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The Provision of Non-Audit Services by Auditors: Let the Market Evolve and Decide*

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This paper searches for and defines efficient regulation of the provision of non-audit services by auditors to their audit clients. From an examination of the particular problems posed by these services it is concluded that they reduce total costs, increase technical competence and motivate more intense competition. Furthermore, they do not necessarily damage auditor independence nor the quality of non-audit services. This assessment leads to recommending that legislative policy should aim at facilitating the development and use of the safeguards provided by the free action of market forces. Regulation should thus aim to enable the parties—audit firms, self-regulatory bodies and audit clients—to discover through competitive market interaction both the most efficient mix of services and the corresponding quality safeguards, adjusting for the costs and benefits of each possibility. Particular emphasis has been placed on the role played by fee income diversification and the enhancement, through disclosure rules, of market incentives to diversify. A rule of mandatory disclosure of client diversification is examined in order to facilitate the task of the market with regard to achieving the optimal degree of auditor independence.

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1 Consequences of the supply of non-audit services

1.1 Effects on costs: economies of scope

Auditors have provided their clients with many types of service since the times when external auditing began in the nineteenth century up to the present day.¹ The reason why accountants and auditors provide services which complement their principal task is connected, now and in the past, with the considerable economies of scope, or joint production, involved—these meaning cost savings obtained when both types of service are provided by the same person or firm. A distinction should be made within these economies of scope between those which originate in the *transformation* process directed towards the production of information and knowledge, often known in accounting literature as *knowledge spillovers*, and those arising from making better use of assets or advantages of a *contractual* nature. *Productive* economies usually arise from the fact that both types of service need to utilize the same set of information and/or the same professional qualifications. For example, the information required to evaluate an internal control system is largely identical to the one needed to improve it. Auditors are therefore in the best possible position to advise on renewing such systems. Similarly, an audit necessitates evaluating the adequacy of provisions for paying taxes, which requires substantial competence on the part of the auditor in the tax field as well as in many other areas. Conversely, qualification in all these areas facilitates audit work and the provision of these services enables the auditor to form a better-founded judgement regarding the client. These possibilities increase with the scope of the audit and the complexity of the organizations audited since more specialized resources are then required and this often means that a wide range of services needs to be provided to make efficient use of them. The existence of economies of a *contractual* nature is connected with the fact that the exchange of professional services involves high transaction costs due to the informational asymmetry existing between supplier of and client for such services. It therefore becomes worthwhile to make use of the safeguards (brand-name, reputation, conduct rules, control systems amongst professionals, client confidence) already developed when contracting and ensuring quality in auditing, thereby reducing the total cost of providing such services. For

¹ For a detailed historical account, see Previts (1985).

this reason, the ability to use the same contractual resources is particularly valuable in safeguarding or protecting the provision of a variety of services, even in the absence of economies of scope of a technological or productive nature in the strict sense.² Audit firms with a good reputation have an advantage when they expand their activities into such services because they are in a better position to provide clients with quality safeguards. However, these contractual economies of scope tend to flow both ways, from audit to non-audit services and vice versa. Thus, the contractual safeguard of auditing will also be easier for firms providing non-audit services.

Both types of economies of scope contribute to enhancing the technical competence of audit firms, this meaning their ability to detect shortcomings in accounts. In particular, non-audit services are an important source of information for professional judgement. When such services are provided to audit clients the auditor can reach a better-grounded professional judgement since he will have a greater depth of knowledge of that part of the value of the business which is rarely reflected in the accounts, such as intangible assets (reputation, solid organizational structure, management capability, etc.). By carrying out purely auditing tasks, it is more difficult to gain an idea of the extent of such assets although those using the accounts would like to receive information on them. The audit can at least provide an indication as to the existence of such assets and the reliability of this indication will depend on the auditor's knowledge which can be substantially increased by providing non-audit services to the same client. In addition, the provision of such services will enable the auditing firm to contract and make efficient use of the experts required to improve and extend its professional judgement as well as to undertake highly specialized activities. For example, in order to audit a highly-regulated undertaking properly, at least one expert in that sector will be required. If consulting services are provided to such clients, it will be more practicable to contract and make efficient use of such experts.

The first type of economy of scope, associated with the joint use of information to provide different services to the same client, was very important in the past and probably remains so amongst smaller firms. Amongst large firms, however, it is becoming less important especially

² Frequently, these contractual advantages are referred to under the label "one-stop shopping", which might be slightly equivocal, as it leads to thinking in terms of the cost of merely searching

with respect to those economies of scope which are specific to a particular client. This is shown by the fact that nowadays different teams or even divisions and companies are responsible for providing each type of service. In the large multidisciplinary organizations, the advantage of joint provision of a wide range of services seems increasingly to reside, therefore, in all types of contractual advantages, and perhaps also in scale and network economies in the production of knowledge, which is not specific to a single client, as in the case of the knowledge spillovers previously referred to, but which can be utilized on a general basis. The latter is particularly the case with the investment necessary for the functioning of a global network of offices providing uniform quality, in terms of training centers and programs as well as data bases, quality control systems and management and organizational systems generally.

Considerable problems arise in quantifying even the most tangible of these economies of scope,³ especially those related to the improvement of technical competence and professional judgement. Most observers, however, accept their existence.⁴ Furthermore, they are probably 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 offsetting negative effects. The principal arguments relate to whether or not they are prejudicial to competition in

for providers, which probably is not the most important cost, when compared with that of ensuring contractual performance.

