

# The Impact of the Prohibition of Non-Audit Services on the Profitability of Big-4-affiliated Audit Firms in Bangladesh

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## ABSTRACT

The purpose of this paper is to study the impact of the prohibition of certain non-audit services by the Securities and Exchange Commission (SEC) of Bangladesh on the profitability of the audit firms which are affiliated with Big-4 international audit firms. This paper is based on personal in-depth interviews with the Big-4-affiliated audit firms. A qualitative approach, in a way which is descriptive and illustrative, is adopted in this research. This research provides evidence for the fact that audit services are the most significant and stable source of income for an audit firm. Although respondents generally admit that non-audit services might be more profitable, they all agree that audit services are indeed the core operations of an audit firm. Findings in this paper reveal a contemporary picture of the auditing profession in Bangladesh and elucidate the impact that the implementation of Corporate Governance Order 2006 has on an audit firm's profitability. This research is the first in-depth study of the impact of the prohibition of non-audit services on the profitability of the Big-4-affiliated audit firms in Bangladesh. Financial reporting regulatory authorities in Bangladesh or other developing countries may find the findings in this paper useful.

## 1. Introduction

Following the collapse of Enron and WorldCom, in order to restore the confidence of the public in the audit profession, the Sarbanes-Oxley Act (SOX) was enacted on July 30, 2002 to prevent similar accounting scandals. All American and foreign companies trading in any American stock exchanges are required to follow the SOX. According to Section 201 of the SOX, an audit firm cannot provide both audit and non-audit services to the same clients. As audit firms used to provide both audit services and non-audit services to their clients, the prohibition of the joint provision of audit and non-audit services might have some visible impacts on audit firms and at the same time on those companies which use both services.

Though the audit market in Bangladesh is not as well developed as that in the United States, restrictions similar to SOX are already in place in Bangladesh. Securities and Exchange Commission (SEC) of Bangladesh issued a Corporate Governance Order in 2006 (hereafter referred to as "CGO 2006"), prohibiting an audit firm from providing both audit and non-audit services to a client. The restricted non-audit services include the design of financial information systems, bookkeeping services, appraisal or valuation services, actuarial services, and internal audit services. CGO 2006 also requires listed companies to rotate their audit firms every three years (Siddiqui, 2012).

The effect of the prohibition of certain non-audit services on the profitability of the audit firms in Bangladesh has not yet been extensively investigated. This research aims to examine such an unexplored area. Findings in this paper may be useful to financial reporting regulatory authorities in Bangladesh, such as Securities and Exchange Commission and the Institute of Chartered Accountants of Bangladesh.

Bangladesh has a rapid growing economy where new corporations are emerging and existing corporations are expanding their businesses. The capital market has experienced several regulatory reforms. The Big-4 audit firms do not operate there directly. Rather, they operate through local audit firms. Therefore, the audit

environment in Bangladesh is may be different from that in the United States. This significance of this study lies precisely because of these issues.

## 2. Institutional Background

### 2.1. Audit Services Market in Bangladesh

The market for audit services is growing rapidly in Bangladesh. The major role of an audit firm is to provide statutory audit functions. However, most audit firms in Bangladesh also provide their clients with a variety of advisory services such as tax, systems design, valuation, and due diligence advisory services. Bangladesh has a fairly strong audit regulatory framework. According to the existent legislative provisions, companies have to conduct statutory audits by either a chartered accountant or a firm of chartered accountants. The legislative provisions come from a number of acts and ordinances, including the Companies Act 1994, the Securities and Exchange Rules 1987 (which was significantly amended in 2000), the Banking Companies Act 1991, the Insurance Act 1938, the Income Tax Act 1922, the Income Ordinance 1984, and the Nationalization Orders of 1972 and 1973. All joint-stock companies registered in Bangladesh have to conduct a statutory audit once a year by a chartered accountant. The professional body of chartered accountants in Bangladesh is Institute of Chartered Accountants of Bangladesh (ICAB). Provisions of the acts and ordinances authorize the members of ICAB to conduct the statutory audits.

According to statistics, as of 30 June 2005, there were 171 public accounting firms in Bangladesh. Among those 171 firms, 110 were sole proprietaries and 61 were partnerships. Sole proprietaries occupy a major share of audit service market by serving the small clients. Most of the partnership firms have two partners while the highest number of members in a partnership firm is 7.

