Auditor-Provided Non-Audit Services:

Post EU-Regulation Evidence from Denmark

ABSTRACT

This survey study focuses on the relationship between the simultaneous provision of audit and non-audit services and auditor independence-in-appearance as perceived by Danish stakeholders. Thereby, the perceived usefulness of the new EU public-interest entity Regulation and Audit Directive is evaluated.

Our findings indicate that the joint provision of non-audit and audit services is negatively associated with perceived auditor independence. However, this differs according to the type of stakeholder group. Many individual services, even those not on the EU blacklist, are regarded as problematic. Nevertheless, the relation to independence-in-appearance differs by type of service. The EU cap on non-audit services fees seems to be too high. The separation between audit firms’ staff that provides auditing services and staff that provides non-audit services, and an approval of non-audit services by the audit committee, are not regarded as helpful in enhancing auditor independence. Finally, respondents see a need to expand the strict EU regulations for audits of public-interest entities to audits of large non-public-interest entities.

Keywords: auditing, auditor independence, non-audit services, EU audit regulation, stakeholder perceptions, survey
I. Introduction

This paper studies the impact of the provision of non-audit services on auditor independence, as perceived by Danish stakeholder groups, after the new EU Regulation on statutory audits of public-interest entities and enactment of the new EU Audit Directive into national law. Through a survey, the perceived appropriateness of the EU Regulation and of the amendment of the Danish Auditor Act is evaluated with respect to auditor independence.

The global financial crisis was instrumental in a renewed focus, both by users and regulators, on the suitability and adequacy of the legislative framework for statutory audits of financial statements. The question was raised as to how to enhance audit quality to mitigate future financial risks and crises (EC 2010). Audit quality can be defined as the market-assessed joint probability that a given auditor will both discover a breach in the client’s accounting system (competence) and report it (independence) (DeAngelo 1981). In the EU Green Paper on audit policy (EC 2010), the independence of auditors in general, and the provision of non-audit services in particular, were a major element, referring to independence as the “unshakable bedrock of the audit environment” (p.10).

The International Federation of Accountants (IFAC) distinguishes between independence of mind and independence in appearance (IFAC 2016). Independence of mind is defined as ‘the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism’ (Sec. 290.6a). Independence in appearance is defined as ‘the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm’s, or a member of the audit team’s, integrity, objectivity or professional scepticism had been compromised’ (Sec.290.6b). Both forms of independence can be affected negatively by the provision of non-audit services, as the IFAC Code of Ethics also acknowledges (IFAC 2016, Sec. 290.154).

To strengthen auditor independence, amongst other things, the European Council, the European Parliament and the European Commission agreed on April 16, 2014 to reform the audit sector, changing the Audit Directive and adopting a new Regulation for public-interest entities (European Parliament and Council of the European Union 2014). The Regulation specifies that audit firms of public-interest entities are prohibited from providing non-audit services to audit clients, which are fundamentally incompatible with their independence function, and lists such
services (blacklist approach). By way of derogation, member states may allow the provision of certain tax and of valuation services. In addition, the law caps non-audit fees to 70 percent of the average audit fees over the last three consecutive financial years. Member states may allow exemptions from this requirement for a period not exceeding two financial years; they may also apply a more stringent cap on non-audit fees.

Previous empirical studies have mainly shown that the provision of non-audit services does not compromise independence of mind (for example Craswell 1999, Ashbaugh et al. 2003, Chung and Kallapur 2003, Hope and Langli 2010), while independence in appearance does seem to be compromised by the provision of non-audit services (for example Krishnan et al. 2005, Francis and Ke 2006, Quick and Warming-Rasmussen 2005, 2009, Dart 2011).

Most studies on independence are US-based, and there are very few studies from Continental Europe and Scandinavia, even though the contexts differ substantially. In addition, these studies are mostly previous to the global financial crisis and, as far as we are aware, all of them before the implementation of the EU audit reform. Yet, the global financial crisis has had extensive and major consequences for the European economies. Trust in financial markets, financial institutions and general businesses has suffered. This has probably also changed the perceptions of stakeholders negatively, with respect to the supposed watch dog, that is, the independent auditor.

Two studies investigate independence in appearance post-financial crisis, but before the EU audit reform. Quick and Warming-Rasmussen (2015) conducted an experiment with German investors in 2010, before the EU Green Book, testing threats to independence for three non-audit services. They found that a high self-interest and a high-familiarity threat may impair auditor independence in appearance, while they did not reveal a significant effect of an existing advocacy threat. Campa and Donnelly (2016) investigate annual reports in the UK over the period 2006–2011, finding that independence of mind is indeed compromised by high non-audit services fees. They also find that independence in appearance (proxied by the client’s earnings response coefficient) is compromised by non-audit services fees, but this is balanced by the simultaneous recognition of benefits arising from the non-audit services. This suggests that the EU is justified in implementing reforms, but does not provide evidence on whether the changes are in line with stakeholders’ expectations and perceptions.

To summarise, it can be noted that there is a lack of contemporary as well as comprehensive European research on the impact of auditor-provided non-audit services on perceived auditor
independence. The objective of the study is to close this research gap. Due to a volatile and dynamic audit environment, a re-examination of issues investigated by prior research alone is reasonable. Beyond that, we expand prior research in a number of ways. A major contribution of this present paper is therefore that we analyse a broad range of stakeholder perceptions directly (that is, not proxied), and in a European (Danish), post-audit reform context. We extend previous research in a number of ways. First, we differentiate between other assurance services and consulting services. Second, we analyse the association with 38 different non-audit services, whereas Quick and Warming-Rasmussen (2005) only examined four non-audit services. Third, our subjects also include lawyers and financial analysts. Fourth, we also test whether the fee cap set by the European Union is too high. Fifth, we test whether there is a demand from stakeholders to expand the strict rules on the provision of non-audit services for public-interest entities to large, medium-sized and small non-public-interest entities. Finally, we test whether an approval of non-audit services by audit committees reduces perceived threats to independence. Overall, this study contributes to an evaluation of the perceived usefulness of the new EU regulation on specific requirements regarding statutory audit of public-interest entities.

