NON-AUDIT SERVICES AND AUDITOR INDEPENDENCE: EVIDENCE FROM BIG-4-AFFILIATED AUDIT FIRMS IN BANGLADESH

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ABSTRACT
This paper attempts to investigate the effects of the prohibition of certain non-audit services on the independence of auditor and based on personal in-depth interviews with the Big 4 auditing firms that are affiliated with local accounting firms in Bangladesh. The approach selected for this research is a qualitative one and has a descriptive and explanatory nature. From this research it becomes evident that independence has always been a central issue in auditing. All the respondents agreed that prohibition of non-audit services increase the appearance that the auditing firms are independent. The findings of this paper present an apparent picture of the field of auditing in Bangladesh. It will also guide the researchers for future investigations.

Keywords: Prohibition of Non-audit services, Audit Services, Non-audit services and Independence of the Auditor.

INTRODUCTION
Since 2001, the market for audit services has changed dramatically, both in the USA and abroad. Scandals involving large public companies such as Enron and WorldCom highlighted the need for more intensive audits (Asthanna et al., 2009) which forced the United States to take precautionary measures. In order to prevent accounting scandals, the United States passed Sarbanes-Oxley Act on July 30, 2002. Being a developing country, Bangladesh faces the threat of similar scandals like United States. So, separation of audit services and non-audit services and prohibition of some specific non-audit services by Sarbanes-Oxley Act has significant relevance for Bangladesh. Though the audit market in Bangladesh is not as developed as it is in the USA, similar restrictions by prohibiting non-auditing services of an audit firm are already in place in Bangladesh. Bangladesh Securities and Exchange Commission issued a Corporate Governance Order (CGO) in 2006, which prohibited an audit firm from giving both audit, and non-audit services to the same clients. Some of the restricted non-audit services include designing of financial information systems, book keeping services, appraisal or valuation services, actuarial services, and internal audit services (Rahman et al. (2016). COG 2006 also demands that listed companies must rotate their audit firms in every three years (Siddiqui, 2012). In order to understand the problem of this study it is important to get a picture of the division between audit and non-audit services in Bangladeshi audit firms.

Apart from traditional auditing, most Bangladeshi audit firms offer services to their clients that are not immediately connected to auditing. Because of the CGO 2006, auditing firms are no longer allowed to offer their clients both audit and non-audit services. The effect of the prohibition of certain non-audit services on auditor independence has not yet been investigated extensively in Bangladesh. So, the present study aims at investigating the impact of the prohibition of certain non-audit services on the auditor independence in case of Bangladesh. This paper attempts to examine what impact of the prohibition of certain non-audit services by CGO has on the independence of the auditor working in accounting firms in Bangladesh.

This paper is based on personal in-depth interviews with the Big Four auditing firms that are affiliated with local accounting firms in Bangladesh. A qualitative approach is chosen for this paper, which is descriptive and explanatory in nature. From this research it becomes evident that independence has always been a central issue in auditing in Bangladesh. The findings of this paper will be of use to financial reporting regulatory authorities in Bangladesh, such as Bangladesh Securities and Exchange

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Commission as well as the Institute of Chartered Accountants of Bangladesh, regarding the corporate governance role played by the auditors in Bangladesh.

The present study covers the scenario of auditor independence in Bangladesh. In fact, the present research adds flesh to the existing knowledge in the areas of prohibition of non-audit services and independence of auditor. It attempts to see whether Bangladeshi scenario matches with the worldwide scenario or there is something different.

Some international and national audit scandals, especially the Enron Collapse, have brought the attentions of professionals, academics, and researchers to the non-audit services. Some believe that the non-audit services hamper objectivity and independence of the auditor. Some others hold the view that there is no relationship between non-audit services and audit quality. In short, earlier studies have found a negative, positive and neutral relationship between the non-audit services and the quality of audit. A few prior studies suggest that non-audit service is negatively related with auditor independence. According to Antle (1984), the auditor independence is the freedom of an auditor from the influence of the management and which the company owners design. He also says that if there is no control mechanism in action, there is a strong possibility that the auditor may ignore independence in favor of management. Based on the empirical analysis of audit reports of 76 publicity listed companies on the Australian stock exchanges issued between 1980 and 1989, Wines (1994) comes up with the conclusion that auditors receiving non-audit fees are rare to issue qualified opinion than the auditors who do not get non-audit fees.