Table 1  
Distribution of audit firms by number of partners

No. of Partners	No. of Firms
1	110
2	47
3	6
4	2
5	1
6	4
7	1
Total	171

Source: Karim and Hasan (2012)

Most audit firms in Bangladeshi are located in the capital city Dhaka, and they usually operate a single office. Of the 171 audit firms in Bangladeshi, 147 operate a single office; 23 maintain 2 offices (mostly in Dhaka and Chittagong or Dhaka and London); and only 1 has three offices. There is no significant difference among firms with single, two, or three offices. However, the number of office(s) of an audit firm may increase with its size. Generally, larger firms are often affiliated with Big-4 audit firms. ICAB has 266 practicing members and 494 non-practicing members. Most of the non-practicing members are in the senior management positions in the commercial sector. Some of the non-practicing members also hold influential positions in the government. There are 127 ICAB members working in different foreign countries. The international Big-4 audit firms are not directly operating in Bangladesh. However, some audit firms in Bangladesh have official affiliations with the Big-4 or non-Big-4 international audit firms.

As the economy of Bangladesh has been growing at an average rate of 5.61 percent per year for the last two decades, a demand for audit services is also growing at a fairly encouraging rate. In addition, the private sector is growing rapidly, resulting in a greater demand for audit services. Prior to its independence, Bangladeshi economy predominantly comprised private enterprises. Following the rationale of socialist economy, the first post-independence government of Bangladesh, through a number of Presidential Orders during 1972-73, nationalized all medium to large enterprises. During the Seventies and the Eighties of last century, the respective governments moved from a socialist economy to a market-oriented economy. The governments of late Eighties and Nineties initiated and implemented the policy of gradually denationalizing the state-owned enterprises. With the on-going denationalization, the number of non-state-owned companies increased, resulting in a keen demand for audit services. During the nationalization period, all the government enterprises were audited as one umbrella company by one audit firm, whereas during the denationalization period, governmental units were detached from the government to form commercial enterprises, thus enlarging the market of audit services for audit firms. For instance, in 1984, there were only two insurance companies and six commercial banks, which were all state owned enterprises; yet in April 2005, there were thirty-nine insurance companies, forty-nine commercial banks, and twelve leasing companies in operation. After 1975, the Governments allowed the establishment of private enterprises in different industries, leading to a sharp rise in the formation of companies in those industries, especially in the manufacturing and service sectors. Garments industry in Bangladesh nowadays has more than ten thousand companies, a phenomenon which could rarely

be found before 1975. As those companies are required to be audited, the demand for audit increases. The rapid growth in pharmaceuticals, textile, seafood, and leather sectors also enlarges the audit market.

Another factor which increases the demand for audit service is the increase of number of Non-Government Organizations (NGOs) operating in Bangladesh. Due to the aftermaths of the devastating floods in 1987, 1988 and 1998, and cyclones in 1991 and 2000, a huge amount of foreign aids flowed into the country in the last three decades. Donors prefer to donate their money through NGOs such as USAID, CARE, SIDA, CIDA, Action Aid, MCC, and OXFAM to help the affected people rather than through government agencies. The change in donor's preference leads to an increase in the number of NGOs operating in Bangladesh. Those NGOs are now playing an influential role in the economy of Bangladesh. Considering the number, size, and scope of activities of NGOs, both government and donors may deem it necessary that their activities and accounts need to be audited by professional accountants. One such example is the world's largest NGO, Bangladesh Rural Advancement Committee (BRAC). In last three decades, Grameen Bank, an NGO, has grown to an extent that its turnover and asset size are much bigger than many state-owned banks. The demand for audit service has increased substantially as a result of the rapid growth of the telecommunication sector. In a few years' time, several cellular phone companies have grown tremendously, resulting in a higher demand for audit services. In 2003, the reported revenue of the leading cellular phone company, Grameen Phone, exceeded the revenue of the largest publicly listed company, BATBC, of the country. The growth in telecommunication sector was so swift that by the end of the financial year 2006-07, the reported revenue of the third largest cellular-phone company, AKTEL, climbed to the same level as BATBC.

Consequently, the market for audit services is no longer confined to the joint-stock companies and government companies. Subsidiaries of multinational corporations operating in Bangladesh are generally audited by those professional accounting firms that have linkages with the international Big-4. In most cases, the parent company suggests the local company to select an audit firm that has a linkage with parent's audit firm. For instance, British American Tobacco (BATBC) selects Rahman Rahman Haq for auditing its accounts as it has linkage with BAT's international auditor KPMG. GEC (Bangladesh) Ltd. is audited by Hoda Vasi Chowdhury and Co., which associates with Deloitte.

