

Chapter 13:

The Impact of Non-Audit Services on Auditor Independence and Audit Quality: Risks, Regulations, and Ethical Considerations

Nur Syafiqah Balqis binti Ramlan, Rabaatul Azira binti Hassan

Faculty of Accountancy, UiTM Cawangan Kelantan

rabaatul@uitm.edu.my

ABSTRACT

The granting of non-audit services (NAS) has been regarded as a controversial area for audit firms in respect to how it might influence their independence and the quality of auditing. Some claim that NAS enables positive spillovers and therefore enhances the quality of audits, whereas others contend that it creates economic dependencies that are detrimental to the objectivity of the auditor. This study analyzes the contradictory effect of NAS with an emphasis on financial dependences and threats to self-interest and self-review as professional scepticism and the justification of bias become easier and more prevalent than the audit outcomes question independence. There is a divide among the jurisdictions on how to respond to NAS, with some being more aggressive in their prohibition while others apply a softer touch allowing a controlled amount of NAS under tighter supervision. There are gaps in existing empirical literature, suggesting that the overwhelming NAS approach to audit quality is too simplistic without considering governance systems, and laws. This study highlights the need for more definitive answers to justify the power of NAS with stronger policy guidance and negative NAS disclosures and NAS in general. It calls for a reconsideration of existing frameworks to ensure that independence of the auditors is guaranteed while guaranteeing that the quality of audit work does not diminish.

Key Words: Non-Audit Services, Auditors Independence, Audit Quality

1. INTRODUCTION

Non-audit services (NAS) encompass a range of offerings from audit firms that go beyond traditional statutory audits. These include advisory, consulting, tax, risk management, and other value-added services. Typically, these services are tailored to the audit firm's understanding of the client's industry, operations, and regulatory landscape (Hao, 2021). NAS assists organizations in tackling challenges, enhancing efficiency, and ensuring adherence to legal standards. Common examples include tax advisory and assistance, where firms aid in tax planning, filing, and compliance (Tiwari & Debnath, 2021). Additionally, as part of NAS, auditors provide consulting services that focus on business process optimization, IT system implementation, mergers and acquisitions, and management consulting (Choudhary et al., 2021). By utilizing their industry knowledge, audit firms offer valuable insights that help clients navigate complex business environments while ensuring regulatory compliance.

Despite the acknowledged advantages of NAS to organizations, getting expertise and value-added NAS services from the same firm that prepares the audit has been under controversy due to conflict of interest issues (Beardsley et al., 2020; Quick et al., 2023). While NAS has been claimed to augur well with the external auditors, its drawbacks are the perceived threats it has on the independence of the auditor (Ahmed et al., 2022). The combined application of audit and NAS to the same client creates a self-review threat through which auditors are likely to review their work. Having this dual role can be perceived as a conflict of interest and may make the audit look otherwise. To tackle these issues, the regulatory authorities have placed several checks that seek to

reduce practitioner's ability to offer NAS to their audit clients to increase the independence of the audit and improve the quality of audit.

2. LITERATURE REVIEW

The provision of non-audit services (NAS) by auditors to their audit clients presents a complex and often debated issue in auditing research. Mahieux (2022) found that, providing NAS compromise auditors independence resulting in low audit quality. Ahmed et al. (2022) asserted that the provision of non-audit services (NAS) creates an economic bond between auditors and clients, which may jeopardise the auditor's independence, potentially due to the emphasis placed on larger clients. Similarly, Friedman & Mahieux (2021) claimed that, the supply NAS compromises auditor independence, potentially diminishing audit quality. Nonetheless, on the positive perspective, they argued that potential to offer NAS based on the identification of financial misstatements enhances auditors' motivation to intensify their audit efforts.

Meanwhile Quick et al. (2023) argued that the prior study of NAS does not obviously demonstrate a detrimental effect of non-audit services on the quality of factual audits. For example, research has shown that tax consulting fees pose less risk to auditor independence compared to other types of NAS. This finding aligns with Chyz et al. (2022), who found that tax planning NAS does not compromise auditor independence or audit quality, while tax compliance NAS is positively associated with audit quality. The benefit of NAS was postulate by theory of spillover as suggested by Pittman et al. (2025) NAS potentially improve the audit clients financial and facilitate knowledge spillovers.

