

Does Sarbanes-Oxley's disclosures produce useful information?

Can Fee Disclosure Be Trusted?

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IN AN EFFORT TO IMPROVE THE TRANSPARENCY of the client-auditor relationship, the Securities and Exchange Commission since 2001 has required firms to disclose the fees they pay to their external auditors for audit and non-audit services. The regulations presume that non-audit services are highly profitable relative to audit services and that a sufficiently high ratio of non-audit to audit fees creates an economic bond between the auditor and the client company that may impair the auditor's judgment and weaken its resolve in disputes with the client. In other words, the auditor may agree too readily with a client's questionable reporting choices in order to preserve non-audit fees. Reporting quality would be damaged.

ARE CLASSIFICATIONS CONSISTENT?

If fee disclosures are to be effective, they must be prepared in a consistent and unbiased manner or else the disclosed information is of little value. To determine the consistency of fee disclosures, we surveyed 31 external auditors (partners and managers) who regularly participate in the fee disclosure preparedness process. Participants were provided with a list of 25 different services typically provided to firms by their external auditors. The surveyed auditors were also provided with a copy of the classification rules that are to be used to classify services as (a) Audit, (b) Audit-Related, (c) Tax, or (d) Other. As summarized in Table 1, only three of the services were classified into the same category by all participants. Fourteen of the services were classified consistently less than 75 percent of the time. In other words, services were not classified in a consistent manner among the participants even in a controlled environment in which there were no external pressures to bias the classification.

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The significant variation in participant responses is likely the result of the language of the disclosure requirements. For example, under the Sarbanes-Oxley Act of 2002 (SOX), the classification rule proscribes that fees for services be classified as Audit if those services are "normally provided" in connection with statutory and regulatory filings. Similarly, fees for services are to be classified as Audit-Related if they are "reasonably related" to the performance of the audit. This vague wording and the survey's findings suggest that the fee disclosure rules may be so unclear that fee disclosures are unlikely to be made in a consistent manner among companies. The situation may be exacerbated over time as new or different individuals are assigned the task of preparing the disclosures.

ARE CLASSIFICATIONS UNBIASED?

Given the current level of scrutiny of the auditor-client relationship and the transparency of fee disclosures, it is likely that the preparers of fee disclosures will be concerned with how investors and monitoring agencies will perceive high non-audit fees and, in particular, whether the fees will create the perception that an auditor's independence is compromised. In other words, if those preparing fee disclosures believe the marketplace accepts the SEC's contention that fee disclosures relay information about an auditor's independence and the quality of the firm's financial reports, preparers may be concerned that the company will be penalized in the form of a reduced stock price if their fee levels or ratios are above a given value. Such a belief by preparers would not be unfounded. For example, Institutional Shareholder Services monitors fees paid to external auditors as part of its efforts to provide company-specific corporate governance ratings and to make recommendations with respect to company proposals.

We assessed whether preparers' fee classification decisions are influenced by measures that are commonly used to gauge

TABLE 1

Survey Responses

Frequency of Classification by Service Type and Category

Service Type	Service Category			
	Audit	Audit-Related	Tax	Other
Acquisition Audits—acquired	51.6	38.7	3.2	6.5
Acquisition Audits—not acquired	19.4	51.6	0.0	29.0
Annual Meeting Attendance	77.4	16.1	0.0	6.5
Audit	100.0	0.0	0.0	0.0
Audit Committee Meeting Attendance	87.1	12.9	0.0	0.0
Benefit Plan Audits	32.3	51.6	0.0	16.1
Comfort Letters	29.0	58.1	0.0	12.9
Consents to Include Audit Report	51.6	48.4	0.0	0.0
Due Diligence	0.0	38.7	0.0	61.3
GAAP Consultations	33.3	50.0	0.0	16.7
Industry Studies	0.0	0.0	0.0	100.0
Preparation of Form 5500	6.7	16.7	66.6	10.0
Quarterly Reviews	83.9	16.1	0.0	0.0
Registration Statements	46.7	50.0	3.3	0.0
Review of Form 10-K	96.8	3.2	0.0	0.0
Review of Proxy	48.4	35.5	0.0	16.1
Review of Tax Accruals	87.1	3.2	9.7	0.0
Software Fees	0.0	3.3	0.0	96.7
Statutory Audits	77.4	22.6	0.0	0.0
Statutory Filings	6.9	20.7	69.0	3.4
Systems Controls Consulting—installed	41.9	32.3	0.0	25.8
Systems Controls Consulting—under development	22.6	29.0	3.2	45.2
Tax Consulting	0.0	0.0	87.1	12.9
Tax Planning	0.0	0.0	96.8	3.2
Tax Return Preparation	0.0	0.0	100.0	0.0
Transaction Structuring	0.0	16.7	16.7	66.6

