comments about the impact on the auditor/client relationship and audit quality. The results of this qualitative analysis are shown in Table 5a and Table 5b in descending frequency of citation.

**Table 5a: Analysis of respondent narrative comments re the impact of NAS regulatory changes\***

Impact of regulatory change on NAS purchase	FDs	ACCs	APs	Total
Audit committees/board feel external pressure to keep NAS fees down	5	2	19	26
Audit committees/board have clear policies on NAS purchase	5	1	14	20
Companies generally buying much less from auditor	3	1	14	18
More tendering and competition for services	5	2	8	15
Audit firms now have policies on NAS provision			6	6
More discussion and scrutiny in company before NAS purchased	4		1	5
Regulation has changed behaviour	1		3	4
No change to services bought		4		4
Only employ auditor where regulations allow and auditor is best provider	4			4
Prefer to use auditor for some services		3		3
Approval procedures create barriers to NAS provision			3	3
SEC rules/influence cause restrictions		1	2	3
NAS restrictions can limit choice of service provider		1	1	2
Greater transparency about what is being done			1	1
Regulation has consolidated best practice		1		1
<b>Total</b>	<b>27</b>	<b>16</b>	<b>72</b>	<b>115</b>

**Note:**

These comments are drawn from 47 FDs, 32 ACCs and 92 APs who responded to this question which asked respondents to volunteer the data.

Table 5b: Analysis of respondent narrative comments re the impact of NAS regulatory changes\* continued

Impact of change on auditor/client relationship and audit quality	FDs	ACCs	APs	Total
Overall less efficient for company	9	2	6	17
Auditors no longer business advisor – more remote	3	2	4	9
Less value in audit service for company	2	2	4	8
Auditor/client relationship now more formal/adversarial	2		4	6
Auditors know less about client business	2		4	6
Audit firms cautious about providing / offering services	5			5
Auditing less satisfying for audit staff		1	3	4
Some restricted NAS is not a threat to independence		2	1	3
Auditors now more focused – better	1	1		2
Firm has split staff between audit and other service provision			2	2
Restrictions do not enhance audit quality			1	1
<b>Total</b>	<b>24</b>	<b>10</b>	<b>29</b>	<b>63</b>
<b>Total from Table 5a</b>	<b>27</b>	<b>16</b>	<b>72</b>	<b>115</b>
<b>Total</b>	<b>51</b>	<b>26</b>	<b>101</b>	<b>178</b>

**Note:**

These comments are drawn from 47 FDs, 32 ACCs and 92 APs who responded to this question which asked respondents to volunteer the data.

The most frequently cited issue regarding the impact of regulatory change, predominantly by APs, is the impact of market pressures on companies to keep the NAS fees down to a certain level. One AP commented about the pressure from active investors:

‘Pressure by activist investor groups and misunderstanding of UK ethical standards for auditors are leading audit committees to stop auditors providing services which are perfectly legitimate and in the interests of shareholders.’ (AP 197)

One FD referred to the need to explain to activist investors why they are using the auditor for NAS:

‘Our principal subsidiary works in a heavily regulated sector and this inevitably requires both routine and non-routine reports. It would be impractical to allocate this work to anyone other than the financial auditor. However, we do ensure that additional work is carefully considered and

properly explained when material in the context of “normal” audit work. External reviewers (such as PIRC, ABI, NAPF, etc) will often raise the level of non-audit work but usually accept the explanation.’ (FD 319)

Another FD commented on the market-driven need to keep NAS in proportion to audit fees:

‘Now more aware of limit on value of NAS vs AS.’ (FD 6)

Others referred to market pressure keeping NAS down, because some users and investors believe there is a link between high NAS fees and auditor independence:

‘Certain commentators adopt a tick-box approach to analysis of accounts. As an eg, the ratio of non-audit fees to audit fees being greater than 1:1 so the auditor cannot be independent which is generally a flawed conclusion.’ (AP 520)

‘There has been general “pressure” in the UK to reduce.’ (ACC 65)

The second most frequently cited influence on the drop in NAS purchasing is audit committee policies. The Combined Code requires audit committees to have a policy on NAS purchase and our respondents indicate that this is both rigorous and restrictive in keeping NAS down to a reasonable level because of the independence perception. A number of ACCs made this clear, for example:

‘If there were requirements for substantial non-audit work, the regulatory change will prevent my company from purchasing (we have a policy).’ (ACC 224)