3. DISCUSSION

The issue of NAS is that they present some potential conflict of interest that can threaten the auditor's independence (Tiwari & Debnath, 2021). Where auditors are involved in both the audit and NAS, there is likely to be perceived or even real self-interest making objectivity an issue (Friedman & Mahieux, 2021). For example, auditors prefer to keep quiet in their concerns regarding the client's financial statements when they are in the same team with the client in areas such as taxation or system implementation. This may be due to concerns with upsetting a particular manufacturer client or risking a large NAS contract, or affecting the wider client relationship (Thottoli & K.V, 2022).

The issue of perceived impaired independence remains a recurring concern whenever stakeholders question auditors' independence, particularly when they provide both audit and NAS (Onulaka et al., 2019). This perception arises from the potential economic dependence of auditors on NAS fees, where substantial financial incentives may compromise their objectivity and lead them to prioritize client retention in which auditors may hesitate to issue qualified opinions or exercise professional scepticism due to financial benefits (Nik Abdul Majid et al., 2022). The perceived lack of independence not only undermines public confidence in the auditing profession but also affects the credibility of financial statements (Higgs & Skantz, 2006).

Next, NAS is allowable and not illegal but there is argument as to whether the providing of NAS has affected on the audit quality. Castillo-Merino et al. (2020) argued that by extending the study of NAS in private firm, NAS provision can adversely affect quality of audit Other than that. Likewise, Fang & Rahmat (2023) also reveal that non-audit services (NAS) compromise the quality of audits as the recurring of NAS potentially lead a collusion between auditors and clients in manipulate the earnings, thereby potentially raising the risk of financial misstatements and restatements of audit client firm. Abdul et al. (2020) posit that recurring and non-recurring NAS fees are associated with lower accruals quality, demonstrating that the provision of NAS poses a threat to both integrity of financial reporting quality and audit quality.

From the finding previous study, most of the researcher in many countries agreed that the provision NAS by auditors presents challenges that can impact the auditor's independence and audit quality. However, this ongoing discussion in research, indicates that the influence of NAS on auditor independence and audit quality may vary depend on the robustness of governance mechanisms and oversight frameworks (Basioudis et al., 2024). Maintaining high audit quality becomes tricky when the same audit firm provides audit services and NAS for various reasons. While NAS can enhance auditors' understanding of a client's business environment by offering relevant business knowledge, they also introduce economic and social capital risks to the engagement. These risks can compromise auditor independence, which is crucial for ensuring audit quality (Friedrich et al., 2024).

Prior study highlights the self-interest threat, where NAS contracts establish financial bonds between auditors and their clients, potentially jeopardize auditors' judgment (Oluwadairo, 2023). Additionally, the self-review threat arises when auditors are required to evaluate their own work or judgments made during NAS engagements, which may impair objectivity as the have financial interest in the client firm such as depending in

the client for significant audit fees. Moreover, the social bonding that develops during NAS engagements can reduce auditors' professional scepticism, ultimately influencing the process of audit when the auditors become too sympathetic on client's interest due to close relationship (Friedrich et al., 2024).

Furthermore, NAS remains another major challenge in the audit firms due to ever changing rules and regulations which make it complex to deal with them. This presents challenges because the major tasks are to maintain good audit quality while containing non audit services. The PCAOB and the SEC have voiced concerns that soils directed towards NAS might divert the attention of audit firms from their standard obligations and might reduce audit quality (Beardsley et al., 2020). One of them is resource allocation. In particular, it discourages technology investments, training staff, and innovation needed for the audit practice, reducing audit quality. Additionally, organizational culture in audit firms changed from the professional services to the commercialization, where the NAS's revenue outweighs audit quality (Quick et al., 2023).

