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Ethics in Providing Non-Audit Services to Ensure Transparency in Financial Reporting

Marilena Mironiuc\textsuperscript{a*}, Ionela-Corina Chersen\textsuperscript{a}, Ioan-Bogdan Robu\textsuperscript{a}

\textsuperscript{a}Alexandru Ioan Cuza University of Iasi, B-dul Carol 1 nr.22, Iasi, 700505, Romania.

Abstract

The professional ethics requirements impose auditors to fulfill the accepted engagement with objectivity, independence and professionalism. Seldom, auditors provided consulting services for the audited firms in order to gain an additional income. But a number of cases proved the existence of a complicity in committing or abetting acts of financial fraud. The auditors’ complicity was supported by the interest in non-audit fees, received by continuing legal relationships. The present study aims to analyze the influence of non-audit fees on the transparency of Client Company’s financial reporting, in compliance with professional ethics demands. The results support the idea that, for companies listed at the New York Stock Exchange, the non-audit fees can affect the auditors independence, with a negative impact on the mission quality and implicitly on the transparency of Client Company’s financial reporting.

1. Introduction

Given the economic and financial crisis events, the interests of all stakeholders can be affected by the evolution of the position and financial performance of firms listed on the capital market. To serve their interests and take the best strategic decisions, stakeholders need for reported financial statements by listed companies to provide understandable, relevant, reliable and comparable information (Hayes \textit{et al.}, 2005). Guaranteeing the qualitative characteristics bears endorsement of the objective, independent and competent opinion provided by a financial auditor.

The notable accounting scandals at the end of the 20th century and the beginning of the 21st century proved in some cases the auditors complicity in committing or abetting acts of financial fraud. Most of the times, their complicity was supported by providing the audited companies with consultancy services (Albrecht \textit{et al.}, 2009). The compensation of non-audit services with significant fees led to damaging the auditor independence and hence the true image of the company audited (Albrecht \textit{et al.}, 2009).

\* Corresponding author: Marilena Mironiuc. Tel.: +40-232-201-454
E-mail address: marilena@uaic.ro

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The purpose of this study is to test and quantify the influence the amount of fees paid for non-audit services on the true image of the company audited, determined by the auditors lack of independence. In order to test the work hypotheses, the study took into account firms listed at the New York Stock Exchange (NYSE). The collected data was comprised of information from financial statements reported in the 2010 fiscal year. The results were determined using advanced statistical methods, and the data analysis was done using SPSS 19.0.

2. Financial auditor role in ensuring transparency for the financial reporting of the client firm

The main purpose of the financial auditor’s mission is to increase the trust of all stakeholders in the accuracy of information in the financial statements reported by companies (Arens et al, 2012). Based on the accepted engagement, the auditor must express a professional opinion regarding the compliance of the financial statements, under all aspects, with reference reporting framework (IFAC, 2009). The deployment of the financial audit mission is based on complying with the auditing standards and the ethics requirements, to ensure the quality of the audit engagement.

According to the Ethics code for professional auditors, issued by International Federation of Accountants (IFAC, 2009), the main criteria and requirements that the auditor must comply with during his assignment are: integrity, objectivity, professional competence, confidentiality and professional conduct. The professional ethics demands focus the auditor in planning and carrying out his activities and lead to maintaining a high quality level of its engagement (Hayes et al., 2005).

Messier et al. (2008) state that the demand for auditing and assurance services comes from the need for transparency in financial reporting. The financial audit mission represents a methodological approach, structured in a standardized sequence of steps and aims at obtaining an audit report (Arens et al, 2012). The point of maximum interest in the report is the opinion regarding the compliance of the audited financial statements with the reporting framework.

The utility of the opinion is supported by the Lending Credibility Theory, through which the audited financial statements are intended to justify the decisions of the managers to the stakeholders (Hayes et al., 2005). According to the Theory of Inspired Confidence, within the relationship between the firm and the outside stakeholders, the audited financial statements offer a true and fair view of corporate responsibility (Limperg Institute, 1985). At the same time, starting from the Agency Theory, the audited firm is regarded as the legal result between the agents and main actors, on two tiers managers - shareholders and shareholder – creditors, and the audited financial statements ensure the diminish of potential conflicts of interest between them (Watts and Zimmerman, 1978).

