Quality suffers for audit offices that emphasize non-audit services, study shows

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Regulators have expressed concerns that audit firms' emphasis on non-audit services (NAS) such as consulting could distract from an audit, and quality does suffer in certain cases, according to new research from the University of Notre Dame.

"The distraction effect of non-audit services on audit quality" is forthcoming in the *Journal of Accounting and Economics* from Erik Beardsley and Andrew Imdieke, assistant professors of accountancy at Notre Dame's Mendoza College of Business, along with Thomas Omer at the University of Nebraska-Lincoln.

Prior research has examined individual clients and whether they hire their auditor for other services. This study is the first to directly examine the "distraction" effect when the audit office places an overall emphasis on non-audit services, not just to a specific client.

"We find that even clients who do not purchase significant consulting services receive lower audit quality from offices that provide high consulting services to other clients," Beardsley explained. "This points to a broader concern of having a business model that includes both audit and consulting services. Too great a focus on consulting relative to auditing can harm audit quality, even if a particular client does not purchase consulting themselves."

The team examined financial statement restatement rates for clients of audit offices from 2005 to 2015. Each firm they examined had data from a varying number of years, for a total of 29,502 observations in the dataset.

When financial statements are restated because of a material error, this means the audit team missed the error in the initial issuance, indicating lower audit quality. The team considered the extent of focus on NAS/consulting at the audit office level using an aggregated measure of total non-audit fees paid by audit clients.

"We provide evidence on what level of non-audit services leads to a reduction in audit quality," Imdieke said. "Our results suggest a reduction occurs when an audit office receives approximately one

quarter of its fees from audit clients in the form of non-audit fees. This provides a benchmark for regulators and practitioners concerned about the point at which an office's percentage of fees could negatively affect audit quality."

The level is significant for regulators including the Public Company Accounting Oversight Board and the SEC, which are concerned about the effects of too much emphasis on non-audit services.

"Our study provides evidence that their concerns are warranted," Beardsley said, "and should be important to consider for audit firms, audit committees and regulators as they consider the impact of these types of services on audit quality."

More information: Erik L. Beardsley et al. The distraction effect of non-audit services on audit quality, *Journal of Accounting and Economics* (2020). DOI: 10.1016/j.jacceco.2020.101380

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