Our findings indicate that the joint provision of non-audit and audit services is negatively associated with perceived auditor independence. However, participant perceptions differ by the type of stakeholder group. Many individual services, even those not on the EU blacklist, are regarded as problematic. Nevertheless, the impact on independence in appearance differs according to the type of service. In the light of our results, the EU cap on non-audit service fees does seem to be too high. The potential safeguard of the separation between audit firm staff that provides auditing services and audit firm staff that provides non-audit services, and an approval of non-audit services by the audit committee, are not regarded as helpful in enhancing auditor independence. Finally, respondents see a need to apply similarly strict regulations to non-public-interest entities that exceed certain size limits.

The remainder of the paper is organized as follows. First, we give an overview of the particularities of the Danish setting. The subsequent section discusses theoretical reasoning and prior research findings regarding the relationship between providing non-audit services and independence of mind and in appearance, and develops our hypotheses. We then describe our survey and the participating subjects in the study. The subsequent section presents and discusses the empirical results. A final section summarizes the main findings, concludes and points out the study’s limitations.
II. The Danish environmental setting

In many ways, the Danish context is similar to other European countries, and to global settings. There are some specific characteristics though. Like other Scandinavian countries, Denmark scores high on feminine values and gender egalitarianism, valuing equality, care, interpersonal trust\(^1\), close social relationships, low hierarchical structures, social obligation and social control (Hofstede 1991, Emrich et al. 2004).

With regard to the Danish financial reporting system, this has traditionally meant that almost all Danish companies have had to be audited. The Financial Statements Act (Årsregnskabsloven; ÅRL) divides commercial companies into reporting classes A-D, with increasing reporting demands for higher classes. Only the smallest companies (reporting Class A) are exempt from the reporting requirements, but can choose to follow the Act voluntarily. According to ÅRL §135, companies in reporting classes B, C and D are required to have their annual reports audited by a statutory auditor.

Only since 2006 has the legislator exempted small Class B companies from the annual audit (with some exceptions, like group accounts or companies sanctioned for breaking the laws). Exemption requires that these companies, at the balance sheet date, do not exceed two of the three following size requirements (changed in 2010) in two consecutive financial years: total assets of 4 million DKK; net turnover of 8 million DKK; average number of fulltime employees of 12. This was done to lift the relatively heavy burden of a statutory audit. Furthermore, the Danish legislator has implemented a rather curious new attestation standard on Extended Review (Udvidet Gennemgang), which can be chosen by non-exempted Reporting Class B companies, instead of a full audit. This Extended Review requires less work than an audit, but more than a review. It still may yield a positive opinion, but provides only reasonable assurance.

The Danish Parliament has implemented the new EU Directive through a new Auditor Act (Revisorloven; RL), which also takes the new EU Regulation on statutory audits of public-interest entities into consideration. Parliament has chosen to maintain an overimplementation with respect to the scope of the law, and a minimal implementation with respect to some other aspects (see below). The new Auditor Act thus remains mandatory for all assurance engagements, where the EU Directive only is required for statutory audits.

A distinctive characteristic of Danish Auditor Acts since 1994 is that the auditor is considered to be ‘the confidential agent of the community’ (offentlighedens tilidsrepræsentant; RL §16). This stipulation requires the auditor to ‘take the company’s surroundings into consideration’,
such as authorities, employees, customers, suppliers, creditors, investors, and local society, ‘even though the auditor is chosen by the owners of the company’ (Guidance on audit report statutory order; Vejledning om Erklæringsbekendtgørelse, p.10). This need for an independent expert as ‘a confidential agent of the community at large’ (Limperg 1932/1985: 43) is the auditor’s most important function, conforming well to Scandinavian values. This demand applies to all audit reports on financial statements, and to all other assurance reports that are used by third parties (that is, not solely meant for the principal’s own use) (RL §1.2). The scope of independence rules is thereby also stricter than in the rest of the EU, where rules only apply to statutory audits. This also raises the question of whether the provision of non-audit services negatively influences stakeholder perceptions of auditor independence and their role as a confidential agent of the community.

In contrast, minimal implementation was mostly chosen with respect to some of the provisions on non-audit services. Denmark used to have general independence rules for almost a century; from the first Auditor Act in 1909, auditors were prohibited from taking public office or working in other companies or lines of business. With respect to non-audit services, this meant that only assistance and consultancy in related areas were allowed, such as accounting, administrative systems, budgeting, prospects, finance, tax and management accounting (Langsted 2010). After several years of lobbying by the Danish professional organization, general independence was all but eliminated in the 2003 Auditor Act, as an almost total liberalization was adopted. Audit firms were then allowed to engage in any consultancy business for which they had or could obtain the necessary competences. Specific independence rules were subsequently made stricter though, also as a response to the Enron scandal (Holm and Warming-Rasmussen 2008). Even so, the only explicitly-forbidden non-audit services were for public-interest entities and only for bookkeeping and recruiting services (Statutory Order on Independence; Uafhængighedsbekendtgørelsen). As a result, liberalization has now reversed the situation, in that non-audit services in 2014 were responsible for 66 percent of total revenue in audit firms, compared to 34 percent for audits (FSR 2015).

The new EU Regulation’s art. 5.2 opens up the possibility for member states to prohibit additional non-audit services, besides those mentioned in the Regulation. However, Denmark has chosen not to use this option. The new Regulation’s art. 5.3 enables member states to allow otherwise prohibited non-audit services, if certain conditions are met. Denmark has, through a new RL §24a, chosen to do so for the following non-audit services: certain tax services (preparation of tax forms; support regarding tax inspections; identification of public subsidies.
and tax incentives; tax advisory services on the application of tax law) and valuation services, including those used in actuary services and for support in court cases. This exemption is on the condition that these services 1) do not have a material influence on the financial statements; 2) this is documented and explained to the audit committee and the board; and 3) that the auditor and audit firm are in compliance with the independence rules in RL §24.

