Non-Audit Services and Improvements in Clients’ Operating Performance and Risk Management

Abstract

We examine whether, and in what contexts, non-audit services (NAS) purchased jointly with the audit provide economic value to clients through improvements in operating performance and risk management. Our investigation is important as it contributes to the ongoing debate between critics and proponents of the joint provision of the audit and NAS. Using DuPont analysis, we find NAS are positively related to subsequent increases in operating performance, consistent with NAS providing access to human capital and other forms of organizational resources that provide economic value for client firms. We further find that NAS are negatively related to future operating risk, indicating that the assurances provided by NAS enhance client firms’ risk management. We find no evidence of NAS that are related to improvements in operating performance increasing earnings management, suggesting that the economic benefits provided by NAS do not impair audit quality. Disaggregating operating performance into its DuPont components and NAS into its three types reveals that increases in operating performance are primarily due to audit-related services increasing future asset turnover and tax services increasing future after-tax profit margins. In supplemental analysis, we split firms into one of three asset terciles and show that our results are not driven solely by size. Small and midsize firms reap benefits with respect to future operating performance while midsize and large firms obtain value in the form of lower levels of future operating risk. Regulators considering whether to further restrict NAS provided by a client’s auditor should exercise caution as restrictions could result in unintended, negative consequences as they would be forcing firms to unbundle the purchase of such services.