

# Non-Audit Services: Let an Informed Market Decide

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One of the crucial elements in any debate on the regulation of auditors is the effect providing non-audit services has on competition and quality. But regulation should help the market to decide by providing additional information —it should not prevent firms from achieving economies of scope.

## **Cost Saving**

Since its origins, the auditing profession has provided a variety of services to its clients. The most obvious reason lies in the economies of joint production from knowledge spillovers since much of the information and resources required for auditing overlap those used to provide other services. Furthermore, and perhaps more importantly, by providing other services the auditor's ability to understand client companies and their specific circumstances is correspondingly enhanced. Therefore, it becomes much easier to arrive at well-founded opinions. This 'professional judgement' is essential if auditors are to transmit valuable information to the markets. Otherwise, we would be encouraging 'defensive' audits in which auditors merely verify formal requirements.

There are also economies of scope of a contractual nature. These arise from the fact that contracting professional services is usually conflictive. Audit firms with a good reputation have an advantage in expanding their activities into such services because they are in a better position to provide clients with quality safeguards.

Most observers accept these economies of scope. Furthermore, it is likely that they are becoming increasingly extensive as the scope of auditing increases and businesses become more complex and their activities more global.

The debate centers rather on whether, in addition to these positive effects, the joint provision of audit and non-audit services has negative effects. The principal arguments relate to whether or not they are prejudicial to competition in audit (1) and service (2) markets as well as to auditor independence (3).

## **A Threat to Competition and Independence?**

1) It is unlikely that complementary services harm competition in the audit market. It is true that the reduction in costs will result in lower prices. Less efficient competitors may argue that this amounts to abusive practices. Regulators should not be seduced by this argument.

In particular it can be expected that the cost saving will be passed on in terms of prices in both markets (auditing and other services) and at each stage (when initially contracting and subsequently) depending on the competitive conditions prevailing in each market at each contractual stage.

In this context, the possible use of introductory pricing or the use of auditing or other services as loss leaders would merely be the spontaneous consequence of inter-temporal competition. This type of competition arises when there are substantial learning and rotation costs, as in this case. In this situation introductory pricing merely reduces future profits from

the commercial relationship and is therefore optimal from the public point of view. Prohibiting it would be equivalent to preventing mobile telephone companies from giving away telephones to new subscribers.

2) Some service suppliers (particularly lawyers) also contend that entry into the legal market by firms linked to auditing damages competition and is a threat to the quality of the services themselves.

Both contentions are in all likelihood groundless. Firstly, if the quality was in question clients would be the first to reject the multiple services offered by a single firm or by sister firms — it is easy for this type of well informed client to evaluate the consequences. Decisions regarding the degree and type of specialization of firms should therefore be taken by clients. If a problem of quality really existed, whether because of a conflict of interest or any other reason, clients appear perfectly capable of making a correction.

Moreover, in this context entry of new suppliers can only increase competition. The fact that criticism focuses on the strategies and operations of firms whose quality is not questioned gives pause for thought in this respect. Perhaps the concern of some critics is not the result of a fear that quality will suffer but that competition will increase.

3) A similar conclusion may be reached when considering that it is lawyers who show most concern for *auditing* quality. The argument that the provision by auditors of additional services will prejudice their independence as such does not hold water either, however. It is not supported by empirical studies, including retrospective analyses of bad audits.

This finding is consistent with the theoretical analysis. Provision of non-audit services increases the volume of assets whose value depends on continuity in the relationship or market presence, so-called ‘specific assets’, specific to the client and firm respectively. Those specific to the firm always have a positive effect on independence and in general on quality. In this respect non-audit services increase independence. The effect of client-specific assets depends on the degree of client diversification — when firms have a sufficiently diversified client base they also have the effect of encouraging independence. As a result, if the problem of independence is posed by providing other services this would only be in cases of insufficient client diversification, which should be avoided whether or not non-audit services are provided.

### **How to Regulate**

For these reasons, it is not appropriate to prohibit auditors from providing non-audit services. If any regulatory policy is required it is perhaps only in regard to independence and, more specifically, in the field of diversification.

In general, client diversification is a desirable objective since it encourages independence at low cost. Rigid diversification rules unnecessarily restrict the activities of audit firms however, particularly the smallest. It is better to stimulate diversification indirectly, enabling firms and clients to reach optimum levels in each particular case and eventually to develop new formulas for safeguarding quality. These might even render diversification unnecessary, using other mechanisms instead.

This indirect strategy involves improving the transparency of the audit market, thus strengthening the market-driven sanctions and incentives that safeguard quality and promote compliance with professional obligations, particularly independence. From this point of view, the provision of non-audit services makes it more important for the market to be aware of

the degree of client diversification. The reason is that the extent of non-audit services is more difficult for the market to estimate than in the case of audit services.

In order to strengthen transparency a minimalist disclosure rule would suffice. General fee disclosure is inadvisable because it is costly without providing additional benefits. These costs are related to the problems it could cause for competition and the expenses involved in preparing and disclosing the necessary information.

The benefits of disclosure are achieved when the market has an accurate idea of the auditor's incentives. For this to happen, it is enough to know how much of an auditor's income comes from its biggest client. Awareness of this maximum concentration in one client would be just as valuable as general fee disclosure. Auditors' clients would have additional information to judge the quality of auditing firms and, more specifically, weigh up the incentives that affect their decisions. Users would also have additional data to assess their quality and demand better auditing from the client companies. This market-driven regulation would be highly effective without discouraging innovation or reducing competition.