³ Empirical evidence on economies of scope is of two kinds. Qualitative signs point clearly to their importance: the persistent interest of firms and clients in the joint provision of services, as pointed out by Antle and Demski (1991: 1); the fall in service provision after rotation (DeBerg, Kaplan and Pany, 1991); the fact that internal auditors increasingly provide non-audit services (see, e.g., "Internal Auditors and Internal Consulting," *Internal Auditor*, June 1996: 10); and the use of auditing as a loss leader to attract service business. This practice, in the absence of economies of scope, can only be explained as a result of predation (which Industrial Organization analysts consider implausible, as explained below in n. 9). Measurement of these economies is difficult, however, as the possible interactions are very complex (Gaver and Gaver, 1995) and available data only allow for indirect tests based on audit prices or costs, there being no figures for non-audit services. Most of the studies, however, identify economies of scope as a cause of the their observations. This is the case of the seminal work by Simunic (1984), which was followed by Palmrose (1986); Turpen (1990); Davis, Ricchiute and Trompeter (1993); Barkess and Simnett (1994); Ezzamel, Gwilliam, and Holland (1996, 1998); and Firth (1997).

⁴ See, for example, the opinion on this regard of Antle, Griffin, Teece and Williamson (1997: section 5.2).

audit (Section 1.2) and service (1.3) markets as well as to auditor independence (1.4). Let us discuss these more controversial aspects of the problem.

1.2 Effects on competition in the audit market

It is unlikely that non-audit services harm competition in the audit market. However, they may lead to confusing price structures. To evaluate this, it is important to understand the economic rationale of introductory pricing and inter-temporal competition. In this respect, standard Industrial Organization analysis shows that cost savings obtained from the joint provision of the two sets of services will be passed on in the form of price reductions in each market (auditing or other services) and at each stage (when initially contracting or subsequently), depending on the competitive conditions prevailing in each market at each contractual stage. If the reduction in costs results in lower prices, less efficient competitors may argue that this amounts to abusive practices. However, introductory pricing and the use of auditing or other services as loss leaders would merely be the spontaneous consequence of inter-temporal competition.⁵ This type of competition arises when there are substantial learning and rotation costs. In this situation, introductory pricing merely reduces future profits from the commercial relationship and is therefore optimal from the public point of view. In auditing, substantial future quasi-rents are generated as the result of the start-up or learning costs of initial audits and the rotation costs that all clients must incur when changing auditor. (The economies resulting from combining auditing and other services are an additional source of quasi-rents). All these factors mean that continuity in their relationship is advantageous to both clients and auditors. If the audit market is competitive, auditors compete to lower the prices of their initial work knowing that they can make up the probable initial loss from future profits. If the initial work tends most frequently to be auditing and there are economies of scope, a larger discount will also be seen in the initial prices of auditing when the auditor is equipped to provide other services. Readers who have recently acquired a mobile phone will probably have benefited from this type of competition—telephone companies generally give the telephones away knowing that customers will be tied to them, generating substantial profits in the future. It is this tie, together with a certain degree of competition, that results in the initial discount. The tie would still exist, however, even if the

connection price had not been discounted, the discount merely being a consequence of anticipated competition for those future profits.

This inter-temporal competitive process is beneficial from the public point of view. A better understanding of the phenomenon will help to avoid the still common mistake of considering the practice of introductory pricing at less than the cost of the initial audit, or “lowballing”, as uncompetitive or prejudicial to independence. This error sometimes leads to proposing or adopting rules aimed at preventing introductory pricing.⁶ Such rules are self-defeating however, in terms of both independence and competition. They firstly raise the total volume of quasi-rents associated with the client since they increase the cost of replacing the incumbent auditor (the aspiring auditor can no longer offer a discount on the initial audit) and therefore also the quasi-rents earned by the current auditor.⁷ Furthermore, they are prejudicial to competitive conditions. Imagine that an oligopolistic agreement or regulation prevented mobile telephone operators offering connection discount—as changing operator becomes more costly it is likely that each operator will be able to charge higher prices to its customers who would thus pay more both for connection and afterwards.⁸ In our case, by preventing potential auditors from discounting the price of the initial audit, the rotation cost is raised and the incumbent auditor can charge a higher price. Once discounting is prohibited, the price of the initial audit rises to equal its cost whilst the prices in subsequent years continue at the level which prevents competitors from coming in, a level which rises moreover because of the higher rotation costs. For these reasons,

⁵ Inter-temporal pricing was first applied to auditing by DeAngelo (1981a).

⁶ For instance, the Green Paper on the role of the statutory auditor within the EU said: “The growing intensity of competition for audit ‘business’, and especially for the audit of large ‘prestige’ companies, is also a cause of concern. There is no doubt that competition sometimes results in low-cost and perhaps even below-cost tenders. The procedure of calls for tenders which ensures transparency and competition, should not have as a consequence that auditors quote an audit fee which does not allow them to carry out their work in accordance with professional standards. Some observers infer that the successful tenderers expect to recoup the balance of the full cost of the audit from non-audit consultancy services. This points to another concern which relates to the provision of non-audit services” (OJEC, 1996: item 4.11). A similar criticism is applicable to rules that constrain or prohibit discounts and introductory pricing in Austria, Belgium, Portugal, Greece and Italy.