(n=31)

the market's perception of auditor independence. The study took advantage of a one-time opportunity that firms had to reclassify 2002 fees paid to their external auditor. In 2003, fee disclosures made in a firm's annual proxy statements to shareholders were classified into three categories (Audit, Financial Systems Design and Implementation, and Other). SOX, among other things, eliminated firms' ability to engage their external auditors for Financial Systems Design and Implementation services and required that external auditor fees be reported in four categories (Audit, Audit-Related, Tax, and Other).

As a result of SOX, fees paid in 2002 and disclosed in 2003 under the three-category scheme were disclosed again as part of a comparative disclosure in 2004 under the new four-category scheme. In addition, the wording of the four-category classification guidelines became less precise than under the three-category classification guidelines. This provided firms an opportunity to reclassify fees paid to their external auditors in 2002. Moreover, in the time interval between the original and new disclosure rules, the level of public scrutiny increased dramatically, raising the incentives for companies to minimize any cost associated with the perception that auditor independence might be impaired.

For a sample of fee disclosures by 501 companies, we

compared the Audit Fee for 2002 as reported under the original three-category scheme to Audit Fee for 2002 as reported under the newer four-category scheme. We find that 37 percent of firms increased the amount disclosed as Audit Fees paid in 2002; the average increase was approximately \$151,000, or 18 percent. Only 7 percent of firms decreased the amount in the Audit Fee category, by approximately 5 percent. (This statistic does not reflect the influence of one firm that decreased its reported Audit Fee by \$5,678,000, which was considered an outlier for purposes of our analysis.) The other firms did not change the amount classified as Audit Fee.

Increasing the amount reported as Audit Fee means a reduction in the amount reported as non-audit fees. This could occur if the individual preparing the fee disclosures was concerned that the level of non-audit fees was sufficiently high to cast doubt on auditor independence and reporting quality. We test for this and find that the greater the likelihood that a preparer had reasons to be concerned with the market's perception of auditor independence, the more likely companies were to have reclassified non-audit fees to audit fees. We reach the same conclusion using alternative methodologies: fee disclosures are not prepared in an unbiased manner. Preparers, when classifying fees, appear to consider the potential signal that the fee disclosures relay to investors.

CONCLUSION

So what does all this mean? Our survey and statistical analyses of company fee data suggest that fee disclosures are not prepared consistently and are not without bias.

Given sufficient motivation and assisted by unclear rules, preparers may consciously or unconsciously bias fee disclosures when there is a high likelihood that shareholders would conclude from unbiased disclosures that auditors lack independence. If fee disclosures cannot be trusted, what is the value of the fee disclosure mandates? R

READINGS

- "The Association between Audit Committee Characteristics and Audit Fees," by L. J. Abbott, S. Parker, G. F. Peters, and K. Raghunandan. *Auditing: A Journal of Practice and Theory*, Vol. 22, No. 2 (2003).
- "Auditee Incentives for Auditor Independence: The Case of Nonaudit Services," by M. Parkash and C. F. Venable. *The Accounting Review*, Vol. 68, No. 1 (1993).
- "The Classification of Auditor Fees and the Influence of Auditor Independence," by D. Dickens, T. Skantz, J. Higgs, and G. Young. Working paper.
- "Do Nonaudit Services Compromise Auditor Independence?" by H. Ashbaugh, R. LaFond, and B. W. Mayhew. *The Accounting Review*, Vol. 78, No. 3 (2003).