Furthermore, the definition of public-interest entities was harmonised with other EU countries and thus changed to only specifically include companies with listed stock or debt instruments, and financial institutions, mortgage credit companies and insurance companies. This narrower definition more than halves the number of public-interest entities in Denmark from around 845 to around 385. Companies that are no longer directly included are certain state-owned public limited companies, municipalities, the administrative Regions, and very large companies, which are not listed and do not trade debt instruments. The government has opened up the possibility though for the Ministry of the Interior to include municipalities and regions under the new public-interest entity rules, which subsequently, with some exceptions, has been implemented.

The new EU Regulation art. 4 gives member states the option to implement a stricter fee cap than 70 percent for non-audit fees, but Denmark has chosen not to use this option. Even though the Regulation allows two years, the new Auditor Act’s §24b allows exempting an audit firm for a maximum of one financial year from the new cap on non-audit fees of 70 percent of the average audit fees. This exemption is only given in extraordinary circumstances, for example, where non-delivery of the consultancy service causes substantial damage to the company. It is at the moment unclear when this is considered to be the case. In most cases, Denmark has thus chosen a minimum implementation of the EU Audit Directive and Regulation.

In comparison to common law countries, investor protection is considered to be weak in Denmark (La Porta et al. 1998, 2000, 2006, Djankov et al. 2007). For example, Gul et al. (2013) derive investor protection scores based on a factor analysis of four investor protection indexes (anti-director rights index, index of disclosure requirement, index of liability standard, and index of public enforcement). They report a score of -1.256 for Denmark, while the United Kingdom and the United States score 0.335 and 0.939, respectively. Auditors might have a more important governance function in countries where legal institutions are weak (Choi and Wong 2007). Auditor liability is an important component of investor protection. Danish auditors are jointly liable (together with an auditee’s management), without limit, for the full amount of any loss suffered by a third party who trusted in the auditor’s report. However, in
practice, liability is limited to the audit firm’s insurance policy maximum amount, in that audit firms are likely to declare bankruptcy, if this amount is substantially exceeded. There are only a few court cases of this kind in Denmark (Sormunen et al. 2013). Thus, the litigation index for Denmark is 4.82, in contrast to 15.00 for the United States (Wingate 1997), indicating a relatively low level of liability exposure of Danish auditors. Since investor protection and liability exposure are relatively low in Denmark, these components do not ensure an appropriate level of audit quality. As a consequence, it is likely that Danish users of audited financial statements are relatively sceptical of auditor independence.

III. Prior research and development of hypotheses

The simultaneous provision of audit and non-audit services increases total revenue from one particular client. Providing non-audit services can also reduce audit costs, due to economies of scope. These economies can be of a contractual nature or consist of knowledge spillovers (Arrunada 1999). There is a trade-off between such spillovers and competition crossovers, at least in oligopolistic markets (Wu, 2006). This may result in audit firms not reducing their audit prices, even though supplying non-audit services enables firms to decrease auditing costs. As a result of these effects, the economic bond between the auditor and the client is strengthened.

Another important aspect is the structure of the audit market, specifically market concentration. Where the EU (2010) intends to decrease audit market concentration and strengthen independence by prohibiting the provision of certain NAS, Bleibtreu and Stefani (2012) have shown that prohibition can have the opposite result, depending on both the cost structure and the level of competition between large and small audit firms.

We distinguish between two lines of research on the relationship between the provision of non-audit services and auditor independence. These are studies on the relation to auditor independence of mind and those on the relation to auditor independence in appearance. The effect of providing non-audit services on independence of mind is difficult to observe. Previous studies in this area are mainly archival, and used proxies for independence (see Table 1). There are also a few experimental studies, such as Joe and Vandervelde (2007). The majority of these studies did not find a negative relationship between the provision of non-audit services and auditor independence.

[insert Table 1 about here]
Numerous studies have investigated the relation between providing non-audit services and independence in appearance (see Table 2). Some of these studies did not find a significant relationship, or even found a positive impact of the simultaneous provision of audit and non-audit services. However, the predominating result is a decline in perceived auditor independence.

[insert Table 2 about here]

Studies which particularly address the impact of auditor-provided tax services mainly yield a similar pattern with regard to independence of mind, that is, they do not reveal a negative association (see for example Kinney et al. 2004, Cook et al. 2008, Robinson 2008, Seetharaman et al. 2011, Krishnan and Viswanathan 2011). However, previous studies that have investigated the impact of audit firm-provided tax services on auditor independence in appearance and perceived audit quality, have yielded ambiguous results and often even a positive association (Mishra et al. 2005, Fortin and Pittman 2008, Quick and Meuwissen 2009, Cook and Omer 2013, Krishnan et al. 2013, Thornton and Shaub 2013). Tax services do not directly affect the accounts in which most misstatements originate (Gleason and Mills 2011) and provide insights into the client’s business, which are highly auditing-relevant. These issues probably explain the differing perceptions.

For our study, European survey research is of particular interest. Quick and Warming-Rasmussen (2005) investigated independence perceptions of a wide spectrum of stakeholders, that is, state-authorized auditors, managing directors, bank loan officers, private shareholders and business journalists. They found that shareholders, bank loan officers and journalists perceive a negative relationship between auditor-provided non-audit services and auditor independence. Furthermore, it was shown that the type of non-audit service influences the degree to which auditor independence is perceived to be impaired. In this context, Quick and Warming-Rasmussen used four different consulting services, namely accounting information systems, recruiting, legal and financial accounting services. Finally, the study demonstrated that a separation of audit firm consulting staff from auditing staff does not increase independence in appearance. In a similar way, Quick and Warming-Rasmussen (2009) surveyed German private investors, analysing 19 different non-audit services, and confirmed the findings by Quick and Warming-Rasmussen (2005). A questionnaire-based study from Dart (2011) revealed that the joint provision of audit and non-audit services is perceived by private and institutional investors as a threat to auditor independence. In addition, by analysing various services banned under the Sarbanes-Oxley Act, investor perceptions of individual non-audit
services were found to vary. Other findings of this study were that non-audit services should be banned, if audit personnel provide them, and that confidence in the independence of the auditor is higher, if a Big 4 audit firm provides non-audit services. Svanström (2013) examined the relationship between audit quality in private firms, as perceived by managers, and the findings suggest that perceived audit quality is positively associated with non-audit services in general, and services in accounting, tax and law in particular, but not with investment services. This indicates that a potential impairment of auditor independence can be offset by knowledge spillovers.