⁷ See DeAngelo (1981a: 124-5) and Grout *et al.* (1994: 329 and 343).

professional concern about lowballing could have more to do with preserving and increasing monopolistic rents than with the alleged objective of preserving independence.⁹

1.3 Effects on competition in the market for non-audit services

The central conflict regarding collaboration between auditors and other professionals has focused in Europe on collaboration with lawyers. It is argued that legislation imposes, or that clients demand (or it is said that they demand), different duties from the two professions, maintaining that whilst auditors have a duty to be independent of their clients, lawyers, on the other hand, have to be the opposite. The question is whether the law should restrict such collaboration or not. A negative answer will be defended here, basically because it is a matter which the parties, particularly clients, seem perfectly capable of deciding for themselves. Any restriction would thus be at least superfluous and, more seriously, run the risk of being counter-productive. In short, the matter should be left to the judgement of the client himself. Clients can assess the clear advantages to them of joint service provision: a lower number of providers, lower costs, better quality and, above all, a better guarantee of quality. Clients are also able to appreciate the risks which may be involved in this joint provision, if in fact they really exist. The client for this type of service is a business client, not a poorly-informed consumer. This kind of client is capable of forming a sensible judgement on the matter and modifying it when appropriate. He is, or will become a well-informed purchaser aware of the conflicts which may be involved. For this reason, audit firms themselves and their professional associations have the greatest interest in structuring the linkage between services in such a way that both conflicts of

⁸ This result was in fact seen over 1997 in the Spanish mobile telephone market where the year began with zero connection charges for low-range telephones and ended with virtually no discounts, a matter which the competition authorities are investigating.

⁹ It is unlikely that low auditing prices and cross-subsidies could be part of a predatory strategy of the type argued by Bain (1949) and criticized by Telser (1966). In addition to the belief that predatory pricing is not viable in general as a monopolizing instrument—see, e.g., Tirole (1988: 368) and Demsetz (1995: 208-10), in the auditing case a monopolizing aim would not make much sense. Firms of all sizes are able to develop this introductory strategy and both markets—auditing and services—are competitive. Furthermore, in many market segments there are strong potential competitors and barriers to entry are not very high. According to some analysts, statutory auditing is an exception, with lack of competition in the market for large firms.

interest and the appearance of conflict are minimized, as described in Section 1.4 (c). Decisions as to the degree of specialization of firms should therefore be taken in the area of the parties' freedom of contract.¹⁰

Some service providers (particularly Bar associations in Europe) oppose allowing audit firms or firms contractually connected with them from entering the field of their own services. They contend that such entry harms competition and threatens the quality of such services. Examination of the problem reveals that both contentions are probably groundless, however. Firstly, if quality is questionable, clients will be the first to reject the multiple services offered by a single firm or by connected firms. Since the situation is readily transparent, it is also easy for this type of well-informed client to evaluate the possible consequences of such connections. Consequently, the market would provide effective corrective incentives if service quality was really endangered, whether because of a conflict of interest or for any other reason.

Furthermore, the claim that the entry of audit firms in the markets for non-audit services harms competition is also unfounded. Entry of new suppliers can only increase competition, especially when these new providers render services with greater added value at a lower cost (at least of a more certain quality and over a greater geographical area).¹¹ A greater degree of collaboration between professions is dictated by two main forces. First, changes in business circumstances so that problems are of growing complexity and scale necessitate a global and coordinated provision of different specialized services which also require an increasing degree of

However, if that was the case, it should be addressed why these alleged oligopolies should risk their position instead of milking it.

¹⁰ In this matter, experience in the advertising field is illustrative since, being a more dynamic and little-regulated sector, the main firms adopted *one-stop shopping* strategies much earlier. The response of clients varied, with some clients seen to value the advantages of geographical and service consolidation more, but others, on the other hand, continuing to give priority to the benefits provided by diverse providers. See, for example, "Advertising: a Passion for Variety" (*The Economist*, 30 November 1996, pp. 82-3).

¹¹ This is even more relevant in those countries where the organization of the legal profession is more outdated. There, the entry of established law firms, whether or not connected with multidisciplinary organizations, is doubly useful since it can provide a powerful spur towards modernization of the profession. Encouraging signs can already be seen in this field, particularly in the development of larger professional firms with international links which for both reasons—size and links—are in a better position to meet the demand from increasingly international businesses.

expertise. Second, and perhaps more important for lawyers, there is an increasing demand for services of guaranteed quality on a global scale and, if these are to be safeguarded, it is in everyone's interest to optimize the use of reputational capital. This is achieved by providing different services under the same commercial guarantees. As a result of this demand for global quality assurance, those professional activities which were previously carried out under a system of restrictions that prevented the development of effective quality safeguard formulas, are most likely to be linked with auditing. Specifically, this could be the case with legal services that are subject in many countries to a series of professional association restrictions which, because of their partial nature (particularly in those countries where in practice there are no effective entry barriers), do little to safeguard quality.

This analysis gives cause to search for explanations from the perspective of the positive theory of public regulation. In particular, one may suspect that proposals restricting freedom to provide services in this field may be the result of the private interests of some service providers in reducing competition. This suspicion is reinforced when considering these two facts. First, criticism focuses on the strategies and operations of firms whose quality is not questioned. Perhaps the concern of some critics is not so much the result of a fear that quality will suffer but rather that competition will increase. Second, it is also lawyers who show most concern for *auditing* quality, and this issue will be examined next.

