Audit, Non-Audit and Information Technology Fees: Some Empirical Evidence

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Abstract

This study examines the purchase of non-audit services by SEC audit clients. Effective February 5, 2001, the SEC has required the disclosure and description of audit, non-audit and information technology fees paid to the incumbent auditor. The SEC enacted this rule due to concerns over auditor independence. Our study reviews these disclosed fees contained in the proxy statements of 265 firms since the effective date of the new SEC disclosure rules. The results indicate that the actual incidence and magnitude of non-audit fees is much greater than the information relied upon during the SEC rulemaking deliberations. Consequently, our study calls into question the data used during SEC rule-making process, as well as the clarity of the current audit and non-audit service distinctions. Our results also suggest that the non-audit service landscape has changed dramatically since the last period of publicly available audit fee data (1978-1981). Finally, our results indicate a need for additional research regarding the provision of non-audit services.

Audit, Non-Audit and Information Technology Fees: Some Empirical Evidence

The objective of this study is to examine the purchase of non-audit services (NAS) by SEC audit clients from their incumbent auditors. This issue, which has continued to be an area of concern for regulators and auditors alike, addresses an intangible, but vital aspect of the accounting profession: the investing public's confidence in the independence of the external auditor. The growth in NAS and the concomitant independence-related concerns were instrumental in the SEC's recent action to prohibit certain types of non-audit services and to require disclosure of non-audit (and audit) fees paid by SEC audit clients to their auditors. Utilizing data obtained from the new mandatory disclosure environment, we examine the magnitude and frequency of NAS and Financial Information Systems services (FIS) fees in relation to audit fees.

During the course of the debate related to the new rules, the SEC (2000a, 2000b) referred to some publicly available data to support its positions regarding the frequency and magnitude of the NAS and FIS fee "problem" and the cost associated with the new rules. Specifically, the SEC relied upon two important suppositions during the rule-making process: one relating to the proportion of audit clients purchasing NAS and FIS from their auditors and the other relating to the magnitude of such non-audit fees. In this study, we examine actual audit, NAS and FIS fee data disclosed in proxy statements filed after February 5, 2001 and compare such data with the SEC's stated suppositions. Our results indicate that the actual empirical evidence is dramatically different from that relied on by the SEC during the course of its rulemaking. In addition, the results also are significantly different from results reported in prior research examining the purchase of non-audit services.

Our objective is not to draw inferences regarding the impact of NAS and FIS fees on auditor independence. Notwithstanding this qualifier, our study contributes to the literature by providing four non-mutually exclusive conclusions. First, our results call into question data that was relied upon by the SEC during the recent non-audit services related rule-making process. Accordingly, the SEC may have significantly underestimated both the frequency with which clients purchase NAS and FIS services from incumbent auditors and the size of the resulting fees. Second, our results support the contention that the NAS and FIS landscape has changed dramatically when compared to the last period of publicly available NAS, FIS and audit fee data (1978 – 1981, under the provisions of ASR 250). Third, in an effort to provide timely information to market participants, the SEC's new disclosure rules likely sacrificed the clarity of such NAS, FIS and audit fee disclosures. In particular, as opposed to ASR 250, the current disclosure environment requires the categorization of NAS and FIS fees into two broad non-audit categories. Consequently, many NAS fees which auditors and others would consider 'audit related' (such as the audit of a company's pension and benefit plans) are now considered part of the larger umbrella of non-audit services.[1] As such, data used to make inferences about the impact of NAS and FIS fees on auditor independence may need to be recalibrated for amounts pertaining to audit related (but not actual audit) fees. Fourth, and perhaps most importantly, our results and the lack of a consensus definition of non-audit services indicate a need for additional research regarding the provision of non-audit services.

The remainder of this paper is organized as follows. The next section discusses the background, and develops the two research questions. This is followed by a discussion of method and results, and the paper ends with a discussion.

BACKGROUND

Regulators' concerns about non-audit services

The provision of non-audit services by incumbent audit firms to their publicly-held audit clients remains one of the most contentious issues ever to face the public accounting profession. Former SEC Chairman Arthur Levitt started expressing his concern about this issue (see, for example, Levitt 1996a, 1998, 1999, 2000). He criticized audit firms for using auditing as "a loss-leader retained as a foot in the door for higher-fee consulting services" (Levitt 1996b). During the course of the hearings and in the final ruling, Chairman Levitt and the SEC contended that:

- audits were priced low, in the hopes of obtaining the more profitable non-audit services
- such low-balling led to reduced audit quality, and
- lucrative non-audit services exacerbated problems with auditor independence.

Levitt (2000) continued to voice his fears that consulting and other services "shorten the distance between the auditor and management" and that "independence – if not in fact, then certainly in appearance – becomes a more elusive proposition." The SEC (2000b) noted that increased reliance on non-audit fees could increase the pressure on auditors to "see it the way the client does" in the grey areas, where the accounting rules may not be very clear. Chairman Levitt (SEC 2000c) noted that the disclosure about audit and non-audit fees "could help an investor establish whether those judgment calls may lean more toward the company's interest or the shareholders' interests."