The theoretical reasoning, in conjunction with the majority of prior research which reports a negative association between auditor-provided non-audit services and perceived auditor independence, results in an expectation of a negative relationship. We expect that negative perceptions apply particularly in the Danish situation. This is due to the above-mentioned social values, a high level of trust which, however, is based on social control, the tradition for auditors to be considered the confidential agent of the community, some weaknesses in the corporate governance system, and the (in practice) relatively low level of investor protection. This probably leads to more concern among stakeholders regarding the provision of non-audit services. Therefore, our first hypothesis is as follows:

**H1: The provision of non-audit services impairs auditor independence in appearance.**

There are information asymmetries between management and the addressees of financial statements. However, the information level differs by user group. As a consequence, the importance of auditor independence varies by user. The more important financial statements are for user decisions, the more important the independence. Private shareholders do not have access to other information than published financial statements and therefore, they depend on the auditor’s report and on auditor independence. In contrast, financial analysts are better informed, for example via analyst conferences or private access to management, and thus often have earlier and better information than those from audited financial statements. Bank loan officers have the power to request internal information, like budgets and forecasts. Also, the provision of debt capital is less risky than the provision of equity capital. Financial journalists and lawyers are not direct users of audited financial statements, but may have other reasons to be sceptical, like competitive thinking or the search for marketable media reports.
Also, most prior studies have revealed a negative relation to independence (see table 2), for example because of self-review or self-interest threats. However, some studies failed to show any relationship at all (for example Ghosh et al. 2009, Campa and Donnelly 2016), or even found a positive association (for example Fortin and Pittman 2008, Nam and Ronen 2012). The differing research results with regard to the relationship between providing non-audit services and perceived auditor independence could have resulted from the analysis of different user group perceptions, for example auditors, directors, financial executives, bank loan officers, financial analysts, private and institutional investors, supervisory board members or business journalists. It is not surprising that differences in perceived independence exist, given the fact that the interests and information level of these groups are different. Therefore, we formulate our second hypothesis as:

**H2: The impact on perceived auditor independence differs by subject group.**

The provision of different types of non-audit services is more likely to create different threats, which could compromise, or could be perceived as compromising auditor independence (IFAC 2016, Sec. 100.12 and Sec. 290.154). Self-interest threats, which are a result of financial or other interests of the auditor, and familiarity threats caused by close relationships between the auditor and client, are related to all non-audit services. In contrast, self-review threats, which occur when a previous judgment needs to be re-evaluated by the auditor, who was also responsible for that judgment, are related only to certain non-audit services. The same applies to advocacy threats, which arise when an auditor promotes a position or opinion to the point that subsequent objectivity may be compromised. Different non-audit services are thereby exposed to different independence threats, which in turn are likely to cause differences in perceived auditor independence.

Prior studies used different types of consulting services, for example bookkeeping (Jenkins and Krawczyk 2001), accounting information systems (Lai and Krishnan 2009), tax planning and preparation (Krishnan et al. 2013), transaction services (Quick and Warming-Rasmussen 2015), executive search (Beattie et al. 1999), actuarial services (Jenkins and Krawczyk 2002), legal services (Jenkins and Krawczyk 2001) and outsourcing of the internal audit function (Hill and Booker 2007). The impact of these different non-audit services on perceived auditor independence varies. Based on the different independence threats exposure and the prior literature, in which perceptions differ by service type, our third hypothesis is:
H3: The impact on perceived auditor independence differs by the type of non-audit service.

The higher the non-audit service fees, the greater the self-interest threat, which increases the economic bond between the auditor and the client. It is quite likely that the relationship is non-linear. The EU assumes that economic bonding only has a negative impact on independence perceptions, when a certain threshold is exceeded.

Quick and Warming-Rasmussen (2005) found that the upper limit of the relative consulting fee varies between Danish subject groups and is 25 percent of total fees. A similar result of 27.9 percent is reported by Quick and Warming-Rasmussen (2009) for German private investors. An archival study by Eilifsen et al. (2015), which is based on earnings-response coefficients, stresses that the optimal non-audit fee cap might be about 56 percent of audit fees. Overall, prior research has revealed that stakeholders tolerate only a low level of non-audit fees, which leads to our fourth hypothesis:

H4: The non-audit fee cap set by the European Union is too high.

Familiarity threats occur due to close relationships between auditor and client. Hence, the auditor is more likely to become sympathetic to the interests of the client. Consulting is based on a special bond of trust between consultant and client management. This is more likely to result in excessive trust in the client and insufficient objective testing of the accounting data. A separation of the two tasks clearly reduces the familiarity threat.

Prior literature has demonstrated that the separation of audit firm staff performing non-audit services from those performing the financial statement audit, has a significantly positive impact (for example Pany and Reckers 1983, Lowe and Pany 1995, Canning and Gwilliam 1999, Lowe et al. 1999, Swanger and Chewning 2001, Hill and Booker 2007, Quick and Warming-Rasmussen 2009). The use of separate personnel mitigates stakeholder concerns. However, findings from Denmark (Quick and Warming-Rasmussen 2005) did not indicate an increased level of confidence in auditor independence through separating the auditing and the consulting function within the audit firm. Due to the fact that separation of staff generally reduces the familiarity threat, we nevertheless state the fifth hypothesis as:

H5: A separation of audit firm consulting staff from auditing staff increases perceived auditor independence.
The EU Regulation and its blacklist of prohibited non-audit services are only valid for statutory audits of public-interest entities. This limited scope is based on the notion that the public-interest function of statutory audits means that a broad community of people and institutions rely on the quality of audits. Audits contribute to the orderly functioning of markets and to achieving a high level of consumer and investor protection. Thus, the EU assumes that stricter requirements for the statutory audit of public-interest entities are necessary, because the potential negative consequences of misstatements for stakeholders are usually greater than for other types of entities. For them, the possible costs of stricter rules probably outweigh the benefits of avoiding audit problems (European Parliament and Council of the European Union 2014). In contrast, private firms are often characterized by a lesser degree of separation between owners and managers, and by a less-dispersed ownership, which in turn reduces the need for an independent audit (Collis 2010). Based on these arguments, we formulate two further hypotheses:

**H6a:** There is no demand for a strict prohibition of non-audit services for the audit of large non-public-interest entities.