Fees for audit services are lower in Bangladesh than in other countries. Audit fees paid by the majority of small and medium sized companies range from Tk. 30,000 (£234) to Tk.100, 000 (£781). The investment of foreign investors in the securities market in the Eighties of last century created a demand for high quality accounting and audit services. International corporations also demand for high standard accounting and auditing for their local subsidiaries. Therefore, there are ample opportunities for raising audit fees by providing high quality audit services in Bangladesh.

Table 2  
Average audit fees of DSE-Listed Companies

Year	Average Audit Fees ('000 Tk)	Average Total Audit Assets (Million Tk)	N	Average Audit Fees (Inflation Adjusted '000 Tk)	Average Total Assets (Inflation Adjusted Million Tk)	Exchange Rates (Tk for US \$1)	Average Audit Fees (US\$)	Average Audit Fees (Inflated Adjusted & in US\$)	Average Total Assets (Inflation Adjusted & in Million US\$)
1990	37.09	303.10	87	37.09	303	36	1,030	1,030	8.42
1991	38.72	297.86	94	36.87	284	38	1,019	970	7.47
1992	36.42	299.89	100	33.04	272	40	911	826	6.80
1993	42.22	317.83	103	36.47	275	42	1,005	868	6.54
1994	35.06	367.72	115	28.85	303	44	797	656	6.88
1995	38.29	448.87	132	30.00	352	46	832	652	7.65
1996	40.05	516.23	144	29.88	385	47	852	636	8.20
1997	41.20	564.30	162	29.28	401	48	858	610	8.35
1998	44.98	599.26	160	30.44	406	50	900	609	8.11
1999	60.87	603.93	193	39.24	389	52	1,171	755	7.49
2000	63.48	661.00	183	38.97	406	50	900	609	8.11
2001	65.65	715.77	187	38.38	419	56	1,172	685	7.47
2002	71.41	776.67	190	39.76	432	58	1,231	686	7.46
2003	78.03	873.15	208	41.38	463	60	1,300	690	7.72

Source: Karim and Hasan (2012)

## 2.2. Big-4 audit firms in Bangladesh

International Big-4 audit firms are not allowed to directly operate in Bangladesh. However, some audit firms have official affiliation with the Big-4 auditors and some with non-Big-4 international audit firms.

Table 3  
International affiliations of audit firms

Name of local affiliates of International audit firms	International firms with local affiliations	No. of Partners	No. of Staff
Local affiliated with Big 4			
Rahman Rahman Huq	KPMG	6	135
Hoda Vasi Chowdhury	Deloitte	7	150
S F Ahmed	Ernst and Young	3	55
A Qussem	PriceWaterhouseCoopers	4	83
Local affiliated with other foreign firms			
Hawladar Yunus	BDO	6	42
M J Abedin	Moore Stephen	2	58

Source: Karim and Hasan (2012)

Big-4-affiliated audit firms owns about 20-percent of the market share of auditing market based on the number of exchange-listed clients. The following table shows the year-wise market concentration of Big-4 and two med-tier affiliated firms for the period from 1990 to 2003. Surprisingly, in contrast to international trends, the affiliated firms' market share declines over the years.

Table 4  
Affiliated firms' share of the market (1999 to 2003)

Year	Big-4-affiliated's share	Two international med-tier linked firms' share	Affiliated firms' total share	N
1990	21	17	38	89
1991	20	17	37	94
1992	19	17	36	100
1993	20	17	38	104
1994	19	18	37	116
1995	17	17	34	132
1996	16	19	34	145
1997	14	16	30	162
1998	14	16	30	160
1999	13	18	30	193
2000	14	17	31	183
2001	14	18	32	187
2002	14	18	32	190
2003	16	18	34	208
Total	18	17	35	2063

Source: Karim and Hasan (2012)

There is a Big-4 premium in Bangladesh's audit market. Big-4-affiliated audit firms appear to earn audit fees which are higher than those of their unaffiliated counterparts. However, we can still find 2 non-Big-4 affiliated firms which earn higher-than-average audit fees.

### 3. Theoretical Framework

#### 3.1. Role of Auditing

The primary function of an audit process, according to Hayes et al. (1999), is to make financial statements reliable. Nowadays, ownership of a company is generally separated from management. Therefore, management has a responsibility to communicate the financial information of a company to investors. Investors obtain financial information from the financial statements so that they can make decisions on investments in the company. Trustworthiness is an important issue in this respect. Both investors and managers expect the financial information to be examined by an impartial external auditor (Porter et al. 1996).