1.4 Effects on auditor independence

The argument that the provision by auditors of additional services will prejudice their independence does not hold water either. It is not supported by empirical studies, including retrospective analyses of bad audits (a). This finding is also consistent with theoretical analysis (b), even without considering corrective actions (c).

a) The available empirical evidence does not support the contention that auditor independence is harmed by providing such services, even to audit clients. No causal relationship can be detected between providing services and a lack of independence in fact from the studies carried out in the United States since the 1970's into cases of improper auditing or those based on indirect indicators. In the most recent study, only in three out of 610 claims against auditors

there were allegations that independence was somehow impaired by the supply of services.¹² The same study shows the clearly opposing time trends followed by consulting fees and the number of claims against Big Six firms from 1990 to 1996: claims went down to half while non-audit fees doubled.¹³ Providing such services does, however, appear to result in a public *perception* that independence could be harmed, especially in the view of poorly-informed or interested participants.¹⁴ (In professional and regulatory circles, considerable importance is given to this distinction between *independence in fact*, given by the absence of interest or influences which could prejudice the auditor's objectivity and which are not directly observable because of their mental or psychological nature, and *independence in appearance*, defined by signs, signals or indicators which are in fact observable).

¹² See Antle, Griffin, Teece y Williamson (1997: section 5.3.1).

¹³ See AICPA (1969: 52), where generic allegations expressed in the 60s are examined; and, mainly, Cohen (1978: 96-8), for a study on litigated cases; as well as POB (1979: 33-4). Thus, there is very little empirical evidence of a direct nature of the effects the supply of non-audit services has on independence of fact. Academic studies provide some indirect evidence. This, overall, does not support the contention that non-audit services have a negative effect on independence. These studies observed that (1) shareholders do not penalize the supply of non-audit services (Glezen and Millar, 1985); (2) there is no correlation between supply of non-audit services and auditor switching (DeBerg *et al.*, 1991; Barkess and Simnett, 1994), apart from the fact that such correlation (as found, e.g. by Beck *et al.*, 1988b) is coherent with alternative explanations in terms of reverse and common causality; (3) finally, attempts at experimental analysis (Dopuch and King, 1991) are seriously limited.

¹⁴ Results are not conclusive, however. As in the first studies in the 60s (Schulte, 1965; Briloff, 1966; Titard, 1971; Hartley and Ross, 1972), new studies keep finding contradictions (Firth, 1980, 1981). This is hardly surprising, considering that they suffer serious methodological problems because they are based on opinion surveys and may suffer a "demand effect", inducing biased answers (McKinley, Pany and Reckers, 1985; Pany and Reckers, 1987 and 1988). Furthermore, the differences in opinion seem to be related to the information different groups of respondents have about the problem (Shockley, 1981; McKinley *et al.*, 1985; Knapp, 1985), as well as across countries (Dyckhoorn and Sinning, 1981; García Benau *et al.*, 1992). Furthermore, some findings of negative correlation between supply of services and qualified auditor opinion were presented as an indication of damage to the appearance of independence (Wines, 1994). However, they probably suffer from selection bias because firms that do not purchase non-audit services are, on average, in a worse financial condition than those that do purchase them. Furthermore, other studies in the same country have not found such correlation (Barkess and Simnett, 1994: 105), and this result was confirmed by a later study (Craswell, 1998).

b) The empirical evidence on independence in fact is consistent with the theoretical analysis of the effect on independence of providing such services.¹⁵ In essence, they result in an increase in client- and firm-*specific* assets— “specific” meaning those resources that are more valuable in their current use than in their best alternative use.¹⁶ The latter always have a positive effect on independence and, in general, on quality,¹⁷ whilst the effect of client-specific assets depends on the degree of client diversification. When firms have a sufficiently diversified client base, they also encourage independence.¹⁸ In other words, by increasing quasi-rents, the auditor becomes more dependent on *all* his clients and therefore more independent on anyone of his clients. (Where the auditor to be lenient with a client, he risks the quasi-rents connected to all other clients—more on this on Section 2.2 below). There is thus a compensating and potentially more powerful effect. Under realistic conditions, the crucial variable is diversification: above a certain level, the dominant effect favors independence. (It should not be inferred from this, however, that the overall effect of providing such services is necessarily negative in the case of auditors with limited client diversification. The main reason is that, although providing such services increases the quasi-rents associated with the clients, so also do firm-specific assets). Apart from specific assets, other effects seem to have a relatively minor importance. This is the case with the following: changes in bargaining power in the allocation of quasi-rents linked to non-audit services; the probability of auditor switching; costs of collusion between auditor and client; specific assets connected to excess capacity; and professional liability.

c) Furthermore, the above conclusion is reached from a static analysis which does not take account of the action and policies implemented by firms and the rules adopted by professional associations to increase both independence in fact and in appearance of independence. A

¹⁵ This point has been developed in Arruñada (1999: 81-8).

¹⁶ Seminal works in the area of specific assets were Klein, Crawford and Alchian (1978) and Williamson (1975 and 1979). The idea that asset specificity economizes in safeguards was suggested generally by Klein and Leffler (1981: 627-9) and applied to auditing by DeAngelo (1981b: 193-4).

¹⁷ This is supported by the empirical results obtained by Davis and Simon (1992), according to which auditors who suffer reputational crisis experience difficulties in maintaining their prices and acquiring new non-audit engagements.

