

## **Audit firm scope and auditor independence.**

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### **Abstract**

I model the joint production of audit and non-audit services in a setting where knowledge capital is fungible across tasks and induces strong economies of scope in production and firms compete for both audit and non-audit clients. A firm's investment in knowledge capital is endogenously determined by the amount of auditing and consulting work it does. Client-specific quasi-rents from non-audit tasks, imperfect incentive alignment within audit firms and ex-post unobservability of auditor independence jointly lead to persistent investor concerns about auditor independence. Due to mandated audit demand, investor preferences for the optimal mix of audit and non-audit services need not be reflected in audit fees so firms have incentives to acquire too much knowledge capital and therefore produce too much non-audit work relative to investors' preferences. However, firms also incentives to spin off non-audit practices once they grow sufficiently large. The firm's preferred divestiture threshold is higher than the threshold investors prefer.