#### 3.2. Non-Audit Services

After auditing a company, the auditor can have a profound understanding about the company. The mastery of both professional skills and knowledge about the client's company makes an auditor an ideal advisor for the client. Such an advisor provides services such as legal advice, tax services, management functions, and bookkeeping. Those services, not directly related to an audit, are considered non-audit services (SOX, 2002). According to Kinney et al. (2004), non-audit services improve audit quality. While providing non-audit services, an auditor extends to control over the overall management system of the client's firm, ensuring an audit to be of higher quality and accuracy.

Nevertheless, there are problems with the non-audit services. Many believe that rendering non-audit services to an audit client may hamper the quality of the audit process (Firth, 2002). When providing non-audit services, an auditor often develops a close relationship with the management. Such a relationship may lead an auditor to take side with the client, instead of following regulations (Soltani, 2004). The increased income from

both audit and non-audit services could make an audit firm more dependent on the client (Firth, 2002). When an auditor is afraid of losing both the audit and the non-audit services from a client, the auditor is probably less willing to criticize a client's financial statements than when the auditor provides only one type of service (Sharma and Sidhu, 2001).

### 3.3. Prohibition of Non-audit services by SEC of Bangladesh

Through CGO 2006, the Securities and Exchange Commission (SEC) of Bangladesh prohibited auditors from providing some non-audit services such as appraisal or valuation services, financial information systems design, book keeping services, actuarial services, and internal audit services. The same corporate governance order also made it mandatory for the listed companies to rotate their audit firms every three years (Siddiqui, 2012). The following are the services, which companies should not engage their external/statutory auditors in:

- *Appraisal or valuation services or fairness opinions:* This category includes valuation of assets, liabilities and real estate. However, services for non-financial reporting are not prohibited.
- *Financial information systems design and implementation:* This category includes the design and implementation of information system for a client in such a way that either the data will be a part of the financial statement or the system will produce important information for preparing the financial statement.
- *Bookkeeping or other services related to the accounting records or financial statements:* This category prohibits traditional bookkeeping and payroll services. An auditor should not assist his client in preparing financial statement whatsoever because it undermines his independence. However, the auditor may advise his client on some issues such as how to convert the financial statements of subsidiaries into parent's currency correctly during consolidation.
- *Broker-dealer services:* an auditor is not allowed to advise a client on whether to buy or sell client's securities. Additionally, an audit firm is not allowed to take investment decisions on behalf of the audit client.
- *Actuarial services:* An auditor is not allowed to provide actuarial services such as the calculation of life expectancy of the employees for the audit client to determine the size of pension funds.
- *Internal audit services:* An auditor is not allowed to provide most of the internal audit services, but he may recommend how to improve the client's quality of internal audit during the audit process.
- *Any other services that the Audit Committee determines.*

## 4. Methodology

This paper is both descriptive and illustrative. To identify the impact of the separation of audit services and non-audit services, as required by CGO 2006, on the profitability of Bangladeshi audit firms, we conducted in-depth personal interviews with representatives from Big-4-affiliated audit firms, one representative from each firm.

The interviewees are persons with sound knowledge of and regular exposure to CGO 2006. They come from firms affiliated with the Big 4 in order to visualize a holistic picture. All the interviewees are in manager level. The interviews were conducted in June 2013. As all the interviewees wanted to remain anonymous, their names and identities are not disclosed in this research. Most leading firms are annually audited by one of the Big-4-affiliated audit firms in which the representative works.

It is important to note that the views of the interviewees represent only the personal views of managers of Big-4-affiliated audit firms, instead of the views of the Big-4-affiliated audit firms. All the interviews were conducted in the respective offices of the interviewees. The interviews were conducted in English by the author. Each interview lasted for about an hour. Notes were taken during the interviews. Both primary and secondary data were collected for this research. The primary data comes from interviews with knowledgeable persons on the subject. Secondary data has been collected from different databases, Internet and literature. A questionnaire used in the interviews is outlined in Appendix 1.