3. Non-audit services and professional ethics

Ahadiat (2011) states that non-audit services represent consultancy activities offered by audit firms to their clients. These services respond to the requests of the client firms and cover areas such as: management, actuarial, fiscal, human resources management, financial investments (Ahadiat, 2011). The notable corporate accounting scandals were generated by frauds uncovered in multinational companies between 1998 and 2011, such as Cendant (1998), Xerox (2000), Enron (2001), Adelphia (2002), WorldCom (2002), AIG (2004) or Lehman Brothers (2010). In all these cases the auditors complicity was proven, tested by way of provision of non-audit services by the audit firms to their clients, which led to the diminish of the auditors integrity and independence.

The non-audit services bring audit firms additional revenue based on the associated fees. Wines (2011) states that an auditor loses his independence or is perceived as lacking independence if he offers a client both types of services. In order to maintain contractual relationships with customers or to win future audit or consultancy contracts, the services offered by auditors must comply with managers’ interests (Bigus & Zimmermann, 2008). According to IFAC (2010) and The Securities and Exchange Commission (SEC, 2001), it is necessary the auditors be independent in mind and appearance. Hillison and Kennelley (1988) affirm that, in order to gain new clients, the audit firms propos low audit fees, following that the losses recorded by offering such discounts be recovered in the
future, based on non-audit fees. At the same time, Ashbaugh et al. (2003) say that the auditors’ independence is compromised by the audited client’s importance and not by the fees level for the non-audit services.

4. Research methodology

The article aims to test the existence of a significant influence of the fees level of non-audit services on the transparency in financial reporting for an audited firm. This influence can be supported by professional ethics demands imposed on the auditor, with an impact on the quality of his mission.

The study proposes the following work hypotheses, for testing and validation:

\( H_1: \) Firms with a high fee level for non-audit services, paid in the current year, have a low level on financial reporting transparency;

\( H_2: \) Firms with a high fee level for non-audit services, paid in the previous year, have a low level on financial reporting transparency, in the current year;

\( H_3: \) The significant variation of non-audit fees, from one fiscal year to another, influences the transparency level for financial reporting.

4.1. The studied population, extraction of analyzed sample, variables used and data source

The studied population is represented by the companies listed at NYSE. Out of this population, a sample was extracted, totaling 86 American firms, structured in two equal sub-samples. The first sub-sample contains the first 43 firms from the FORTUNE 500 top from 2011. The second one presents the first 43 firms with the lowest transparency in financial reporting and is based on the Russell 1000 top from 2011.

To get the research results, the study used a series of variables: \( \frac{\text{NAF/NI}}{\%} \) (Non-Audit Fees/Net Income * 1,000); \( \frac{\text{NAF/TO}}{\%} \) (Non-Audit Fees/Turnover * 1,000); \( \frac{\text{NAF/AF}}{\%} \) (Non-Audit Fees/Audit Fees * 100); \( \text{VarNAF} \) (\( (\frac{\text{Non-Audit Fees}_{i+1}}{\text{Non-Audit Fees}_i}) \) / Non-Audit Fees * 100). For the proposed variables, the data was taken from the financial statements of the sample firms, stored in the SEC’s EDGAR (Electronic Data-Gathering, Analysis, and Retrieval System) database.

4.2. Method of data analysis

The results were obtained using the discriminant analysis (DA). Jaba and Robu (2011) state that DA is a multivariate classification method. The study aims to classify the companies in groups, with or without transparency in financial reporting, based on the variables taken into account.

For the \( H_1, H_2 \) and \( H_3 \) hypotheses, applying the DA aims to use the following model, that offers a \( Z_i=1,...,86 \) score, for classifying firms:

\[
Z_i = \beta_0 + \beta_1 \frac{\text{NAF/NI}_{2010}}{\%} + \beta_2 \frac{\text{NAF/TO}_{2009}}{\%} + \beta_3 \frac{\text{NAF/TO}_{2010}}{\%} + \beta_4 \frac{\text{NAF/AF}_{2010}}{\%} + \beta_5 \frac{\text{VarNAF}_{2009}}{\%} + \epsilon_i
\]

(1)

where \( \beta_j=0,...,5 \) represents the coefficients of the model and \( \epsilon \) is the residual variable.