Most auditors who received a high portion of non-audit fees issued clean opinions while other auditors who did not receive non-audit fees issued opinions with at least one qualification. In another survey conducted by Gul (1992) using Australian companies, found that the provision of management advisory services affect the informative of earnings. The study also found that firms providing management advisory services have less explanatory power of earnings for returns. The levels of discretionary accruals are higher for firms where the auditors of those firms offer non-audit services to their audit clients than for firms whose auditors do not offer non-audit services (Frankel et al., 2002). According to Beeler and Hunton (2002), unintentional bias in the judgments of auditors is increased by contingent economic rents such as potential non-audit revenue. The studies of Frankel et al. (2002) and Larcker and Richardson (2004) identified the evidence of potential links between the measures of earnings management and non-audit services. The study of Beck et al. (1988) says that the fees of non-audit services strengthen the bond between the auditor and the client, which increases the earnings of the audit firm.

Revisiting the Adopted Disclosure Requirements (ASR) 250 fee disclosures, Hackenbrack and Elms (2002) found a negative relationship between non-audit fees and stock returns for the sample companies with the highest ratio of non-audit fees. The study of Brandon et al. (2004) claims that if there is joint provision of audit and non-audit services, the auditors will not perform audit services objectively and it will hamper perceived independence of the auditors. The study of Mitchel et al. (1993) identified that the joint provision of audit and non-audit services may create unfair competition.

Some earlier studies have identified a positive correlation between non-audit services and auditor independence. By studying the perceptions of New Zealand bankers, Gul (1989) identified a significant positive relationship between non-audit services and auditor independence. He identified that in Malaysia non-audit service increased the confidence in auditor independence. According to the study of Arruanda (1999), the joint provision of audit and non-audit services would improve the technical quality of auditing leading to the enhanced competition lowering overall costs. Consequently, the auditor independence would increase. The study of Carlton and Perloff (2005) identifies the effect of non-audit services in the form of a more efficient allocation of scarce resources without duplicating
efforts. According to the study of Kinney et al. (2004), if an auditor knows about the information system and tax accounting of a client, it will help the auditor to improve the audit quality and identify errors in the financial reporting.

The study of Dopuch and Simunic (1982) identifies auditor’s concern for reputation and the study of Palmrose (1999) and Shu (2000) identify legal liability as the driving forces for auditors to maintain their independence. Larcker and Richardson (2004) study the relationship between non-audit fees and accrual in the entities where the governance is weak. The study identifies that the auditors working for firms that provide large non-audit services do not select strategies that lead to large abnormal accruals. The study interprets that the auditors who work with weak governance plays a vital role in establishing stronger governance by selecting strategies which produce less number of abnormal accruals. Consequently, non-audit services exert an incremental positive effect on audit quality.

After studying 8940 firm-years for an observation period of over three years (2000-2002), Ghosh and Kallapur (2006) found a negative correlation between non-audit services fees ratio (ratio of non-audit service to total fees of a given client) and Earning Response Coefficients (ERC). Sharma (2006) studied the impact of non-audit services and the tenure of audit firm on the efficiency of audit. He was in favor of joint provision of audit and non-audit services. By giving evidence, his study proved that an increasing amount of non-audit services reduces the audit lag. His study also concludes that while extended audit firm tenure reduces audit lag, shorter audit firm tenure increases the audit lag. Gore and Singh (2001) found a positive relationship between non-audit services and earnings management in UK companies. Their study also suggests that when auditors provide non-audit services to audit clients, their reporting standards are affected. The study of Lennox (1999) finds that by providing non-audit services, an auditor increases knowledge on clients, which enables the auditor to find problems more effectively. Some prior studies found no relationship between auditor practices and auditor independence.