## 5. Interviews with the representatives of the Big-4-affiliated audit firms

### 5.1. Effect on Profitability

The distribution of revenue between audit and non-audit services is an important indicator to measure the effects of CGO 2006 on the audit firms. Most of the interviewees opined that the revenue from audit service is more important than the revenue from non-audit services. All interviewees believe that audit service is of primary importance for an audit firm. According to CGO 2006, the contract period of an auditor in a business firm is generally three years. At the same time, an auditing contract should specify the audit fees in order to ensure that an audit firm can earn an income from this source. According to some interviewees, the downward trend of the fees of audit service is the major challenge faced by audit firms. They argued that, before CGO

2006 was passed, since most firms hired the same audit firm for both audit service and non-audit services, audit firms could earn more from non-audit services even though the audit firms charge a lower fee for audit services. However, after the enactment of CGO 2006, the audit firms now have to offer a lower fee to get the contract of audit service, yet they cannot provide the more profitable non-audit service.

All interviewees consider that non-audit service is more profitable. At the same time they also consider that providing a good audit service is important for maintaining a long-term relationship with clients because clients usually depend on their same auditors. If an audit contract lasts for a longer time, an audit firm can plan the audit work and they can better control the cost. Though the contract period of non-audit service is shorter, non-audit service is more profitable. Two interviewees emphasized that an auditor should have a competence to perform an audit. They consider both audit and non-audit services equally important.

## **6. Analysis**

### *6.1. Effect on Profitability*

The respondents of the Big-4-affiliated audit firms put more emphasis on audit revenue. Although non-audit services are more profitable, audit services are more secure because audit contracts usually last for several years. As the audit service is mandatory, it is less vulnerable to economic fluctuations. On the contrary, non-audit service is more vulnerable to economic fluctuations. Upon the introduction of CGO 2006, a company is expected to employ an audit firm for audit services and another audit firm for non-audit services. The audit services continue to be a more stable source of income compared to non-audit services.

CGO 2006 may have an impact on both audit and non-audit fees. Some of the interviewees pointed out that there was a falling trend in audit fee. In the past, in order to secure a non-audit service contract, audit firms lowered the prices of audit services because they consider that lower profit on audit service could be compensated by the profit from non-audit services.

## **7. Conclusion**

In order to avoid accounting scandals and increase the confidence of the public in the audit profession, Securities and Exchange Commission (SEC) of Bangladesh issued a Corporate Governance Order in 2006, which prohibited an audit firm from providing both audit and non-audit services to the same clients. Some restricted non-audit services include the designing of financial information systems, bookkeeping services, appraisal or valuation services, actuarial services, internal audit services, etc. This study investigates the impact of the prohibition of certain non-audit services by the SEC of Bangladesh on the profitability of the audit firms which are affiliated to Big 4 international audit firms.

This paper is based on personal in-depth interviews with the Big-4-affiliated audit firms. After interviewing the persons with sound knowledge of and regular exposure to the Corporate Governance Order 2006 of SEC of Bangladesh, we find that the distribution of revenue between audit and non-audit services of an audit firm will not be changed substantially by the implementation of CGO 2006. Findings in this study shows that auditing is the most significant and steady source of income for audit firms. However, the pattern and amount of the revenue flowing from audit and non-audit fees may be affected to a certain extent. If audit firms no longer consider non-audit service contract attractive, they may raise their audit fees as a compensation for the loss of profit in the non-audit services. Meanwhile, competition among audit firms for non-audit services may result in a reduction of the prices of non-audit services. As a result, CGO 2006 may have some impacts on the pattern of profitability in the audit firms.

This research presents a contemporary picture about the impact on profitability due to the implementation of Corporate Governance Order 2006 by SEC of Bangladesh. Findings in this research are useful not only for the academic community as a piece of contemporary information for further research, but also for the financial reporting regulatory authorities in Bangladesh or other developing countries for policy review and planning.

## Appendix A

Questionnaire used in this research:

The aim of the interview is to find out the impact of the prohibition of certain non-audit services by SEC of Bangladesh on the profitability of the Big-4-affiliated firms in Bangladesh.

1. What are your experiences in dealing with the impact imposed by the Corporate Governance Order 2006 regarding the prohibition of certain non-audit services?
2. Which companies audited by your audit firm are mostly affected by the Corporate Governance Order 2006 by SEC of Bangladesh?
3. Which type of revenue - audit or non-audit - is more important?
4. How important are audit services to an audit firm?
5. Which service - audit or non-audit - is more important to an audit firm?
6. Which service - audit or non-audit - is more profitable to an audit firm?
7. Which service - audit or non-audit - creates long-term relationship with clients?
8. How important is the level of competence of an auditor?
9. What are the main problems faced by your audit firm in relation to profitability, after the implementation of Corporate Governance Order 2006 by SEC of Bangladesh?

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