‘(Auditors) simply not considered for any service outside a tight definition.’ (ACC 89)

FDs also commented on the restriction imposed by the audit committee:

‘We basically now try to buy “nothing else” from the auditors although we recently used them for Class I circular work as there is no real alternative. The Audit Committee would like us to do pretty much no tax work but we don’t think this is practical from the Co. side. We recently developed a formal policy in this area which is a pragmatic solution for all.’ (FD 1 36)

‘The Audit Committee has made it clear that it wishes to minimise “Other Services” to our auditor, to reduce the risk of a breach of independence.’ (FD 58)

APs were also very conscious of the audit committee policies, some of which go beyond the regulatory requirements in the policy to keep NAS down:

‘Yes – not because they breached rules, but because the audit committee wanted to reduce non-audit fees.’ (AP 328)

‘In recent years the audit committee has become more sensitive to the % of audit to non-audit fees. The concern appears to be one of perception, not of independence.’ (AP 1 76)

Interestingly, another barrier to using the auditor for other services was the internal company administrative process. One AP refers to this:

‘Need for approval biases the non-board tax director towards other suppliers where audit committee approval is not required.’ (AP 188)

There is evidence that more tenders are being held for NAS and some respondents indicated that they would only use the auditors if they were clearly the best supplier and it was within the company policy. However, one FD believed competition had improved the services the company received, but at a price:

'The regulatory changes which resulted in us purchasing other services from non-audit sources has introduced us to new service providers. I find their expertise to be better than the similar teams in our auditors. We therefore have benefited from the change. For the auditors, the change has meant that they are far less involved in our business and this has been a serious negative for them. For us, we have to spend time and money briefing them on the activities that have occurred, which is wasteful.' (FD 281)

The comments about how NAS purchasing decisions are made indicate that there has been a major change in behaviour. A significant influence in keeping NAS levels down has been market pressure from active investors which preparers believe emanates from independence concerns if the level of NAS is high in relation to the audit fee. In order to avoid criticism from investors, some audit committees are restricting the proportion of NAS to audit fees and in some cases going beyond the strict regulatory requirements. Market forces and audit committee policies are having a significant influence on NAS purchasing by companies.

### **Respondents' views about the impact of the NAS change on the auditor/client relationship and audit quality**

Table 5b summarises comments about some consequences of the NAS change. The number of these comments is lower than the comments on the changed purchasing behaviour but nevertheless some potentially serious issues emerge. There are complaints about inefficiency and additional costs arising because companies are not able to get the help from their auditors that they wish to have. An FD and ACC explain:

'It is becoming increasingly difficult to get help from the auditors because of [NAS limitation]. This is ludicrously inefficient!' (FD 446)

'As there are no real indications of non-audit services causing audit failure, the reduction in use of the audit firm for tax & accounting systems issues is an expensive nuisance.' (ACC 195)

Another emerging concern is that the auditors have less knowledge and understanding of the business because they carry out less NAS for the client. One FD explains:

'Now that they do not do non-audit work, they are less conversant with our business.' (FD 281)

This view is echoed by APs, who believe it is now more difficult to offer more general business advice to their client and audit is perceived as adding less value to the business:

'Restrictions on non-audit services mean the firm does less and therefore [we] have fewer opportunities to add value: This leads to a client perception that audit adds less value.' (AP 286)  
Another AP offers a more worrying outcome to the NAS independence concerns:

'Management use, "audit independence", as an excuse not to tell us what is going on, on a timely basis. Relationship more adversarial.' (AP 318)

One ACC has a concern about staff not gaining the wide-ranging experience that they previously were, whereas an FD believed that auditors were becoming paranoid about regulation:

'It is clear that the non-audit services fee issue, whilst theoretically something which should be monitored vs independence, is weakening the experience of audit firm staff. Over time, I believe this is detrimental compared with allowing more widespread use of auditors for non-audit services and managing any potential conflicts.' (ACC 224)

'This excessive legislation is simply making them paranoid. This affects the level of service they are prepared to give – eg, preparing accounts.' (FD 190)

This concern is echoed by APs. For example:

'I think a pretty good case could be made that in the longer term regulatory creep will have an adverse impact on audit quality. The reasoning being the "narrower" the role of the auditor becomes (or he/she is precluded involvement in more and more advisory services), the more boring the job becomes, and the harder it will be to retain talented people within the profession.' (AP 328)