The studies of Glezen and Millar (1985); Corless and Parker (1987); Wines (1994) and Kinney et al. (2004) could not found evidence which shows that when auditors provide more non-audit services, they violate their independence. The study of Frankel et al. (2002) identified a number of prior studies, which found negative effects of non-audit services on audit quality. After reexamination, the study found no relationship between non-audit services and auditor independence. The study of Abdel (1990) found no significant difference in audit fees irrespective of only audit services or both audit and the auditor provides non-audit services. Using Discretionary Accruals (DA) as an alternative to auditor objectivity, Reynolds and Francis (2004) find no relationship between non-audit service and Discretionary Accruals. They conclude that to identify the negative effects of non-audit service on auditor’s objectivity, the evidence is very rare.

According to the study of Palmrose (1999), less than one percent lawsuits of auditor litigation were based on non-audit services. In order to rate the perceptions of auditor independence, integrity and objectivity, Jenkins and Krawczyk (2010) asked 83 Big Five and 139 Non- Big Five accounting professionals and 101 investor participants. The study found that non-audit service provision does not influence the investment decisions at all. To investigate the perceptions of the effect of the joint provision of audit and non-audit services, Malaysian auditors, loan officers and senior managers of public listed companies were used as respondents in the study of Sori (2006). Most of the respondents opined that the same audit team should out non-audit services as well. The study of Chung and Kallapur (2003) found no statistically significant relationship between abnormal accruals and the ratio of client fees to total fees of the audit firm. Researchers found three different types of effect that the provision of non-audit services has on auditor independence. They could not agree on one conclusion.
Theoretical Framework

Role of Auditing: According to Hayes and Wallage, (1999), the primary function of audit is to make financial statements credible. Nowadays, ownership of a company is generally separated from management, which also removes the investors from running the company. Therefore, management has the responsibility of communicating the financial information of the company to the investors. Investors collect financial information from the financial statements so that they can take the decision of investing in that company. Trustworthiness is an important issue in this respect. Both the investors and the managers expect the control of the financial information by an impartial, external auditor (Porter et al., 1996).

Auditor Independence: According to Porter et al. (1996), independence is the “cornerstone of auditing”. If an auditor carries out an audit who does not feel independent is not going to be trusted by the users of financial statements. The skills and knowledge on how to carry out an audit are not enough for an auditor. The auditor also needs to be independent of the client to be able to report errors and demand changes. To be independent an auditor has to be impartial, should not have any personal interests in the client’s company and is not vulnerable to pressure or influence (Firth, 2002). According to Beck et al. (1988), auditor independence is a great indicator of market because it makes the financial statements credible. The credibility of financial statements makes the financial markets more efficient because the investors now can take rationally more correct decisions (Soltani, 2004). It is to be noted that, as the client pays the audit fee, the auditor is dependent on his or her clients to some extent. This means that the auditor may have to criticize the financial statements of his or her payer of salary. However, risking independence is deadly to an auditing firm because audit firms depend a lot on reputation.

Different Approaches to Independence: Independence generally has two broad aspects: ‘independence in fact’ and ‘independence in appearance’. Both are equally important for the quality of audit. ‘Independence in fact’ deals with the objectivity of an auditor. It maintains the importance of objectivity and impartiality (Hayes and Wallage, 1999) and enables to evaluate and criticize the financial statements without being biased (Porter et al., 1996). ‘Independence in appearance’, on the other hand, is how other people understand the independence of the auditor (Hayes and Wallage, 1999). The auditor needs to create an impression that s/he is indifferent to the outcome of the audit. The auditor has to have no problem criticizing the client’s financial statements if needed (Barlett, 1991). It is important for the auditor to be aware of the actions that might make other people doubtful of his or her being independent and objective (Porter et al., 1996). Mautz and Sharaf, (1961), presented independence from another angle. They have pointed out three stages of independence. The first stage of independence is the independence of approach and attitude, which demonstrates through self-reliance, professional judgment and being free from the pressure of the client. The second stage of independence is being critical during the audit process. Mautz and Sharaf, (1961) think that freedom from bias and prejudice, exposed and hidden, is fundamental to maintaining a critical approach. To be independent, an auditor needs to be aware of the risk of being influenced by the client’s opinion. Acceptance from the public of the audit opinion is the third stage of independence. Furthermore, Watts and Zimmerman (1983), define auditor independence as a discovered breach in the financial reports, which makes it probable.