**H6b:** There is no demand for a strict prohibition of non-audit services for the audit of small and medium-sized non-public-interest entities.

The EU Regulation states that the auditor should be able to provide non-audit services which are not prohibited, if the provision of those services has been approved in advance by the audit committee (art. 5.4). Audit committee tasks include monitoring and checking the reporting process, internal controls, risk management, external audit, independence of the auditor, and the provision of non-audit services rendered by the auditor (RL §31). Thus, we assume that approval by the audit committee mitigates stakeholder concerns about auditor independence and we thus form our final hypothesis as:

**H7:** An approval of non-audit services by the audit committee increases perceived auditor independence.

**IV. Methodology**

To address our hypotheses, we developed a questionnaire which was sent to lawyers, private shareholders, bank loan officers, financial analysts and financial journalists. Lawyers were included, because they can be regarded as major competitors of auditors with regard to many
consulting services. Also, they often are members of the supervisory boards of Danish companies. Finally, they are members of the independent audit tribunal under the Danish Business Authority, and they involve themselves in legislative processes concerning the Auditor Act. We included private shareholders, because they are important providers of equity capital and they do not have access to information other than published financial statements. There is, thus, a high need to protect them, for example by independence rules. Bankers were selected, because they are the major providers of debt capital. Financial analysts are of interest, since their expertise is generally high and their assessments are highly influential. Finally, our sample also comprised financial journalists, due to their influence on public opinion. They can thus be considered representatives of the community at large.

With respect to H1 and H2, the participants were asked to assess the following questions on a 7 point Likert scale:

Q1. ‘What is the effect of the joint provision of audit and other assurance services on auditor independence?’ 1 = substantial improvement, 4 = no effect, 7 = substantial decline.

Q2. ‘What is the effect of the joint provision of audit and consulting services on auditor independence?’; 1 = substantial improvement, 4 = no effect, 7 = substantial decline.

With respect to H3, prior research has revealed that the type of non-audit service is associated with the degree of perceived independence (for example Quick and Warming-Rasmussen 2005, 2009 and 2015). Therefore, we performed separate analyses for 38 different non-audit services (see Table 7). We included services which were subject to prior research and those currently discussed or already prohibited by regulators. In addition, we visited the webpages of large audit firms to identify currently-offered consulting services. We asked the following question, separately for each individual service:

Q3. ‘What is the effect on auditor independence, when the same audit firm provides the following non-audit service to its audit client?’; 1 = substantial improvement, 4 = no effect, 7 = substantial decline.

With respect to H4 on the new EU cap on non-audit services fees, the participants were asked to quantify their acceptable percentage:

Q4. ‘Total fees for non-audit services shall not exceed ___ % of total fees of the auditor before auditor independence is regarded as insufficient! Please estimate a percentage!’.
To test our fifth hypothesis whether the separation of audit firm consulting staff from auditing staff increases independence, the participants were asked to assess on a 7-point Likert scale the following question:

\[ Q5. \text{‘Your confidence in an independent audit will increase significantly, if auditing and consulting services are provided by different accountants from different departments of the audit firm’; 1 = strongly disagree, 4 = indifferent, 7 = strongly agree.} \]

With respect to H6a and b, on the extension of strict requirements to non-public-interest entities, participants rated the following statements:

\[ Q6a. \text{‘The law should prohibit audit and non-audit services for the same client for all very large entities, whether they are listed or not (very large entities are defined as having a balance sheet total ≥ 5 billion DKK; sales ≥ 5 billion DKK; number of employees ≥ 2,500’; 1 = strongly disagree, 4 = indifferent, 7 = strongly agree.} \]

\[ Q6b. \text{‘The legal restrictions concerning the joint provision of audit and non-audit services for the same entity should apply equally to small and medium-sized entities’; 1 = strongly disagree, 4 = indifferent, 7 = strongly agree.} \]

To test H7 on the impact of audit committees, we included a statement referring to this issue:

\[ Q7. \text{‘Your confidence in an independent audit will increase, if the provision of non-audit services by the statutory auditor requires an approval of the audit committee’; 1 = strongly disagree, 4 = indifferent, 7 = strongly agree.} \]

The questionnaire was tested to ensure understandability and completeness by five people: a lawyer, a private shareholder, a banker, a state-authorized public accountant and an accounting academic. Only minor changes were suggested and made. The distribution was done in cooperation with the chairpersons of the Danish Stockholders Society, Danish Finance Society, and Danish Lawyers and to two databases with 990 bank loan officers. Danish Stockholder Society limited the distribution to 200 selected members, who are leaders of local member groups in Denmark, and can be regarded as key informants (that is, having high levels of knowledge and influence). The others forwarded the questionnaire to all their members. In addition, we contacted one of the most well-known financial journalists in Denmark, who informed us that only 20 of his colleagues were knowledgeable enough to participate in our survey and he forwarded the questionnaire to these key informants.
The questionnaire was motivated by a clear description of the (then ongoing) auditing law regulation initiated by the EU, and the need for current data. The potential respondents were promised anonymity, offered a summary of the results, and asked to respond before Easter 2016 (which gave them a response time of approximately 10 days). They could gain access to the electronic questionnaire in Survey Xact by clicking a web link. This process resulted in 110 usable responses. To increase the number of participants, all subject groups received a reminder. The survey finally resulted in 205 usable responses (33 lawyers (response rate 1 percent), 51 private shareholders (25 percent), 59 bankers (6 percent), 51 financial analysts (4 percent), and 11 financial journalists (55 percent)).

To assess the risk of non-response bias, based on the assumption that late responders are similar to non-responders, early and late responses were compared by performing a series of Mann-Whitney U-tests (Oppenheim 2000). More precisely, we used the concept of successive waves, by comparing responses received after the call for participation, with responses after the reminder. Subjects who responded in the second wave are assumed to have responded because of the additional stimulus and are assumed to be similar to non-respondents (Armstrong and Overton, 1977). These tests did not find significant differences between the judgments of early and late respondents (significances between 0.173 and 0.967), indicating that the null hypothesis that early and late respondents have the same distribution was not rejected.

