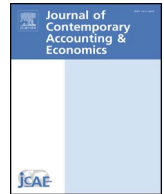




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## Knowledge spillover from other assurance services<sup>☆</sup>

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### ABSTRACT

We argue that services which are complimentary and closer aligned to the annual report audit provide greater insight about risk and are more likely to exhibit the existence of economies of scope (knowledge spillover) through a positive association with audit fees. Specifically, we consider the potential for knowledge spillover from the auditing of triennial Long-Term Plans (LTP) to the annual report audit for a large sample of New Zealand municipals over the period 2005–2013. We find the LTP audit fees are positively related to municipal annual report audit fees and other fees (audit of for-profit subsidiaries, non-audit services) are not. This suggests that knowledge spillovers are dependent on the nature of the additional services. We also find evidence of higher fees for private sector auditors for both the annual report and the LTP audit. The LTP (forecast) audit fee is associated with municipal size, complexity, and political competition.

### 1. Introduction

The relation between the provision of audit and other services by the same auditor has been extensively debated. [Causholli et al. \(2010\)](#) summarise the empirical evidence as inconclusive as to whether there is a positive, negative or no relation. The nature of this relation is important because it either supports the arguments for economic bonding between the auditor and client (non-independence) or for the existence of economies of scope (knowledge spillover). Concern over the joint production of auditing and other non-auditing services was originally related to services such as tax advice, internal audit and consulting. However, issues relating to the joint production of audit and other assurance services (OAS) may become more prevalent in the near future as non-financial assurance has been emphasised as a growing and developing area by practitioners (IASB, 2016), with auditing standards ISAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information* and ISAE 3400: *The Examination of Prospective Financial Information*.

In this study we investigate an institutional setting where a municipal council purchases an annual report audit for both itself and its council-controlled organizations (CCO), which are typically for-profit subsidiaries (e.g., utilities). They also purchase non-audit services (NAS) and an audit opinion on a long-term plan (LTP), a ten-year forecast required every three years. We examine the relation between audit fees and the purchase of other audit and assurance services. This decomposition of fees allows us to

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hypothesize which of these activities is likely to result in knowledge spillover. The conceptual basis for the efficiency and independence trade-off between auditing and consulting or other assurance services supplied by the same auditor is developed in Simunic (1984). Palmrose (1986) extends Simunic (1984) by examining whether the proximity of the additional services influences the existence and magnitude of any joint supply. We argue that knowledge spillover from auditing a LTP, which contains the forward estimates of financial information, is more likely to be present than from the provision of NAS (which in contrast to the LTP audit is normally conducted by a different non-audit partner and team) or the audit of unrelated activities (e.g., CCO audits). The LTP audit would provide greater insight about municipal audit risk than, for example, tax consulting. It is more likely to identify areas where further work would be required by the auditor. Accordingly, based on Simunic (1984) and Palmrose (1986), we expect a positive association between the LTP audit fee and the municipal annual report audit fee. As there may be efficiencies from the joint production of audit and other services, we adopt a two-stage least squares approach.

We use a sample of hand-collected data from 65 New Zealand municipalities for the years 2005–2013, and find the LTP audit fee is positively associated with the municipal annual report audit fee. This supports the view that fees for both the audit and other services are jointly determined (Antle et al., 2006; Chan et al., 2012), although it is contrary to results found by Hay et al. (2006a, 2006b) and Whisenant et al. (2003). However, economies of scope arise only for LTP assurance, but not for other types of OAS or NAS. This emphasizes the importance of differentiating the nature of the additional services being provided before identifying whether there is likely to be direct knowledge spillover to the annual report audit.

In undertaking the two-stage approach, we document the determinants of municipal audit fees and those for the assurance of a LTP. The determinants of municipal annual report audit fees are similar to those found in prior research (Baber et al., 1987; Bandyopadhyay and Kao, 2001, 2010; Lowensohn et al., 2007; Ward et al., 1994; Rubin, 1988). For the assurance of a LTP, the auditor is required to offer an opinion on the ‘information assumptions’ underlying the LTP and whether it provides an effective basis for community consultation. Consistent with the Office of the Auditor-General (OAG) (2011) comments, we find that LTP audit fees are associated with audit effort, complexity and risk. We argue that higher political competition and debt levels require more audit effort. Private sector auditors also have higher audit fees.

This paper makes a number of contributions. First, we contribute to the knowledge spillover literature and show economies of scale are dependent upon the nature of the other audit, assurance, or non-audit services. Second, we contribute to the literature on the audit of forecasts by documenting that municipal size, complexity (current, leverage and proportion of assets that are cash), political competition and auditor type are associated with a higher LTP audit fee. Other than the annual report, the audit of prospective information is the most frequent category of other assurance services with respect to financial data (Hasan et al., 2005; Reed and Buchman, 2011). Prior research in this area has typically been restricted to Initial Public Offerings (IPOs) (Beatty, 1993; McConomy, 1998; Willenborg, 1999; Clarkson, 2000). However, the external validity of evidence from IPO audit fees for other forecast assurance services is likely to be low. IPOs are typically one-off events, where forecast data are not systematically and continuously reported.

Third, we extend the audit fee determinants of municipal entities to a setting beyond US municipal audits. Furthermore, we document there is a private sector auditor premium that extends to the auditing of forecasts. This contrasts with Chong et al. (2009) who document that no premium exists where a municipal audit is subcontracted to a Big N auditor and the audit firm cannot sign under its own name. In the New Zealand setting, where the auditor signs under his or her own name, we find a premium. This suggests that private sector auditors either provide more auditing or are able to charge a brand name premium. Given the OAG reviews auditor appointments and provides external arbitration on fee negotiations, any higher audit fee charged is likely to be related to more auditing being conducted. Last, we contribute to the literature on management forecasts by providing a setting where multi-year forecasts are audited and mandated and more likely to be credible. Prior research in this area has been limited to unaudited, single-year management forecasts that are voluntarily provided (Kato et al., 2009; Muramiya and Takada, 2017).

The remainder of the paper is structured as follows. The second section provides background information on the institutional setting, reviews the previous literature on municipal audit fees and develops the hypotheses. The third section describes the research method (audit fee model and sample). The fourth section reports the results, while the fifth section concludes.

## 2. Background and literature review

### 2.1. Institutional setting

Financial reporting in a municipal setting is important as accounting information plays a key role in ensuring accountability to constituents (Local Government Act, 2002). New Zealand municipalities are considered to have high quality annual reports for the following reasons. First, since the introduction of a Resource Accounting and Budgeting regime in 1989, financial statements are based on accrual accounting (Pallot and Ball, 1996; Pallot, 2001). Second, municipalities follow sector-neutral New Zealand equivalents of International Financial Reporting Standards (NZ IFRS) (Bradbury and van Zijl, 2006; Baskerville and Bradbury, 2008).<sup>1</sup> Third, under the Local Government Act 2002, New Zealand municipalities must produce a LTP every three years. LTPs are strategic plans based on financial forecasts for the next decade. Thus, the first LTP prepared in 2006 was in respect of the ten financial years ending 30 June 2016. Municipalities must circulate draft plans and hold public meetings to receive feedback.

LTPs must be prepared on a basis consistent with the annual report and follow NZ IFRS. The content of prospective financial

<sup>1</sup> In April 2012, a new Accounting Standards Framework was introduced in New Zealand. The new Framework is based on a multi-sector, multi-tiers reporting approach and was rolled-out progressively during the 2012–2015 period.

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