



A short review of Non-Audit Services and its Regulations

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ABSTRACT

Non-Audit Services and its regulations were summarized in this short review. First is to introduce what Non-Audit Services is and then review the regulations of Non-Audit Services in the U.S. and the European Commission. Finally, we analyze the research problem in Non-Audit Services.

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Definition of Non-Audit Services

According to claimed services provided by Big 4 on their websites, all non-audit services (NAS) can be summarized as consulting and advisory services, taxation, human capital services, assistances under regulatory conditions, and accessing technological and strategic solutions (PwC, E&Y, Deloitte, KPMG). Additionally, NAS can be quantified by NAS fees to be reflected on companies' financial reports, and belong to categories under different requirements like tax-related fees and other fees. In 2003, The U.S. Securities and Exchange Committee (SEC) required companies to disclose their auditing fees into 4 categories as follows, audit, audit-related, tax-related and other fees.

As for detailed definition for each category, audit fees generally conclude expenses on examining financial reports, and relative costs incurred during assurance process. Audit-related fees often include due diligence costs in merger or acquisition, accounting consulting and internal control evaluations. Tax fees contain 3 main types, they are tax compliance, tax planning, and tax advice. Tax compliance relates to taxation designing, tax return, and refund. Tax planning and advice services can provide assistance in mergers or acquisitions, employee benefit plans and explaining authorities' regulations and rules.

For the motivation held by companies to purchase tax services, firstly, it is relating to the size of the company, according to former studies, larger companies are less likely to apply tax-related services, as they employ their own tax professionals. Besides, the need to apply tax services is decided by the company's situation, for example, a company owns great amount of intangible assets with deducted taxes needs to apply tax services for tax deduction purposes, and when the company concerning about the pay-back method, to pay dividends or to make repurchases, need to be decided by more favorable tax policy. In addition, NAS are growing rapidly in recent years, which is shown by research data, with increased financial complexity in auditing industry, and the emergence of various financial instruments.

In reality, NAS have become an essential business in accountancy firms, in 2015, advisory

services revenue in KPMG constitutes 37.2% of total revenue in the year, and the figure in PwC is 31.8% (Statista). Hence the influence of NAS cannot be overlooked not only on clients but also on financial environment as a whole. However, it is a controversial subject with heat debates for many years, as people are concerning about impaired independence and conflicts of interest when auditors carrying on NAS. In response, many legislations and rights like Serbian-Oxley Act (SOX), European Commission (EC) statements are issued by world-wide regulatory authorities aiming to solve these problems.

NAS Regulations

If considering about significant auditing legislation effects, regulatory entities like the SEC, Public Company Accounting Oversight Board (PCAOB) and the EC need to take into considerations. SEC is an agency of the US. government, its prime responsibility is to regulate security industry and enforce federal security laws. Not only the United States, there are 13 EU countries approved to be compliant with the SEC's regulations, they are Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, and Sweden (Geographic Listing, the SEC). The foundation of the PCAOB is accompanied by the issue of SOX, targets to assurance investors' interests and further public interests with mandate information disclosure, it provides guidelines to auditors regarding auditing quality. All PCAOB's rules and standards must be approved by the SEC, and basically for EU countries who registered in the PCAOB, also follow rules of the SEC. The PCAOB is a cross-border institution that non-U.S. countries can also register in, including 8 EU countries Denmark, Finland, France, Germany, Hungary, Luxembourg, Netherlands, and Spain, they are declared in the website of the PCAOB. With regard to the EC, it is an executive body of European Union, in this study, it is taken into significant position as its regulations caused directly influences on European countries. Therefore, targeted companies of this study can be limited to the U.S. and European companies, because they all under the influence of regulatory entities illustrated above.

The U.S.

The publication of SOX in 2012 is one of the most significant events in auditing field, which resulted from a series of financial scandals over the century, and with the intention to discipline financial market and boost professionals' confidence. Its main purpose is to increase the level of transparency in public firms and create a tighter regulatory environment. For detailed measures exerted on companies are underlined internal risk control mechanism, like dividing responsibilities to each authority body, completing the governance of audit committee etc. The audit committee works on supervising the board of director to fulfill their responsibilities and help shareholders to grasp the state of auditors' independence and integrity. For achieving auditors' independence and integrity, it engaged to limit accountancy firms' rights to carry on NAS, like regulating audit partner's rotation in fixed years (OECD, 2009).

SEC Rule No. 33-8183 (2005–2007) admitted that any kind of NAS, including tax-related services are not prohibited if they are proven not to hurt auditors and accountancy firms' independence. The condition is that these NAS need to get pre-approval of the issuer's audit committee. 9 kinds of prohibited NAS regulated by SEC Act are: bookkeeping and other services relating to accounting-recording, the implementation and design of financial system, appraisal or valuation services, actuarial services, internal audit outsourcing services, management functions or human resources, advisory or investment banking services, legal services and expert services unrelated to the audit and any other services disapproved by regulations. They are quite similar to prohibited NAS issued by EC in 2014. Tax-related services are sometimes distinguishable in NAS, because tax issues have their own legislation systems that need to be complied during whole processes, and accountancy firms have provided wide a range of tax services for a long time. The regulation also set the limit for auditors to sell NAS, as auditors can get compensations when selling extra NAS to clients, which is considered to threat the auditors' independence.