Table 3 outlines the characteristics of respondents. Participants were predominantly male (90.2 percent) and their average age was 51.8 years (with a variance between 26 to 82). The mean of group-specific experience of the surveyed professionals was 21.8 years and ranges between 1 and 50 years. Finally, the participants self-assessed their accounting expertise as higher than their auditing expertise.

To test our first hypothesis:

**H1: The provision of non-audit services impairs auditor independence in appearance,**

V. Empirical Results

1. The provision of other assurance and consulting services in general

To test our first hypothesis:
that is, to examine the general association between other assurance services and independence in appearance and between consulting services and independence in appearance, we tested whether the means of the responses to Q1 and Q2 differ significantly from 4, by applying one-sample t-tests. The results indicate that the provision of other assurance services (mean = 4.322, T = 3.945, p = 0.000) and the provision of consulting services (mean = 4.995, T = 9.780, p = 0.000) both have a highly significant negative impact on perceived auditor independence. Therefore, H1 is confirmed. However, when differentiating by stakeholder group, it can be shown that the negative influence of other assurance services is driven mainly by lawyers (mean = 4.594, T = 2.343, p = 0.026) and financial analysts (mean = 4.340, T = 2.351, p = 0.023), whereas no significant association was found for bankers, private shareholders and journalists. However, the impact ratio is highest for journalists, indicating that this group perceives a decline in independence most frequently. In contrast, all stakeholder groups perceive a highly significant negative impact of consulting services on independence in appearance (lawyers: mean = 5.788, T = 7.798, p = 0.000; private shareholders: mean = 4.784, T = 3.800, p = 0.000; bankers: mean = 4.661, T = 3.602, p = 0.001; financial analysts: mean = 4.980, T = 4.879, p = 0.000; journalists: mean = 5.455, T = 3.525, p = 0.005). For details, see Tables 4 and 5.

In summary, our findings suggest that auditor-provided consulting services are perceived as problematic by stakeholders and thus, that regulatory initiatives to restrict the provision of such services are justified. Moreover, in the light of our results, the provision of other assurance services might also endanger independence in appearance. This potential problem has not been covered by regulators so far. Lawyers have the most negative perceptions, which may be caused by the fact that they compete with auditors with regard to many non-audit services (for example, tax services). In contrast, the concerns of bankers are the lowest. This may reflect creditors being less dependent on audited financial statements, because they have the market power to demand insight into internal documents before granting credit.

To test our second hypothesis:

**H2: The impact on perceived auditor independence differs by subject group,**
that is, to examine whether the general relation of other assurance services and of consulting services to independence in appearance differs by subject groups, we performed Kruskal-Wallis-tests. Regarding the association with providing other assurance services, the test does not indicate significant group differences (z-score = 2.711, p = 0.607). However, perceptions concerning the association with auditor-provided consulting services differ significantly between types of participant (z-score = 19.448, p = 0.001). In addition, we performed pairwise comparisons between the individual subject groups by applying Mann-Whitney U Tests. Table 6 shows that there are no significant differences between the different types of participants with respect to the provision of other assurance services. Regarding the provision of consulting services, we particularly identified differences between direct financial statement users, such as investors, and indirect ones, such as journalists. Consequently, H2 can be partially accepted.

[insert Table 6 about here]

2. The association with individual non-audit services

To explore the relationship between auditor independence and 38 different non-audit services, we tested whether the means of the responses to Q3s differ significantly from 4, by applying one-sample t-tests. Based on the results (for details, see Table 7), it can be assumed that the provision of practically all services potentially endangers independence in appearance (all means exceed 4.0). With the exception of preparing financial statements (mean = 4.163, T = 1.163, p = 0.165), the t-tests revealed a significant association with all services. Thus, H1 is again confirmed.

[insert Table 7 about here]

Separate analyses for individual stakeholder groups show that the amount of services perceived as being critical differs by the type of stakeholder (lawyers: 35, private shareholders: 21, bankers: 18, financial analysts: 32, journalists: 17 – the relatively low number of services, which are significantly perceived as having a negative impact is probably related to the low number of participants from this group). This confirms prior research, which shows that independence perceptions indeed differ by service type. Moreover, our results also confirm the observation from previous studies that perceptions differ by subject group, for example auditors, directors, financial executives, bank loan officers, financial analysts, private and institutional investors, supervisory board members or business journalists. This might be explained by the fact that the interests of these groups and their expertise in accounting and auditing are different, as are their levels of information.
To analyse whether independence perceptions differ by the type of non-audit services and thus to gain support for our third hypothesis:

**H3: The impact on perceived auditor independence differs by the type of non-audit service,**

we performed a Kruskal-Wallis-test. The result indicates significant differences between the independence perceptions for different non-audit services ($z$-score = 396.889, $p = 0.000$) and confirms H3.

Several lessons can be learned from these observations. Firstly, a general prohibition of all non-audit services by statutory auditors does not appear necessary, and the selective blacklist approach thus seems appropriate. Secondly, the fact that independence perceptions differ by subjects poses problems for regulators, who need to decide what stakeholder group is to be preferred. Thirdly, there is only a partial overlap between prohibited services and services perceived as critical. Some non-audit services are prohibited by the EU, because they cause a self-review threat, for example designing and implementing internal control procedures, but are not perceived negatively by stakeholders. Many non-audit services are not prohibited by the EU, for example those related to treasury management, project management, or performance management. They are presumed to create little threat to auditor independence, but are perceived as problematic by the participants of our study. One possible explanation for this gap is a lack of understanding of these services by stakeholders, a problem which is difficult for regulators to solve.

Fourthly, the new EU Regulation (as implemented in the Danish RL §24a), allowing certain otherwise prohibited tax services and valuation services, should also be considered critically. As can be seen in Table 8, all are perceived as problematic. However, the degree of perceived negative impact differs by the type of tax service, for example, preparing tax forms does not impact nearly as much on perceived auditor independence as the provision of valuation services, the identification of public subsidies and tax incentives or other tax advisory services. In addition, perceptions differ by stakeholder group, that is, the results are often driven by lawyers and by financial analysts, whereas private shareholders and bankers normally do not believe that the provision of tax services impacts negatively on auditor independence.

