

The Provision of Non-Audit Services by Accounting Firms after the Enron Bankruptcy in the United States

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This study aims to examine the current non-audit services after Enron, went bankrupt when massive accounting fraud was uncovered. We investigated 767 accounting firms in Taiwan and found that currently tax advisory service is the most popular the non-audit service provided by accounting firms. With a higher certified public accountant (CPA) to employee ratio, accounting firms will have better non-audit performance. Organization size is positively related to non-audit performance, while the independence of the accounting firm shows negative effect on non-audit performance.

1. Introduction

The services of accounting firms have expanded and extended beyond traditional areas in 1980s. Traditional certified public accountant (CPA) market has come to its prime and saturation; the increasing number of CPAs has aroused severe competition in Taiwan. However, the internationalization of industry and complicated management policy encouraged the companies to have extra demands on CPA service. As Accounting Today in USA (2001, April) states, the income of accounting firms in 2000 showed that the proportion of international and national assurance service was 35%, whereas that of tax advisory service and management advisory service accounted for 21% and 44% respectively. According to the data of the Ministry of Finance in Taiwan, R.O.C., the income of non-audit service in 1992 grew from 157% to 212% in 2001. It shows that management advisory service has become the source of total income of accounting firms; in a sense, WAs are encouraged to launch into non-audit services. Non-audit services namely, information system planning, human resources, strategy and planning, investment and tax advisory, initial publication offer (IPO), investment in China and law advisory, could all be provided by accounting firms. Thus, regardless of their size, many firms dedicated themselves to non-audit services in order to gain competitive advantage in a saturated market.

However, while provision of non-audit services is on its foremost progress, Enron, the biggest bankruptcy in American business in 2001, has exposed the problem of audit independence, where CPA provided both audit and non-audit services; in other words, CPA played the role of the coach and the referee at the same time. It has caused the American Senator Paul Sarbane to propose the well-known—Sarbanes-Oxley Act of 2002, also called the “Business Revolution Act”. The Act came into effect on July 30. It focuses on the independence issue that, for the same client, CPA could not provide both audit and non-audit services as stipulated by the Public Company Accounting Oversight Board (AOB).

This study aims to examine the current non-audit services in Taiwan, the effect of CPA independence on non-audit performance, and the future development of non-audit services in Taiwan after the bankruptcy of Enron.

2. Literature Review

Non-audit services generally refer to the services above and beyond the related audit services or services other than traditional CPA work. Scholars in their studies use different terms for some relevant issues, namely, "Management Advisory Service" (MAS) and "Management Consulting Service" (MCS). While there is no particular restriction for the scope or classification of non-audit services, diverse classification methods have been employed by the researchers (Schemer and Kiger, 1982; Pany and Reckers, 1983). Purcell and Lifison (2003) defined non-audit services as traditional CPA works (including assurance, investment assurance, commerce registration and accounting affairs, and so on.). As well as, tax advisory service, management advisory service, finance and investment advisory service, and information technology advisory service.

Firth (1997a) contends that the major source for the growing income in accounting firms is non-audit services, such as tax advisory, information systems design and implementation, management functions and human resources. Such tendency has been confirmed by several scholars since 1980 (Palmrose 1986; Abdel-khalik 1990; Barkess and Simnett 1994), and influenced the market of rising demand for non-audit service and diminishing need for audit service. Purcell and Lifison (2003) states that most of the business growth comes from non-audit services that CPAs provide for their clients when dealing with auditing affairs. Owing to the fierce competition and slashing prices among the peers, audit service is not as profitable as it was before. Moreover, Chen and Liu (2003) finds that the income of non-audit services in accounting in Taiwan firms are over 33%, with growing the need of management advisory service.

As for the motivation and attraction in provision of non-audit services, Firth (1997a) contends that companies usually entrust outside consultants for service in the following situations: (1) one-off assignments; (2) urgent problems; (3) expert techniques; (4) arbitrating initial disputes; and (5) seeking advise. Hillison and Kennelley (1998) also indicate that accounting firms expanding non-audit services could decrease the risk of overall management. The economic causes for offering non-audit services include (1) growth opportunities; (2) personnel attraction and retention; (3) meeting client's needs; and (4) risk diversification Opportunities. In addition, Simunic claims that the provision of non-audit services by accounting firms to their audit clients could create the so-called "Synergy". Such synergy could either lower the spending of service cost or increase more audit services; thus, Simunic (1984) and Beck et al. (1988) call it "Knowledge Spillover."