¹⁸ See, on the contrary, Grout *et al.* (1994: 330-1). They introduce a crucial qualification, however, by saying “at this level of analysis...” (p. 330). In our opinion, essentially this means “assuming that the auditor has only one client”.

consideration of such action and regulation reinforces the argument that providing services encourages independence. Firstly, firms' activities range between a radical abstention from carrying out management or decision-making functions and implementation of service provision by firms which are connected to them contractually but have separate management and assets. This is a suitable formula for achieving the economies of scale and scope available in certain types of joint activities (basically investment in training, reputation and quality control) and for achieving certain product attributes (globalization) whilst preserving the advantages of different firms specializing in different types of service.¹⁹ In addition, many incentive and control devices of an individual, hierarchical and mutual nature ensure that both individual auditors working for these firms as well as divisions within a firm and affiliated firms within a network have strong incentives to maintain the required attributes of service quality, including independence. (The following are a few of these devices: partners' remuneration is not based primarily on revenue generation or short-term local profits, but on performance variables which encourage them to take a broad perspective, including the global results of the firm and measures of service quality; internal procedures to avoid individual biases and overconfidence are common, such as having audit engagement partners serve public companies for no longer than a certain number of years; finally, control is also exercised among offices and countries, by having personnel from one area inspecting the work of another geographic area). Secondly, the rules adopted by professional associations aim at controlling potentially conflictive situations and in particular at preserving a public perception of independence. Specific rules are applied for this purpose in the field of professional services to avoid possible confusion as to the professional standards applicable to them.²⁰ For example, the AICPA mandates serving the client's interests, establishing an understanding with him in which the responsibilities of the parties and the nature, scope and limitations of the services to be provided are set out, and notifying him of possible conflicts of interest and significant reservations.

¹⁹ The provision of audit and non-audit services by different divisions has been shown to increase the perception of independence (Lowe and Pany, 1995 and 1996).

²⁰ See, on non-audit services, AICPA (1996), the ethical code of the International Federation of Accountants (IFAC, 1996), and the opinion of the Fédération des Experts Comptables Européens (FEE, 1995: 4.2.1 and 4.2.3; as well as 1996: 26). On abstention of management services, see AICPA (1975: 20) and FEE (1995: 4.2.3).

2 How to regulate the supply of non-audit services

2.1 Market prohibition or market facilitation?

There is considerable variation in the types of service which different domestic regulatory systems within the OECD and even the European Union allow auditors to provide to their audit clients.²¹ Some countries allow all types of non-audit services to be provided. These include Australia, Canada, Ireland, Luxembourg, The Netherlands, Sweden and the United Kingdom. In all these countries, and in those which allow certain types of non-audit services to be provided, auditing is nevertheless subject to the generic rules protecting auditor independence. In a second group of countries there is only a prohibition on providing some kinds of non-audit services to audit clients. This is the case of book-keeping and accountancy in all countries except Australia, Canada, Denmark, Ireland, Japan, Luxembourg, The Netherlands, Portugal, Sweden and the United Kingdom; tax and management advisory services are allowed in all countries, except Japan; legal services are forbidden in Denmark, Greece, Japan, Portugal and the United States; and, finally, provision of corporate recovery services is forbidden only in Japan and Portugal. Lastly, Belgium, France and Italy prohibit the provision of any type of non-audit service. Nevertheless, in Belgium and France this prohibition applies only to the provision of audit services by the same legal entity. Hence, auditing networks provide them in co-operation with other legal entities. This possibility has been restricted in France to material services provided to listed companies.

In view of the above analysis, prohibitive rules do not make much sense. Prohibitive rules of a general nature are clearly inadvisable, both from the point of view of the audit market (where they are harmful to efficiency and quality) and in relation to competition in service markets, apart from the fact that they are usually ineffective. Furthermore, they are said to suffer from serious enforcement problems.²² From the perspective of this paper, which emphasizes the role

²¹ See, for details, Arruñada (1999, 140-2) whose data are adapted, for EU countries, from Buijink *et al.* (1996, p. 74).

²² Some firms are said to easily circumvent the prohibition by separating their activities amongst different legal entities which nevertheless are centrally controlled. According to Ridyard and de

of private market-based safeguards, this latter possibility is very harmful because high-quality firms with very good reputations are placed at a disadvantage. The reason is that they cannot afford to get around the rule. Even if the legal system would not sanction them for doing it, the market will probably would.²³ In addition, restrictive rules of a particular nature, whether prohibiting certain types of service or making them subject to specific restrictions, are less negative but also suffer from substantial problems of the same nature. Above all such rules necessitate ample and detailed knowledge on the part of those drawing them up. They are perhaps only justified, therefore, when they confirm good practice in the field.

The legislator would consequently do well to refrain from introducing detailed regulations. In particular, he should be concerned to re-define audit market conditions so that the market provides sound incentives to firms and to professional associations to act as self-regulators. The guiding principle of regulation should then be to allow audit firms, self-regulatory bodies and audit clients to discover through competitive market interaction both the efficient mix of services and the corresponding quality safeguards, adjusting for the costs and benefits of each possibility. The reason for entrusting this task to the market is that the incentives and the ability of market participants seem perfectly capable in this case of guiding such a discovery process. Regulators, on the other hand, frequently lack both the required knowledge and the right incentives to define the efficient framework. The lack of knowledge is inherent to their position as neither producers nor clients. The defective incentives stem from at least two potential biases. They may tend, firstly, to exaggerate eventual external effects and consequently require higher than optimum quality and quantity, as this additional quality involves no cost for them. Second, they are bound to be swayed by private interests alien to the audit market, as shown by the variety of prohibitive or restraining regulations and the above analysis of competition in the market for non-audit services.

Allowing the market to be the driving force behind the evolution of the industry does not mean that there is no role left for regulation. Rules are still needed for facilitating the smooth

Bolle, this is clearly the case in France and Portugal and perhaps in Italy (1992: 67). A similar opinion was expressed by the EU Green Book (OJEC, 1996: 4.13).