Non-audit services: When auditing, the auditor should have an extensive knowledge of the client’s company. The combination of professional skills and knowledge of the client’s company makes the auditor a perfect advisor for the client. Such an advisor provides legal advice, tax services, management functions, and bookkeeping. These services, which are not directly related to an audit, are considered as non-audit services (SOX, 2002). According to Kinney et al. (2004), the non-audit services can make the audit better. While providing non-audit services, an auditor extends more control over the overall management system of the client’s firm through which higher quality and accuracy of the audit could be ensured. Still, there are problems connected with the non-audit services. Many
believe that rendering non-audit services to an audit client may hamper the quality of the audit (Firth, 2002). When providing non-audit services, the auditors often develop a close relationship with the management, which may lead the auditors in taking sides with the clients, rather than, following regulations (Soltani, 2004). The increased income from both audit and non-audit services could make an audit firm more dependent on the client (Firth, 2002). When an auditor is afraid of losing both the audit and the non-audit services of a client, the auditor is probably less willing to criticize a client’s financial statements than if the auditor gives only one service (Sharna and Sidhu, 2001).

However, the effect of the prohibition of certain non-audit services on auditor independence has not yet been investigated extensively. So, the present study aims at investigating the impact of the prohibition of certain non-audit services on the auditor independence in case of Bangladesh.

METHODOLOGY

This paper is both descriptive and illustrative. To identify the impact of the separation of audit services and non-audit services, as required by CGO 2006, on the independence of auditor firms, we conducted in-depth personal interviews with representatives from Big-4-affiliated audit firms, one representative from each firm. Rahman Rahman Huq is affiliated with KPMG; Hoda Vasi Chowdhury is affiliated with Deloitte; S F Ahmed is affiliated with Ernst and Young and A Qussem is affiliated with PriceWaterhouseCoopers (Karim and Hasan, 2012).

The interviewees are persons with sound knowledge of and regular exposure to CGO 2006. They come from firms affiliated with the Big 4 in order to visualize a holistic picture. All the interviewees are in manager level in the Department of Audit & Assurance. The interviews were conducted in June 2015. As all the interviewees wanted to remain anonymous, their names and identities are not disclosed in this research. Most leading firms are annually audited by one of the Big-4-affiliated audit firms in which the representative works. Because of this, no representatives of any smaller auditing firms were interviewed that four main interviews would be sufficient for the purpose of this paper.

It is important to note here that the information received from the interviews is the opinion of the persons asked, and not the opinion of their represented firms. As the intentions of the interviewee’s have been to be anonymous, the identities of the interviewees remain anonymous. Notes were taken and questions were asked. All the interviews were conducted in the respective offices of the interviewees. In this study both primary and secondary data were used. The primary data were gathered from this research consists of interviews with knowledgeable persons on the subject. Secondary data had been collected from different databases, the Internet and literature.

FINDINGS

Effects on Independence

Out of four interviewee one interviewee opines that the division between audit and non-audit services and prohibition of some non-audit services by CGO 2006 will increase auditor independence. The interviewee believed that with specific rules, the auditor does not have to judge which services make worse independence and therefore, he or she will be in no doubt. Another interviewee believed that the division between audit and non-audit services is not going to affect the auditors ’independence. He claimed that the media has exaggerated the issue of independence a lot and it is not going to help implementing rules and regulations. Another interviewee believed that though the division of the audit and non-audit services may not increase the independence of the auditor, it may increase the confidence of the public. Another interviewee worried that the division of audit and non-audit services may create
some problems for small companies since they often rely on their auditor’s knowledge in many issues not directly related to the audit. This particular interviewee believed that not only the small companies are at risk when discussing auditor independence; the large companies should also be more cautious, so that independence is not in jeopardy when auditing large companies. One of the other interviewees opined that if the public believes that division increases independence, then the CGO 2006 has done something. One interviewee was afraid that the companies may consider all non-audit services as prohibited, which is not true. All the interviewees opined that, in the context of Bangladesh, due to their size and financial conditions, many of the clients may not have the capacity to produce quality financial statements on their own, and may require the assistance of their auditors. As long as the audit firms have adequate safeguards in place, audit independence should not be that much of a concern. A brief summary regarding the impact of the prohibition of certain non-audit services on the independence of auditor is given below.