Regarding the relationship between non-audit services and audit fee, Simunic (1984) states that the effect of the provision of non-audit by accounting firms on audit fee is determined by "demand elastic that the client requests to audit service. Furthermore, Abdel-khalik (1990) points out that audit fee and non-audit fee are positively related. In

addition, Barkess & Simnett (1994), and Firth (1997a) also indicate the significant correlation between audit fee and non-audit services fee.

In non-audit service and its independence, England and Australia have asked companies to publish audit and non-audit services fee in their annual financial report. Such regulation was mainly made considering that the provision of non-audit services by accounting firms to their audit clients would affect independence of audit. Beck et al. (1998a) hold that recurring NIAS would bring out "synergy" between auditor and auditee, which would make it difficult for other CPAs to get into the company and on the other hand prolong the tenure of its auditor. Beck et al. (1998b) also say when the company buys more MAS from the current accounting firm, the accountant will have longer tenure.

According to Firth (1997b), synergy would occur between auditor and auditee when an accounting firm provides audit and non-audit services simultaneously, and consequently it would influence independence of auditor. (Beck, Frecka, and Solomon 1998b; Pany and Reckers 1983, 1988) The reasons are that (1) CPAs would not comment on advisory service provided by consulting department of the firm, and (2) the firm would not miss the profit of giving consulting service. Nevertheless, independence becomes an issue. Simunic (1984) indicates that CPA providing non-audit services would decrease the possibility for presenting the true financial statements, and would influence the users of the statements on the recognition of CPA independence. It would further affect audit quality, the reliability of financial statements and the judgment of decision-making. Beck et al. (1998a) claim that the recurring MAS could strengthen the value to auditor and auditee, affect audit independence, and finally drive the company to reject buying such services.

3. Hypotheses

The research hypotheses, measurement variables, and sampling of this study would be explained below.

When the ratio of CPAs to employees is high, it means employees have better ability in control and supervision. The firm could thus have better audit efficiency and provide better professional services. Thus, high ratio of CPAs to employees represents better performance, so the following hypothesis is established.

Hypothesis 1. The ratio of CPAs to employees in an accounting firm is positively related to non-audit performance.

In an accounting firm run by Portfolio Investment, management policies is determined by owners; therefore, the development of a company is assured and client sources are stable. However, the Securities and Futures Commission of the Ministry Finance announced the assurance model for financial statements of the audit companies. It is stipulated that accounting firms must have at least three CPAs to be able to perform some audit work to companies in the open security market. This study intends to verify the effect of the organization type of accounting firms on performance, so the second hypothesis is developed.

Hypothesis 2. The bigger the organization size of an accounting firm is, the better the non-audit performance will be.

Firth (1997a) proposes that economic bond would be established between auditor and auditee when both audit and non-audit services are provided to their audit client by accounting firms, and thereby, the CPAs independence would be influenced. It is because the firms do not want to lose the profits obtained by the advisory service. Thus, the independence of CPAs is negatively related to non-audit services.

Hypothesis 3. The independence of CPAs is negatively related to non-audit services.

After establishing the hypotheses, a questionnaire was sent to each accounting firm in the samples. The firms were listed in CPAs Community of Taiwan; the samples contained a total of 767 firms. Pre-test, design of the questionnaires, and reliability and validity analysis will be explained below.