5. Results and discussion

Following the application of the DA on the analyzed sample a series of descriptive statistics for the variables included in the model are obtained, separated in groups of firms (with or without transparency in financial reporting).

| Table 1. Descriptive statistics of the variables associated with non-audit fees, calculated on groups and on the entire sample |
|---|---|---|---|---|---|---|
| Variables | \( \frac{\text{NAF/NI}_{2010}}{\%} \) Mean | \( \frac{\text{NAF/TO}_{2009}}{\%} \) Mean | \( \frac{\text{NAF/TO}_{2010}}{\%} \) Mean | \( \frac{\text{NAF/AF}_{2010}}{\%} \) Mean | \( \text{VarNAF}_{2009} \) Mean |
| 100 Fortune | 0.84 | 0.05 | 0.04 | 13.31 | 11.47 |
| | 1.34 | 0.06 | 0.05 | 16.79 | 61.39 |
| Black List | 1.19 | 0.18 | 0.23 | 14.56 | 104.80 |
| | 1.52 | 0.27 | 0.35 | 18.94 | 379.43 |
| Total | 1.02 | 0.11 | 0.13 | 13.94 | 58.13 |
| | 1.43 | 0.20 | 0.27 | 17.80 | 274.23 |
In Table 1, the DA results indicate that the firms from Fortune Top 100, with a high level of transparency in financial reporting, record a low fee level for non-audit services, compared to the net income or turnover, both in the current and previous fiscal year. Unlike the first group, the firms from the Black List, with a low level of transparency in financial reporting, have a high fee level for non-audit services, both in the current and previous fiscal year.

On average, for 2010, for a 1000 net income units, a firm with a high level of transparency in financial reporting has a fee level for non-audit services of 0.84 units. The Black List firms present, for the same result level, 1.19 units. From 2009 to 2010, the firms with financial transparency recorded a diminish in non-audit fees, from 0.05 units to 0.04 units, reported to 1,000 units turnover. For firms without transparency an increase in non-audit fees is observed, from 0.27 units to 0.35 units, reported to 1,000 units turnover. It can be estimated that an increase in the non-audit fees influence the company to a diminish in financial reporting transparency, while a decrease of non-audit fees leads to an increase in the transparency level. What is more, a high fee level for non-audit services has direct influence on the professional ethics requirements, by affecting auditor’s independence.

For quantifying the influence of the non-audit fees on the firm classification in two distinct groups, with or without transparency in financial reporting the study uses the DA. Based on the variables used in the research, Table 2 synthesizes the parameter estimates of the proposed regression model.

Table 2. Parameter estimates of the regression model for classifying the firms in transparency groups

| Variables                  | NAF/NI2010%o | NAF/TO2009%o | NAF/TO2010%o | NAF/AF2010%o | VarNAF2009%o |
|----------------------------|---------------|---------------|---------------|---------------|--------------|
| β                          | -0.125        | 0.732         | 0.691         | -0.898        | 0.452        |
| Influence on classification| 0.681         | 0.644         | 0.318         | 0.225         | 0.065        |

The values of the (βs) regression model parameters, from Table 2, indicate the variable influence direction on a firm belonging to one of two groups, with and without transparency in financial reporting. For 1000 units net income, a 1 unit increase in the fee level for non-audit services determines a decrease of 0.125 units of the score linked to the classification for a firm in the transparency group, for the current fiscal year.

In relation to turnover, an increase of the fee level for non-audit services, in the previous or current fiscal year, leads to an increase of the score linked to the classification for a firm in the non-transparency group.

As regards to the intensity of the variable influence on the firm classification, it can be said that NAF/NI2010 and NAF/TO2009 have a significant influence in determining if a firm belongs to one of two transparency groups. Thus, 68.1 % of the, in variation in fee level for non-audit services relation to the net income, and 64.4 % of the ratio variation between non-audit fees and the turnover lead to classifying the firm in one of the two transparency groups.

Conclusions

Bases on the analysis results, the study validate all the three proposed work hypotheses. The empirical data showed that for audited firms, an increase in time of non-audit fees, reported to the net income or the turnover, lead to a diminish in financial reporting transparency. The link is explained by the professional ethics requirements that the auditor must respect, and damaging these requirements determines a decrease of the mission quality, with a direct impact on the audit report.

The problem regarding offering non-audit services derives first of all from the auditor’s fees value. In order to maintain his legal relations and to gain future economic benefits, the auditor is tempted to compromising on his professional ethics requirements. An insignificant fee level for non-audit services, compared to the audit fees, can lead to removing auditor’s temptations to fulfill its mission under the quality standards of the profession. In this case strict regulation regarding consultancy services is mandatory, services that the auditor can do and based on which he can be paid via non-audit fees.

The future research directions what to identify the types of consultancy services that can significantly influence the auditor’s independence as well as the critical level for non-audit fees for which professional ethics criteria can be broken by the auditor.
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