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<tr>
<th>Impact</th>
<th>Prohibition of Non-Audit Service by CGO 2006</th>
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<tr>
<td>Auditor Independence</td>
<td>✓ Increase auditor independence.</td>
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<tr>
<td>Public Confidence</td>
<td>✓ Increase Public confidence.</td>
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<td></td>
<td>✓ CGO 2006 has done something.</td>
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<tr>
<td>Small Companies</td>
<td>✓ Create problems for small companies since they rely on auditor.</td>
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<td></td>
<td>✓ Less quality financial statement.</td>
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<tr>
<td>Large Companies</td>
<td>✓ Independence is not in jeopardy when auditing large companies.</td>
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<td></td>
<td>✓ Increase internal control system.</td>
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DISCUSSION

Effects on Independence

If an auditor is impartial, has no personal interests in the client’s company and is not vulnerable to pressure or influence, then the auditor is enjoying independence. The CGO 2006 prohibits some specific non-audit services to help auditors to maintain their independence. Only one among the four persons believed that CGO 2006 increases auditor independence. According to Watts and Zimmerman (1983), auditor independence depends on the auditor’s ability to resist any pressure from the client. So, auditor’s independence depends upon the auditor’s character and competence.

Auditor independence is not only a product of proper rules and regulations, but it also depends on the control of the auditor’s judgment. It is of great significance that the auditor desires to be independent, no matter what regulations are in effect. However, more detailed regulations on what services harm independence refrain auditors from losing their independence. Clear guidelines may help the auditor to resist pressure from the client.

According to Hayes and Wallage (1999), the auditor has to have an independent appearance in the eyes of the public. As the financial statements have to be credible, the appearance of the auditor has to be independent; otherwise, people may not trust the information given by that auditor. Most of the representatives of the Big Four state that the division of the audit and non-audit services may increase the confidence of the public. If it really does so, the CGO 2006 then had done something.
CONCLUSION

In order to avoid accounting scandals and increase the confidence of the public in the audit profession, Securities and Exchange Commission (SEC) of Bangladesh issued a Corporate Governance Order in 2006, which prohibited an audit firm from providing both audit and non-audit services to the same clients. Some restricted non-audit services include the designing of financial information systems, bookkeeping services, appraisal or valuation services, actuarial services, internal audit services, etc. This study investigates the impact of the prohibition of certain non-audit services by the SEC of Bangladesh on the independence of the audit firms which are affiliated to Big 4 international audit firms.

This paper is based on personal in-depth interviews with the Big-4-affiliated audit firms. After interviewing the persons with sound knowledge of and regular exposure to the Corporate Governance Order 2006 of SEC of Bangladesh, we find that independence has always been a central issue in auditing. All the respondents agreed that prohibition of non-audit services increase the appearance that the auditing firms are independent.

Auditor independence is not only a product of proper rules and regulations, but it also depends on the control of the auditor’s judgment. It is of great significance that the auditor desires to be independent, no matter what regulations are in effect. However, more detailed regulations on what services harm independence refrain auditors from losing their independence. Clear guidelines may help the auditor to resist pressure from the client.

This research presents a contemporary picture about the impact on auditor independence due to the implementation of Corporate Governance Order 2006 by SEC of Bangladesh. Findings in this research are useful not only for the academic community as a piece of contemporary information for further research, but also for the financial reporting regulatory authorities in Bangladesh or other developing countries for policy review and planning.

REFERENCES