- (1) Pre-test: For the research, we designed a questionnaire according to our research objective and hypothesis, with reference to a great deal of research in accounting. We assessed this questionnaire by the Likert seven-point measure, scored on seven-point with anchors 1 equals to not at all and 7 equals to a great deal. In order to avoid situations in which interviewees misinterpret the questions due to the ambiguous sentences, we interviewed four experts in the field of non-audit CPAs and five scholars majoring in Accounting. Then 25 EMBA's with at least six-years experience in accounting firms assessed the first draft of questionnaire.
- (2) Design of questionnaires: according to the pre-test samples and interviewees, the definition of non-audit services is "the services beyond traditional CPA work". The classifications are: (a) tax advisory service, including tax advisory and planning, international tax planning, tax planning for individual and family, tax reduction and administration charity, and tax planning for cooperative investment; (b) management advisory service, including business operation evaluation and strategic planning, business procedure and quality control, operation system planning and design, human resources management and real estate consulting; (c) finance and investment advisory, including investment proposals analysis, funding and loaning advise for starting or expanding a business, business merge and strategic alliance, domestic and overseas investment planning and consulting, and other finance or investment related advisory services; and (d) information technology advisory service, including information system design and function evaluation, financial management information system, financial and accounting software, computer system control and audit function, and professional application software evaluation and implementation.
- (3) Reliability and validity analysis: (a) Reliability: some related studies are the primary references for the samples design. High reliable measurement approaches and items that were used by many scholars are undertaken in this study. (b) Validity: measure validity is applied in making questionnaires. After the pre-test, those companies were also asked to give some suggestions.

Finally, samples were sent to domestic accounting firms in May of 2003. Until the end of June, 767 copies were sent and there were 153 valid return samples excluding the empty or incomplete questionnaires.

4. Results

Descriptions of effective samples and of the non-audit services provided by accounting firms, as well as the regression results, will be given below.

- (1) Effective return samples: In terms of size, there were 128 (84.2%) small firms, 19 (12.5%) medium firms and 5 (3.3%) large ones.
- (2) The supply and demand of non-audit service: Among the 153 effective return samples, 149 firms provide "tax advisory service", taking up 97.4% of the whole sample, which is the highest proportion in four kinds of non-audit services. The next is "management advisory service- provided by 121 firms, which takes 79.1%. There are 99 firms (64.7%) providing "finance and investment advisory service. The lowest is "information technology advisory service" provided by 32 firms, which only constitutes 20.9%.
- (3) The impact factors of non-audit services performance: As seen in table 3, the regression result shows that "CPA Rate", "Organization Type" and "Non-auditing Income Rate" all have significant positive effects. "CPA Independence", on the other hand, has negative effect. Thus, hypotheses 1 to 3 are verified and confirmed.

Table 1: Descriptive of effective samples

Size	Number of Employees	Number of firms	Rate (%)
Small	Under 49	128	84.2%
Medium	50 ~ 299	19	12.5%
Large	Above 300	5	3.3%
Total		152	100.0%

Table 2: Descriptive of non-audit services provided by accounting firms

Classification	Samples:	Firms (n=153)	
		Number	%
Tax advisory service		149	97.4%
Management advisory service		121	79.1%
Finance and investment advisory service		99	64.7%
Information technology advisory service		32	20.9%

5. Discussion of Results

The issue of Enron arouses great concerns on corporate governance revealing the audit independence problem when CPAs provide audit and non-audit service for the same clients. The purpose of this study is to investigate the non-audit services performed by accounting firms in Taiwan and discuss the future development for non-audit services after Enron. The findings are concluded as below.

Among the non-audit services provided by accounting firms in Taiwan, "tax advisory service" takes the highest proportion followed by "management advisory service and "finance and investment advisory service", with the last being "information technology advisory service."

Hypotheses 1 to 3 have been verified, proving that in an accounting firm, the higher the ratio of CPAs to employees is, the better the non-audit performance will be. Moreover, the size of the organization type is positively correlated with non-audit performance.

In view of the frequent occurrences of cases as Enron in recent years, some business-related regulations and restrictions have become rather strict. Affected by the downturn of global market, the growth has become smaller this year, and therefore the accounting firms hold somewhat conservative views concerning the development of non-audit services that was expected to surpass traditional audit service. Meanwhile, as far as CPA independence is concerned, accounting firms will be more careful and stricter in dealing with non-audit work.

Footnote

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Table 3: Regression result of non-auditing performance

Independent variables	Regression Coefficients	t-value	p-value
CPA Rate	0.243	1.832	0.03*
Organization Size	0.250	2.448	0.02*
Non-auditing Income Rate	0.246	2.532	0.01**
CPA Independence	-0.253	-2.631	0.01**
F Value		3.403**	
R^2		0.35	

Note: * $P < 0.05$, ** $P < 0.01$

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