Maintenance of this particular aspect of the auditor is a daunting task when it comes to the outside world. Auditors may be technically independent but personnel in the organisation under audit may not have confidence in the independent status of the auditor since any compromise in appearance weakens the confidence in the audit process. This paper finds that public perception depends on NAS factors like joint supply of audit and NAS, and NAS fee/audit fee ratio. For instance, the EU Regulation 537/2014 extending on audits of integrated reports and other relevant assurance or non-assurance reports notes that the very impression of dependence stemming from high NAS fees undermine confidence in the auditor's impartiality (Walker & Hay, 2013). People are not comfortable when auditors seem economically tied to their clients since they receive large NAS fees. This perception erodes confidence in this audit process even though technical audit independence is not compromised (Tonye & Igoniderigha, 2023). People have learned about potential conflict of interest from major corporate scandals that have been experienced around the world like the Enron and WorldCom scandals. These cases disclosed some allegations of auditors that sold their independence to have huge NAS contracts, supporting the apprehension by DeAngelo (1981) as well as Abdul Wahab et al. (2020) that NAS provision may bias the auditor's judgment. Therefore, the public tends to link joint provision of audit and NAS with decline in the quality of financial reporting as well as concern over the credibility of the audit.

From these issues and challenges, it can be concluded that while the provision of NAS by auditors is an area that can offer potential benefits in terms of knowledge spillovers, it is also an area that contains threats that can destroy any audit quality gains plus threaten perceived auditor independence. Having the auditors combined in both the audit and NAS services will always pose a conflict of interest and issues of impartiality might be raised from time to time. Regulatory authorities have sought more forceful policies to tackle these risks, but difficulties persist in achieving an appropriate balance between business drivers and the basic missions to protect audit quality. In addition to past experiences with corporate scams and high NAS fees, public trust in auditors' independence is further questioned, even though the core principle is still upheld. Finally, the ongoing combination of audit services and NAS continues to be a contentious topic, with ongoing debates about how this arrangement impacts the quality and integrity of the audit process.

4. RECOMMENDATION

The provision of non-audit services (NAS) by audit firms to their clients poses a intricate challenge, as it necessitates harmonising the potential benefits of improved audit quality through knowledge spillovers with the risks associated with compromised auditor independence. Addressing these issues requires a thorough attempt that takes into account regulatory frameworks, market dynamics, and the specific contexts of non-audit services provision. This document explains appropriate strategies for addressing challenges associated with NAS.

The audit recommendations on NAS concerning audit quality and auditor independence are that firms should have adequate internal controls with sufficient measures to solve conflicts of interest arising from NAS. These policies should endeavour to enhance the independence of audit functions more as well as maintaining the integrity of audit. Some may involve having a different structure of the audit and non-audit services, adopting policies of moderation between the two so that you do not find yourself in a situation where the same people are providing services to both entities and coming up with strict measures for approval of NAS engagements (Lai, 2023). Providing both audit service and NAS, is a challenge to auditor independence because it creates economic ties between the auditors and clients that can compromise auditor independence and thus affects the audit quality. These risks can be solved by enhancing market transparency to facilitate private mechanisms that safeguard quality and strengthen independence. It emphasizes the importance of allowing audit firms and clients the freedom to contract, promoting client diversification, and using indirect strategies to stimulate diversification. Additionally, careful design of disclosure policies is crucial to avoid overemphasizing negative effects and to ensure that market participants can accurately evaluate auditor independence and service quality (Arruñada, 2000).

In addition, regulators should evaluate the conflict between the beneficial incentive effects of NAS and the possible reduction in auditor independence. Eliminating limitations on contingent audit fees could improve audit quality while preserving auditor motivation. Furthermore, examining the effects of imperfect competition in the audit market may yield additional insights into the influence of NAS on auditor effort and overall audit quality, thereby contributing to the development of more effective regulatory frameworks (Mahieux, 2022) .