'Reduced special work from existing audit client = less knowledge of client and more formal relationship. This last point affects more junior audit staff most. Work is less fun. Harder to attract and retain good staff. Hopefully it will have improved standards of "bad" auditors though I have my doubts. The main controls to ensure good audits are: Bright people, knowledge of clients, time and peer review.' (AP 318)

A small number of respondents express a contrary view, believing that the changes have helped by providing more focus for auditors and taking the pressure away to sell other services:

'The reduction in the provision of non-audit services by the auditor has increased audit focus and commitment.' (ACC 49)

'The clear rules on non-audit services have made the role of audit partner as auditor not salesman much clearer.' (FD 350)

These comments provide evidence of some unintended negative consequences associated with NAS restrictions emerging from the current regime. Auditors may have less understanding of the business and are less engaged with the client. This may undermine the value for audit, not just to the company, but to the shareholders as well and over time auditors may have less overall business experience. A further concern is that auditors are reluctant to provide what companies consider to be necessary help, because of concerns about breaching ES 5 and being caught out. Two respondents believed that the change has improved the auditor/client relationship. There is no suggestion from respondents that regime change is needed.

## **Conclusion**

The CGAA (2003) set out an agenda for a tougher and more restricting NAS regime to protect both the appearance and fact of auditor independence following the Enron scandal. Following these changes there has been a substantial drop in NAS fees paid to audit firms particularly by the larger companies. At the same time audit firm fees from non-audit clients have increased, suggesting that companies have changed service suppliers in response to the regulatory changes.

Our evidence indicates that there are four main drivers of these changes, two from the company perspective and two from the audit firm perspective. The enhanced role of the audit committee in developing a policy for NAS purchase, which was introduced by the Combined Code (2003) and the Smith Report (2003) has made audit committees more conscious of the importance of auditor independence and therefore reluctant to buy services from their auditor. The second, less visible driver, is the risk to the directors of a challenge from activist investors and from adverse publicity where the level of NAS appears too high or the services disclosed appear inappropriate. Evidence from other academic studies suggests that high NAS fees can also damage share prices eg, Francis and Ke (2006).

For the auditors the requirement to comply with ES 5 has restricted their ability to provide many services regardless of client need, and we find evidence of a wide range of services which firms no longer provide to their audit clients. Furthermore, the UK's rigorous audit inspection regime has created an environment where breaches of ethical standards or inaccurate reporting of the breakdown of NAS are likely to be discovered, providing a further deterrent to NAS provision by the auditors.

It is therefore clear that the post-Enron reforms brought in by the CGAA have been successful in restricting the level of NAS and engaging the interest of audit committees and investors in considering auditor independence and NAS. Despite being principles-based, the regime has in effect introduced de facto prohibitions to auditors providing a wide range of NAS. Dart (2009)



finds that investors are concerned about independence in appearance in relation to NAS provision, but our evidence suggests the provision of the services which most concern investors has already been restricted. The academic literature has not found a systematic link between NAS provision and factors in financial reporting or auditing which might suggest a lack of independence in fact, although the perception issue remains, particularly at a high total fee level (Holland and Lane, 2009). This perception is mitigated in the UK by the current regulatory environment and engagement of investors with NAS fee levels. Investors are also better informed about the type of NAS being provided by auditors via the enhanced disclosure requirements brought in by Statutory Instrument 2005/2417.

Some directors believe the changes have been a good thing and have focused auditors much more on their key tasks. However, there is also emerging evidence of inefficiencies in the current regime. Directors have complained that auditors are reluctant to give advice which the company needs, because of the risk of breaching ES 5 and that it is more costly and inconvenient to have to use other suppliers for some services. Some auditors and directors have expressed concerns that auditors now have less understanding of their clients' activities due to their more restricted engagement with other aspects of the business.

The evidence from this Briefing indicates that the UK's current market-based approach underpinned by regulation based on clear principles has brought about significant reductions in the level of NAS supplied by audit firms to their clients. By limiting the opportunities for NAS provision, these safeguards have therefore contributed significantly to reducing the perceived risk to auditor independence arising from high levels of NAS provision. No regime is perfect and there is always room for improvement, but further changes need to be considered in the light of the effectiveness of the current regime in reducing the amount of NAS provision. It is not obvious from our evidence that a total ban is needed. Furthermore, the already emerging unintended consequences to the efficiency and effectiveness of the financial reporting and auditing process arising from the existing restrictions on NAS delivery are likely to be exacerbated by a total ban or by further restrictions on NAS provision.

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