Moreover, the proposed rules increased the number of disclosed audit fees' categories from 3 to 4, they are audit fees, audit-related fees, tax fees, and all other fees respectively. And in the past, registrants were required to disclose audit fees only in 3 categories, including audit

fees, financial systems design and implementation fees and all other fees. The proposed disclosure requires financial information for 2 most fiscal years, rather than the most recent fiscal year. Additionally, companies need to describe the nature of the services in subcategories that are divided as audit-related fees and all other fees. In total, there are several possible benefits that can be achieved by the final rules, for example, it rescued investors' and accountants' damaged independence and confidence. For effective rules, they need to arouse people's contribution to public interests, not just focus on their own benefits. Investors can be more possible to make right choices with the assistance of enhanced information disclosure, and new rules are expected to increase market's efficiency and decrease the cost of capital.

SEC (No. S7-13-00) was issued in November 2000 based on the concern that high portion of NAS fees could impair auditor's independence and lead to improper audit conclusions. Companies are required to disclose their audit fees and non-audit fees respectively in their proxy statements after the year 2011.

The PCAOB released concepts regarding auditor independence in Release No. 2011-006, 2011. These actions intended to ameliorate financial environment after a series of companies' scandals, such as Enron and WorldCom. PCAOB plays a role as an independent governance institution established by the Congress. Its main task is to arrange regular inspections, providing the board a deeper understanding about audit professionals and situations of audit in companies. Independence rules restrained the types of NAS might further constraint a company's choice of auditor, to be specific, a big-size company might employ one sizable accountancy firm as its main auditor, and apply NAS that are prohibited from another (or more than one other) accountancy firm.

The European Commission

After the financial crisis in 2007, EU regulators increasingly realized the necessity of auditing reforms. From the year 2011, EU Commissioner for Internal Markets Michel Barnier, expressed his apprehension that investors' confidence was impaired by previous adverse financial events,

and quick measures should be taken to deal with this problem. Since then, continuing legislation proposals were prepared by different parties. Subjects under these regulations also include subsidiaries of groups owned outside the EU.

In December 2013, the EC launched new regulations on NAS that taking a form of a cap on the amount of NAS fee, and listing types of forbidden NAS, they are tax-related services that effect directly on auditee's financial report, services involving managing and decision-making process in audited company, book-keeping, accounting records and financial report services, valuation and promoting services, and other services relating to auditee's internal operation, financing, capital strategy. The EC required that group NAS fees should be capped at 70% of the average of group statutory audit fees over the previous 3 years. The calculation of the cap on NAS of companies can be visually explained by the picture below.

According to European Commission Statement about revised rules to improve statutory audit quality in 2014, a strong independence command was underlined, mainly to limited auditor's tenure in public-interest entities (PIEs) up to 10 years, banned certain types of NAS in PIEs, containing tax-related services linked to auditee's financial and investment strategy, this aimed to avoid situations when auditors guarantee for their own work outcomes. The EC also explained the definition of 'public interest entity', which includes all companies listed on an EU-regulated market, unlisted banking and insurance companies and groups, unless they are small. The definition also containing entities governed by EU law with transferable securities listed on an EU-regulated exchange, credit institutions licensed by an EU financial services regulator, and insurance undertakings who carry out insurance activities except insurance brokers (PwC, 2014).

As for independence issues in EC's regulations, Directive EU of *the European parliament and of the council* issued in 2014, with the intention to remain auditors' independence that interest-related entities and people are not permitted to anticipate in the auditing process, it is also essential to leave records when auditors carry out audits. Furthermore, auditors and accountancy firms are responsible to prevent any exposures

to intervene auditors' independence. For example, statutory auditors need to reject the client when they have financial or business interests in, or trade their financial instruments. The statutory auditor and the accountancy firm should not get involved in auditee's internal decision-making process. Regulations in the EC are similar to SOX, but it is not as strict as SOX.

It is also needed to indicate that for regulations issued by the EC in 2014, since a three-year record of statutory audit fees is required, thus the cap will be applicable in the middle of 2016. In other words, the outcome of this regulation cannot be revealed very quickly. It is easier to examine effects brought by legislations and laws that issued earlier, thus this research will focus more on regulations published by the SEC and the PCAOB.

Purpose of the Research Problem

Even though there are existing legislations that aim to diminish harmful factors of NAS, it seems that not many papers mentioned regulatory influences on NAS after the publication of SOX in 2002 and the evaluation or feedback of issued regulations and rules. In addition, most previous studies have shown that NAS do not cause adverse impacts, while the latest researches tend to reveal that NAS impair auditor's independence. In this study, it can be preliminarily presumed that NAS are able to exist until now because of its admitted justifications. But as a research topic, critical considerations and prudent conclusion with evidence are required.

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