²³ The fact that prohibitive rules are ineffective might also explain why interest in this type of restriction occasionally extends to some multidisciplinary firms. These might be those which, because of their lesser reputation, would be in a position to circumvent the rule at low cost.

functioning and the speedy adjustment of the market. Regulators should therefore concentrate on promoting and facilitating competition in order to enhance market incentives by means of policies aimed at increasing informational transparency and facilitating the creation of private quality safeguards. Specific measures would involve both introducing new standards (for example, for disclosing client concentration as explained below) and eliminating some current restrictions (such as those relating to advertising and unsolicited offering of services, which have been demonstrated to be beneficial to quality in the United States). In this context, it would also be appropriate to review the conditions governing demand for auditing, applying the legal requirement for statutory auditing to those cases in which the audit actually reduces contractual costs (taken in their widest sense to include all types of external effects).

2.2 Client diversification as a regulatory objective

Let us now briefly analyze one possibility of this low-intensity regulatory strategy in the field of non-audit services. Among the instrumental variables that are potentially useful for regulatory intervention of a facilitating nature, fee income diversification shows good properties. Both common sense and scientific analysis of the problem agree that client diversification is an essential element in private safeguards of audit quality and, specifically, in auditor independence in relation to each of his clients. When an auditor's fee income is not concentrated in the client whose accounts are being examined the auditor will be less dependent on that client. The reason is that the estimated cost of dependent conduct (motivated by possible loss of clientele) is much higher than that of independent conduct (associated with the loss of the client in question).

In more technical terms, in the auditor-client relationship both parties are investing in "specific assets" (particularly knowledge) which are only of value if the relationship continues. Because of this, they have an interest in continuity, and a potential risk to independence emerges. This potential risk only materializes, fortunately, when the clientele is concentrated and disappears when it is diversified. To auditors with many clients, independence can endanger the assets specific to one of them but it maintains or even increases the value of the assets which are specific to the remainder (as well as those specific to the firm, principally its reputation).

Because of this effect of encouraging independence, client diversification is in general a desirable objective of audit regulation. As such, it has two further advantages. Firstly, it

encourages the use of a type of low-cost safeguard, thanks to the productive nature of the specific assets, which add their directly productive functionality to their capacity to generate contractual safeguards as a free by-product. This objective is relatively easy to monitor, either by the regulator or by the market. Furthermore, it is also advisable in the particular field of non-audit services since, to a certain extent, the effect of these services on independence depends on the degree of diversification.

The possibility of substituting quality safeguards and developing innovative safeguards in general makes it inadvisable to adopt rigid diversification rules, which could restrict firms' activities unnecessarily. It would suffice to establish an obligation to disclose one or more indicators providing information as to diversification. In other words, diversification should be an objective of the rule but the rule should leave it to the market to decide on a suitable degree of diversification and on other safeguards, along with the possibility of replacing it by other guarantee mechanisms.

The legislator has two main types of instrument available to promote client diversification amongst auditors. The first is by directly introducing a rule preventing concentration beyond a certain limit.²⁴ This kind of rule restricts firms' activities unnecessarily, however. As a consequence, it should play at most a secondary role in terms of the objective of increasing diversification, being useful only in establishing a maximum concentration limit. The reason is that the optimum level of auditor diversification depends on the characteristics of the auditor himself as well as those of his clients. A single diversification rule would force a standard level which would be too high in some cases and too low in others.

In other words, the diversifying objective should be compatible with freedom for auditors to work with different degrees of diversification and other safeguards, provided that this is known to the public. This way, market participants are not prevented from seeking an efficient substitute from amongst the different types of quality safeguards. As these safeguards are costly,

²⁴ Great Britain, United States, Ireland, Denmark, Australia and Germany restrict the maximum income from a single client in relation to the total income of the audit firm, laying down a maximum percentage which ranges from 10 percent for listed companies in the UK and Ireland to 50 percent in Germany, this being computed over a consecutive five-year period (see details for EU countries in Buijink *et al.*, 1996: 76-7). In most other countries there is a restriction defined in very general and unquantified terms, the practical importance of which thus varies.

it is desirable that substitution decisions (between solvency guarantees and diversification, for example) be taken by those who have most incentives and the information necessary to adapt to them in an optimal manner.

2.3 Analysis of mandatory disclosure

The limitations of direct regulation of diversification could make it sensible to use an indirect strategy to stimulate diversification and at the same time give sufficient flexibility to firms and their clients to place themselves at optimum levels in each situation. This indirect strategy involves improving transparency in the audit market, which will facilitate the operation of private mechanisms to safeguard quality and strengthen incentives to meet professional obligations, in particular the need for independence.

In this context, the provision of non-audit services might make it all the more necessary for each audit firm to make a specific disclosure of its degree of client diversification since it is difficult for the market to estimate the extent of non-audit work or even its existence. If auditors only provided audit services, it would be relatively easy to gain an idea of their client diversification. A substantial and positive correlation can be expected between assets specific to each client and audit fees. The latter in turn will depend on the size of each client. Since the size of clients and firms is relatively easy to ascertain, the market would be in a position to estimate the diversification of each audit firm's clientele. However, this is not so easy when non-audit services are provided, because the projects vary greatly in size and their size is not as well correlated to the size of the client as audit work is.²⁵

The desirability of introducing mandatory disclosure can be disputed, however, inasmuch as, if the information were truly valuable, firms would already be disclosing it at their own initiative to avoid being classified as a bad quality provider.²⁶ The presence of collective action problems or third-party effects may, however, prevent individual voluntary disclosure from reaching

²⁵ Using US data on a sample of audit and non-audit works provided by Turpen (1990: 66), the variation coefficient of audit works is estimated at 91.38% for initial engagements and 152.38% for subsequent audits. The figures for non-audit services are much higher—268.87% and 484.26%, respectively.