Next, the audit firm must call for regulatory changes hence adopting measures to enforce stringent rules separating the audit and non-audit services ensures independence of the auditors and quality audits. In this respect, through specification of auditors' responsibilities such reforms can counterbalance the inherent risks arising from the delivery of NAS to the audit clients. Asare et al. (2008) highlights that the prohibition of certain non-audit services is based on concerns about auditors' potential opportunistic behaviour. On top of that, firms may need to focus on enhancing transparency, establishing clear ethical guidelines, and ensuring that auditors maintain independence and integrity in their decision-making process (Fatemi et al., 2020).

As highlighted by PwC under NAS restrictions and listed in its annual global review (2016), the foregoing profiles a clear threat to auditor independence. Other services that are clearly prohibited based on information gathered based on the established common principles must be prohibited globally and a clear downloadable list of prohibited services is desperately needed. It is with such reforms that we would see that anything that poses a risk to independence is dealt with while enhancing stakeholder confidence. PwC also stresses the idea of the ongoing review of the list of services that are prohibited in order for changes in the business models, new technologies, and emerging standards of accounting. This flexibility helps to keep the regulation appropriate while the market changes in front of our eyes. In turn, regulators want to get a higher level of separation and have more transparency to create an environment that is based on the principles of scepticism and impartiality in the audit field and eliminate conflicts of interest where possible.

Also, greater disclosure minimizes NAS engagements' possible conflict of interest as it provides specific information regarding the NAS's operations and engagements to the clients, regulators, or the public allows them to determine the effect of the mentioned conflicts on the quality of the audits. Ruiz-Barbadillo et al. (2022) note that focusing on NAS provision at the audit office level can have negative effects on audit quality because it hinders resources and attention from focusing on routine audit functions. This distraction effect is highly undesirable because it might entail diversion of scarce personnel and technology to less relevant pursuits and away from the comprehensive and painstaking analysis that characterises a high-quality audit.

Thus, a required high level of auditor's reporting can offset these risks by proving that audit firms are always ready to protect the credibility of their services. These transparent disclosures performed by NAS are a way of compliance of regulatory legislation as well as measures of self-regulation by the industries. Regular and comprehensive reporting means that the regulators can track the level of compliance of these firms with the independence standards and thus prevent NAS engagements from causing a compromise of the auditors. Such disclosures may not only pertain to how measures are put in place to ensure the NAS's independence, including separation of NAS and audit personnel or limiting the type and extent of permissible NAS. Altogether, these suggestions call for a multi problem solving approach to address the challenges accompanied by NAS. This paper therefore recommends that audit firms should embrace sound internal policies, progressive legislation change and improved disclosures to successfully manage and mitigate conflict of interest which is key towards strengthening the independence and improving the audit. These measures are crucial in order to sustain the people's trust in the audit profession and to maintain the profession in the ever-growing sphere of economic development.

5. CONCLUSION

In summary, NAS enhances auditors' awareness and understanding of client operations, thereby facilitating knowledge spillover that contributes to improved audit quality. However, specific risks arise when the same audit firm conducts both an audit and non-audit services for the same client. Risks include self-interest and self-review risks, economic symbiosis, and diminished public credibility concerning auditor neutrality. Prior to examining the recommendations, it is essential to consider insights from corporate fraud cases like Enron and WorldCom, which illustrate the repercussions of perceived or actual auditor impartiality. It is important that auditors are always independent; this will make the audit to be quality as well as promoting confidence in the whole process.

Therefore, recommends that regulatory bodies, audit firms and stakeholders need to work together to define the roles and relationship between audit and NAS engagements. It is high time that policy makers took necessary actions like NAS can be controlled or eliminated by making new strict rules in financial industry, financial firms themselves should develop new policies to handle the conflicts of interests, and disclosures should be made much more elaborate and clearer so that investors are fully aware of the risks they are bearing.

The above outlined steps will go a long way in ensuring that auditors continue to offer independent, critical and objective opinions and assurance of the financial statements and generally create and sustain the needed public confidence in the financial reporting system. While regulatory measures and market-based solutions offer pathways to address issues in non-audit services, it is essential to consider the specific context and industry dynamics. The balance between enhancing audit quality through NAS and maintaining auditor independence remains a delicate one, requiring ongoing evaluation and adaptation of strategies.

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