[insert Table 8 about here]

3. **Further analyses**
a. Fee cap

We tested whether the new EU Regulation capping non-audit services fees at 70 percent of audit fees is appropriate by asking participants to quantify their acceptable percentage.

Overall, the mean is about 27 percent (equal to about 37 percent of audit fees) and the median is 20 percent. Again, the assessments differ by subject group (lawyers: mean = 22 percent, equal to about 29 percent of audit fees, median = 10 percent; private shareholders: mean = 31 percent, equal to about 45 percent of audit fees, median = 25 percent; banker: mean = 29 percent, equal to about 41 percent of audit fees, median = 27 percent; financial analysts: mean = 28 percent, equal to about 38 percent of audit fees, median = 25 percent; journalists: mean = 16 percent, equal to about 19 percent of audit fees, median = 10 percent). For the analysis of the fee cap, we had to eliminate eight outliers, that is, answers exceeding 100 percent, which have to be classified as incorrect, because such a percentage is of course impossible. In summary, our results demonstrate that non-audit fees, which fall below the EU cap are also perceived as negative, that is, the determined cap might be too high (see Table 9).

To investigate whether the mean is significantly lower than the EU non-audit fee cap, and thus to test our fourth hypothesis:

H4: The non-audit fee cap set by the European Union is too high,

we performed a t-test. The outcome (T = -7.184, p = 0.000) indicates a significant difference between the mean threshold evaluation of our participants and the one included in the EU Regulation. Therefore, H4 is supported.

b. Staff separation

Auditors are required to consider and apply safeguards to eliminate significant threats, or at least to reduce them to an acceptable level (IFAC 2016, Sec. 100.2, 100.7). Such safeguards include making arrangements so that personnel providing consulting services do not participate in the audit engagement (for example IFAC 2016, Sec. 290.168, 290.173, 290.181, 290.186, 290.188, 290.189, 290.207, 290.209, 290.213, and 290.214).

To test our fifth hypothesis:
H5: The separation of audit firm consulting staff from auditing staff increases perceived auditor independence,

that is, to examine whether the separation of audit and consulting staff increases confidence in an independent audit, we tested whether the mean of responses to Q5 is significantly different from 4 by applying one-sample t-tests. Our findings suggest that this safeguard is not effective (mean = 4.179, T = 1.029, p = 0.305). Consequently, the results do not support H5. This finding might be associated with a perceived flat hierarchy, relatively small organizations and close interpersonal relations within Danish audit firms (village market; Hofstede 1991). When the individual subject groups are evaluated separately, a significant positive influence can be identified for bankers (mean = 4.857, T = 2.465, p = 0.020) and (weakly) for private shareholders (mean = 4.500, T = 1.715, p = 0.095). Thus, the findings of a prior study based on Danish data (Quick and Warming-Rasmussen 2005), which did not find an increased level of trust in the auditing function through separating the auditing and the consulting function within the audit firm, are confirmed. For more details, see Table 10:

[insert Table 10 about here]

Danish subjects (apart from bankers and private shareholders) either do not believe in the effectiveness of such a safeguard or they assume that such a separation of tasks is already applied by audit firms.

c. Application to Non-Public Interest Entities

The EU Regulation and its blacklist of prohibited non-audit services are only valid for statutory audits of public-interest entities. Therefore, we tested whether there is a demand for an extension of such strict requirements to non-public-interest entities, that is we tested H6a and H6b:

**H6a:** There is no demand for a strict prohibition of non-audit services for the audit of large non-public-interest entities.

**H6b:** There is no demand for a strict prohibition of non-audit services for the audit of small and medium-sized non-public-interest entities.

Again, we tested whether the mean of responses to Q6a is significantly different from 4 by applying one-sample t-tests. Our results indicate that our subjects prefer equally strict requirements for large non-public-interest entities (mean = 4.774, T = 4.435, p = 0.000). H6a
has to be rejected. This impact is mainly driven by the lawyers (mean = 5.960, T = 7.006, p = 0.000), but apart from financial analysts who are indifferent, perhaps because they do not deal with private companies, all other subject groups perceive the same, with a weak or medium level of significance. One explanation for this unexpected finding could be that traditional Danish values imply expecting a certain degree of equality, social control and social obligation, justifying a demand to extend the same prohibition of non-audit services to large non-public-interest entities. Table 11 documents the results in detail:

[insert Table 11 about here]

Concerning small- and medium-sized entities, we tested whether the mean of responses to Q6b is significantly different from 4, by applying one-sample t-tests. Our results show no support for stricter rules. The participants are indifferent (mean = 4.231, T = 1.456, p = 0.148). H6b cannot be rejected. Only lawyers (mean = 5.308, T = 3.648, p = 0.001) and, with a weak significance, journalists (mean = 4.750, T = 2.049, p = 0.080) agree to applying a similar regulation regarding the provision of non-audit services for small- and medium-sized entities, see Table 12.

[insert Table 12 about here]

d. Approval by audit committee

According to the EU Regulation, a statutory auditor or an audit firm should be able to provide non-audit services which are not prohibited, if the provision of such services has been approved in advance by the audit committee. Thus, to test hypothesis 7:

**H7: An approval of non-audit services by the audit committee increases perceived auditor independence,**

we examined whether a preceding approval of a non-audit service increases user confidence in an independent audit. We tested whether the means of responses to Q7 differ significantly from 4, by applying one-sample t-tests.

For the total sample (mean = 4.211, T = 1.559, p = 0.121), we did not identify significant support for an approval by the audit committee, that is, H7 is not supported. When differentiating the stakeholder groups, only journalists show a clear preference for this measure (mean = 4.750, T = 2.393, p = 0.048), see Table 13. The agreement ratio is highest for bankers, which means that the support for an approval by the audit committee is most common for bankers.
Possibly, users assume that audit committee members do not sufficiently understand the perceptions of users and therefore, act in the interest of management instead.