²⁶ See on this Grossman and Hart (1980), Grossman (1981) and Milgrom (1981).

optimal levels with regard to both the amount and content of the disclosed information.²⁷ For instance, the disclosure of some diversification indicators could damage the confidentiality of the relationship with the affected client, possibly revealing information of some strategic value for his competitors. Even if private costs are smaller than private benefits, it may be the case that the net surplus is positive only when all firms disclose. However, individual firms may be better off not disclosing if some other firms do disclose, with the final outcome that no firm discloses.²⁸ Likewise, disclosed information might be more valuable when it is used to obtain knowledge about the industry or, more pertinently to the case under discussion here, it serves to compare firms in the industry. In both uses, the value of the information disclosed by any one firm is not fully appropriated by it, generating positive externalities. In addition, disclosure needs ex post verifiability to function, and this may require a centralized agent to accumulate and to some extent monitor the disclosed data. In performing this task, regulatory bodies may have an advantage over self-regulatory bodies when the latter represent firms with diverse degrees of diversification. Moreover, in a context in which the market itself is unaware of the concentration levels of other firms, the initial discloser may run a certain risk of creating confusion amongst economic agents who are unaccustomed to assessing such information. Furthermore, regulation may enjoy some advantages over the market in standardizing the contents and the language of disclosure.²⁹ Lastly, third party effects may appear within the firms themselves, particularly as a consequence of their hybrid structure. The existence of inter-temporal or geographical variability within firms could incline them not to disclose from concern that their image may appear distorted in some periods or, mainly, in some geographical areas. For instance, interests may diverge within a federation of firms. This could be an important consideration for those still developing a global standard of quality.

²⁷ For an account of the main issues involved in corporate disclosure which holds a similar line to the one argued here, see Easterbrook and Fischel (1991, pp. 276-314).

²⁸ Jovanovic (1982), Verrecchia (1983) and Dye (1986) model situations in which uninformed parties do not always infer bad quality from nondisclosure, due to the presence of disclosure costs. As a consequence, voluntary disclosure is less than optimal. In particular, disclosure is not profitable for providers of bad but not the worst quality at some point in the quality scale.

²⁹ This can be particularly important when limiting discretion controls the informational content of the disclosure, because discretion affects how the disclosed information is seen by recipients, as modeled in Fishman and Hagerty (1990).

Because of these possible contingencies, regulators should focus their job on eliminating those barriers that might be hindering disclosure on a voluntary basis. Candidates for this can be derived directly from the previous discussion. In particular, mandatory disclosure should be seen and structured as a solution to free-riding problems among potential disclosers. The regulator could also define diversification scales in order to reduce the risk of disclosing information which might be sensitive to the affected client. Moreover, the regulator himself, in promoting voluntary disclosure, would eliminate the risk of confusion borne by the initial discloser. He can, finally, act as ex post verifying agent and, by emphasizing the substitutability of safeguards, he might even aspire to reduce the risk of misinterpretation.

To apply these generic principles, the choice of a policy of disclosure should take into account its relative effectiveness and the costs it may generate. In particular, effectiveness will depend on whether it provides the market with information that is useful to correctly assess economic incentives favoring independence. The main cost is its potential effect on competition:

a) *Benefits of the rule.* The benefits of disclosure arise when the market can gain a more accurate idea of an auditor's incentive to be independent. For this reason, public disclosure is desirable in a standard form (to reduce processing costs). The content of the disclosure should ideally relate to the economic variables on which incentives depend (the value of specific assets). As this figure is not known, it is preferable to use other more objective indicators, such as fee income. With respect to the computational scope of the rule (for both firms and their clients), it would be appropriate to use the decision unit definitions which are standard in Corporation Laws. In addition, the relevant figure is the concentration of fee income and not its composition. For this reason, it would be worthless to disclose data on the relative weight of auditing and service fees, as this relationship does not affect independence.

b) *Costs of the rule.* The main cost of disclosure is related to the problems it could bring to competition. In particular, full disclosure of individual fees, which is in force in some countries,³⁰ probably makes competitive strategies more difficult and less profitable for audit

³⁰ According to Buijink *et al.* (1996, pp. 80-1), in Ireland, Norway, the United Kingdom, Denmark and Belgium, the auditor must disclose fees received for both mandatory auditing and non-audit services, except in Belgium where the obligation relates to service but not audit fees. Likewise, in Italy clients must specify audit fees in their annual financial statements, although

firms, reveals sensitive information about their clients and, in some cases, facilitates the monitoring of collusive agreements in the audit market. In addition, the direct cost of gathering and publishing data will increase with the amount of information required. For both reasons, it would in general be advisable therefore to minimize the amount of information required.

The US experience with the Securities and Exchange Commission disclosure requirement also calls for caution when assessing the impact of disclosure on parties' behavior. After contemplating mandatory disclosure of fees this possibility was discarded and from 1978 to 1982 SEC registrants had to disclose the ratios of total and material individual non-audit services fees to audit fees.³¹ The requirement was rescinded in 1982, however, because the SEC itself came to believe that it was "not generally of sufficient utility to investors" (SEC, 1982).³² Accounting firms, in particular, claimed that it had produced a curtailment of non-audit services. It was alleged that parties perceived that the SEC was deprecating the benefits of management advisory services performed by the auditor and that the SEC might question or criticize the independence of the auditor considering only the disclosed ratios of non-audit to audit fees.³³ Seemingly, at that time some clients were even setting arbitrary percentage fee limits on the non-audit services provided by their auditors and deciding not to engage their auditors to perform services discussed prior to the issuance of the interpretative release ASR 264, without considering the nature of the service and the potential impact on independence. Even if there are discrepancies regarding the real impact of the SEC rules,³⁴ the controversy shows that some mandatory

this rule does not apply if the audit has been carried out by one of the regulated firms, which are the larger ones. Also, in Australia, the financial statements of publicly listed companies make full disclosure of remuneration received by the auditor for both audit and other services.

³¹ See the SEC's *Accounting Series Release* (ASR) no. 250 (SEC, 1978). One year later, the SEC issued an interpretative release (SEC, 1979) describing several factors that auditors and registrants should consider when contracting non-audit services.

³² The possibility of re-introducing a fee disclosure rule was also rejected in the SEC report on auditor independence in March 1994. Auditing standards for publicly quoted corporations in the United States do require, however, that each audit firm disclose annually to the audit committees of their clients the nature and amount of the fees received for non-audit services provided to such clients.

³³ See SEC (1981, p. 3810; 1994, pp. 28-9).

³⁴ At least one study claimed that the rules did not significantly reduce the quantity of services provided (Scheiner, 1984). This result is questionable, however, on at least two accounts. First, the estimation did not consider the expected growth of non-audit services. In other words, the comparison was made between quantities *before* and *after* the rules and not *with* and *without* the

disclosures or, in particular, regulatory activism on the matter risk over-emphasizing the negative effects of non-audit services (unfortunately, it is impossible here to disentangle the two effects: the impact of disclosure on the market, which might be considered less risky, from that deriving from possible criticism or action by a powerful regulator.) In both cases, the difficulties that less-informed market participants have shown in correctly evaluating auditor independence (remember their apparent bias against non-audit services, documented in Section 1.4, n. 14), may lead clients to acquire less than optimum non-audit services from the auditor.

Taking these costs and benefits into account, a rule making it obligatory to disclose maximum concentration (the contribution of audit firms' biggest clients to their total fee income) is preferable to a general disclosure of individual fees. Awareness of the maximum concentration figure (perhaps within a discrete scale of diversification) would provide valuable information for all those directly or indirectly involved in the market. Clients of the audit firm will thus have additional information to gauge the quality of the auditor, especially as to some of the incentives that affect his decisions. In the same way, those using the clients' accounts will in turn have additional information to assess their quality. The information held by those using the accounts of all of the auditor's clients will also indirectly be improved.

In any case, given that mandatory disclosure surely involves hidden and unforeseen costs and benefits which differ according to the different rules, its introduction and appropriateness are empirical questions which can never be answered completely. Arguments are useful when designing disclosure policies to avoid mistakes. However, careful attention to how the market reacts to the rules, and flexibility to eventually cancel or modify them, is also essential.

rules. Second, the impact of the rules on clients with the largest ratios of non-audit to audit fees (the ones claimed to be most affected) might have been underestimated. The impact on clients buying substantial non-audit services was indeed tested, but this test was made considering as "substantial" those clients with total non-audit services above the audit firm median. Both problems probably have the effect of substantially underestimating the alleged reduction in non-audit services.

3 Summary and conclusions

During the last few years there has been renewed interest on how to regulate the provision of non-audit services by auditors, audit firms or networks of audit firms to their audit clients. This provision of non-audit services has important consequences for service cost, audit competition, service quality and auditor independence. After examining these effects, this paper concludes that the provision of non-audit services reduces total costs, increases technical competence and motivates more intense competition. Furthermore, it does not necessarily damage auditor independence nor the quality of non-audit services.

With regard to cost savings, it causes two kinds of economies of scope—productive and contractual. *Productive* economies of scope are usually referred to in the literature as “knowledge spillovers”; audit and service provision share information both as a product and as a process. Economies of scope of a *contractual* nature exist because contracting professional services is potentially very conflictive. Therefore the same private safeguards can be used to provide audit and non-audit services.

A second effect relates to competition in the audit market. Applying standard analysis in industrial organization shows that the provision of non-audit services is unlikely to harm competition in the audit market. There is, however, a risk of confusing observations mainly because cost savings will cause price reductions in both markets and at each stage (initial or subsequent engagements), depending on specific competitive conditions. Also, in this industry, regulators and practitioners continue to see the pricing of initial engagements below cost—what usually is called “introductory pricing” or “lowballing”—as a bad practice instead of seeing it as a mere symptom of healthy competition. (However, prohibiting lowballing would be equivalent to preventing cellular phone cos. from giving away telephones to their new subscribers).

The third effect is on competition in the markets for non-audit services. This is probably the most clearly beneficial effect. Quality arguments here do not hold because clients are well informed about the eventual prejudicial effects of joint production. Therefore, it is an issue for the market to decide.

Finally, the discussion on independence is formulated in terms of quasi-rents. It is true that service provision increases auditor quasi-rents which are *specific to the client*. It might be

argued that this is detrimental to independence. However, in so doing, non-audit services also increase quasi-rents specific to *all clients*. Therefore the effect can be more than offset. What might be needed is just client diversification to ensure that the positive effect is larger than the negative effect.

On the basis of this analysis of the consequences of non-audit services, auditors should be allowed to provide all kinds of services and/or to self-regulate such provision. Regulation, if any, should focus on client *diversification* and help the market to act as the main disciplinary agent. Given that the variability of non-audit service fees is higher than that of audit fees, regulators might try to facilitate the role of the market when evaluating the incentives of audit firms. For this purpose, mandatory disclosure of fee income diversification is sufficient. In that case, disclosure of the maximum concentration reached with the best client would provide similar benefits without the more substantial costs involved in full disclosure of fees. However, given that mandatory disclosure rules surely involve unforeseen costs and benefits, careful attention should be paid to how the market reacts to their introduction. Flexibility in eventually canceling or modifying them is also essential.

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