VI. Conclusion

Auditor independence is commonly referred to as the cornerstone of the auditing profession. Following the global financial crisis, the public has critically scrutinized whether statutory auditors are sufficiently independent of their clients. As a consequence, the European Union confirmed that independence should be ‘the unshakable bedrock of the audit environment’ (EC 2010: 10) and took action to reinforce the independence of auditors and to address the conflicts of interest which are inherent to the provision of non-audit services by audit firms. This resulted in the EU Regulation (European Parliament and Council of the European Union 2014), which includes the prohibition of a long list of non-audit services and a cap on non-audit fees, as means of enhancing the independence of statutory auditors and audit firms carrying out statutory audits of public-interest entities.

Our study contributes to the discussion on the appropriateness of these measures. It was designed as a survey and based on a comprehensive questionnaire to analyse the independence perceptions of various stakeholders from Denmark. Independence of appearance is a necessary condition for enabling auditors to fulfil their societal role. The participants perceive a negative impact of the provision of non-audit services on auditor independence, that is, in the light of our findings, the related actions of the European Union are justified. However, the assessments of our respondents differ between the included subject groups and, in particular, only lawyers and financial analysts perceive a negative impact of the provision of other assurance services. Possibly, many subjects might have had knowledge spillovers in mind, when making their related assessments. This confirms the European Union’s decision to exclude other assurance services from its blacklist and reveals the fundamental problem that stakeholders have heterogeneous interests, which cannot be completely served simultaneously.

When analysing the relationship with individual non-audit services, it was revealed that the perceived impact of individual non-audit services differs by type of service and again by stakeholder group. As a consequence, a general prohibition of the provision of non-audit services, as proposed by the ‘audit firm only-approach’ of the European Commission, seems
unnecessarily strict. However, many services which are not on the blacklist, were evaluated negatively. This might indicate an expectation gap, and a lack of completeness with regard to the EU prohibitions. Another notable result is that services which encompass a self-review threat (for example, internal control systems, preparation of financial statements or accounting information systems), in addition to self-interest and familiarity threats to which all non-audit services are exposed, often are perceived as less negative. Possibly, subjects do not perceive self-interest threats as important.

With regard to the upper limit of non-audit fees set by the European Union, the outcome of our study suggests that 70 percent of the audit fees might be too high to ensure that auditors are perceived as independent. Separation of audit and consultancy staff are not regarded as helpful in enhancing auditor independence. Such a measure reduces only the familiarity threat and perhaps stakeholders consider this threat as less relevant. In the light of our findings, there might be a need to extend strict prohibitions of non-audit services to large non-public-interest entities as well, but not to small and medium-sized entities. Finally, our results indicate that a preapproval of auditor-provided consulting services by the audit committee is not regarded as helpful. Possibly, our respondents lack confidence in audit committee member competence in identifying independence threats.

Due to several limitations of our research project, its findings must be interpreted with caution. Firstly, we decided to perform a survey, because this method enables a particularly comprehensive analysis. However, the research objectives of surveys are quite clear, which increases the risk of dishonest or opportunistic answers. Furthermore, certain questions, for example regarding the scales of our 7-point Likert scales, may be interpreted differently by different respondents, which then yields unclear data. Secondly, we collected the assessments of very different stakeholder groups on the joint provision of audit and non-audit services. Nevertheless, we were unable to include all relevant users of audited financial statements. Other addressees, such as institutional investors or supervisory boards, or audit committee members, might think differently. Thirdly, the number of participants and the participation rate are quite low. This applies in particular to lawyers, financial analysts and bankers. Non-participants might have different attitudes and as a consequence, we cannot guarantee the representativeness of our results. Our tests for non-response bias might therefore be limited in value (Wallace and Mellor, 1988). These tests did not indicate a non-response bias. Nevertheless, a self-selection bias cannot be excluded, since participation in our survey was voluntary and it is possible that, for example, highly critical subjects were more likely to participate.
Fourthly, despite the pilot tests we performed, it is possible that participants did not correctly understand our questions and consequently provided biased responses. Fifth, our study deals with the impact of auditor-provided non-audit services on perceived auditor independence, that is on independence in appearance. Their relationship to independence of mind is not analysed and might be different. Sixth, we performed a series of tests with regard to the individual subject groups. The low sample size per group reduced the likelihood of significant findings. Seventh, according to DeAngelo (1981), audit quality is defined as the joint probability that auditors reveal material misstatements (auditor competence) and that they are willing to report them (auditor independence). The provision of non-audit services results in knowledge spillovers, that is, increase auditor knowledge of the client and thus might improve auditor competence. Therefore, a negative influence on perceived independence need not result in perceptions of reduced audit quality. Finally, our data are from Denmark and the findings might not be directly applicable to other environmental settings. However, there are other European countries with quite similar settings with respect, for example, to cultural values (Hofstede 1991, House et al. 2004), market and general legal mechanisms for investor protection (La Porta et al. 2006, Gul et al. 2013), and governance structures amongst others, specifically other Scandinavian countries, Baltic countries, the Netherlands and to a lesser extent, countries with a German legal tradition, and the results should also be of interest there.

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We regard trust as an attitude (as opposed to a behavioural choice). Control and trust are then complementary supplements and not conflicting substitutes (Li, 2007). Trust-as-attitude is then either an antecedent or a consequence of control. Furthermore, the effect of formal control should be judged by its purpose, rather than its mere presence. That is, audits are not used as a control mode, but rather to signal one’s long-term commitment.

An overview of prior research is provided by some meta-studies, see Lin and Hwang (2010), Habib (2012), Quick (2012), DeFond and Zang (2014), Sharma (2014).

Dansk Aktionærforening, Finansforeningen (financial analysts), Danske Advokater. The two databases with bankers are maintained by two banking academics at the University of Southern Denmark and Aalborg University.

To complement the information on the means, we have calculated the ratio between the numbers of respondents who answered 5-7 in relation to the number of respondents who answered 1-3 here. We have also done this in Tables 4, 5 and 10-13. We refer to these as the impact ratio and agreement ratio respectively. The meaning of these results is quite similar to that of the means.