Both during the SEC's hearings about the rule proposal and in response to the proposed rule, many auditors and others noted that there are benefits from the joint supply of audit and non-audit services. More specifically, Elliot (SEC, 2000d) posited that non-audit services may actually increase total audit quality due to knowledge spillovers obtained during the provision of such services. Elliot (SEC, 2000d) also noted the scale and audit scope economies that may

accrue to the audit client as a result of providing such non-audit services. In addition, critics of the SEC proposal noted very few audit failures have ever been attributed to independence problems arising from the supply of non-audit services.

In response, the SEC (2000b) posited that non-audit services "create economic incentives that may inappropriately influence the audit" and increase the "risk that the auditor will be less vigilant in its objectivity." Specifically, the SEC (2000b) responded that:

> "We must make judgments about the circumstances that render a loss of auditor objectivity more or less likely…the actual issue is whether providing these services makes it unacceptably likely that there will be an effect on the auditor's judgment, whether or not the auditor is aware of it…the more the auditor has at stake in its dealings with the audit client, the greater the cost to the auditor should he or she displease the client, particularly when the non-audit services relationship has the potential to generate significant revenues on top of the audit relationship."

SEC rule proposal in July 2000

In response to growing concerns about the effect of NAS fees on auditor independence, the SEC issued a rule proposal that would have severely restricted the supply of non-audit services by incumbent audit firms to public audit clients. In justifying the rule proposal, the SEC (2000a) cited and relied upon the following representations:

- For the five largest public accounting firms, management advisory services (MAS) fees received from audit clients amounted to ten percent of all revenues in 1999. Almost three-fourths of audit clients did not purchase any MAS from their auditors in 1999. This means that purchases of MAS services by one-fourth of firms' audit clients account for ten percent of all firm revenues.
- The percent of Big 5 audit clients that paid MAS fees in excess of audit fees did not exceed 1.5 percent until 1997. In 1999, 4.6 percent of Big 5 audit clients paid MAS fees in excess of audit fees, an increase of over 200% in two years.

The SEC gathered the above data from annual reports filed by the public accounting firms with the SEC Practice Section (SECPS) of the AICPA. The SECPS requires member firms

to classify the number of their audit clients for whom the management consulting fees ratio falls in the following categories: 0, 0.01 to 0.25, 0.26 to 0.50, 0.51 to 1.00, and more than 1.00.

It is worthwhile to note that the SECPS used a category titled "Accounting and Auditing" which is more expansive than the "Audit Fees" category used by the new SEC rule (and, in the previous incarnation under ASR No. 250). The SECPS required detailed data (such as the proportion of clients with fees exceeding audit fees) only for management consulting services, otherwise known as management advisory services – but not for overall non-audit services.[2]

Non-audit services (NAS) and Management Advisory/Consulting Services (MAS)

While the SEC expressed its concerns about non-audit services (NAS), the above data cited by the SEC refer only to Management Advisory Services (MAS). MAS is only a subset of NAS because NAS includes many other services, such as internal audit outsourcing, litigation support services, and tax consulting services.[3]

This confusion between NAS and MAS can be observed in the initial SEC rule proposal, at many of the hearings subsequent to the rule proposal, and in the final SEC rule. Here are some examples (note: below and elsewhere in this paper, we have added the emphasis).

From the Rule Proposal (SEC 2000a):

> "Currently, the five largest public accounting firms audit approximately 12,800 public companies. Other public accounting firms audit approximately 3,900 public companies. According to reports filed with the AICPA, of the 12,800 public companies audited by the so-called "Big 5," approximately 9,500 did not purchase *any consulting services* from their auditor in the most recently reported year. Of the approximately 3,900 registrants that are audited by other public accounting firms, approximately 3,100 did not purchase *any consulting services* from their auditor.
>
> "For the 12,600 registrants that did not purchase any consulting services from their auditor, the proposed amendments would not have affected their purchase of *non-audit services* in the most recently reported year. . . .

> "Of the approximately 4,100 registrants that were reported to have purchased *non-audit services* from their auditor, many may have purchased *non-audit services* that are not covered by the proposals."

Note that the first paragraph above refers to "consulting services"; the next paragraph mixes "consulting services" and "non-audit services"; the third paragraph, even while relying on the data from the first paragraph, uses the phrase "non-audit services."

The confusion persisted during the hearings on the rule proposal. Here are some comments from the hearings:

> "given that a small fraction of audit clients use *non-audit services*, I believe the release points to 25 percent . . ." (Robert Elliott, Chairman of the AICPA [SEC 2000d])

> "The point has been made that since only 25 percent of audit clients currently receive *non-audit services* from their audit firm . . . The fact is that while we perform consulting or advisory work for a minority of our audit clients in any one year, we use these competencies to help us do a quality audit on almost all of our audit clients every year." (James Copeland, CEO of Deloitte and Touche [SEC 2000c])

Before issuing a new rule, the SEC is required to perform a cost-benefit analysis of the rule. As part of the cost-benefit analysis, the SEC (2000b) stated:

> "To obtain an estimate of the number of individuals and businesses that may benefit, we note that, in any given year, *approximately 74.3% of companies purchase only auditing services from their Big Five auditor*.[4] It may be reasonable, therefore, to estimate that only twenty-five percent of audit clients will be directly affected by the rule."

The SEC did request comments on the accuracy of the data. Specifically, SEC (2000a) noted that "we also request comment on the accuracy of the estimated number of issuers [SEC registrants] that would be affected by the proposed amendment." However, the Final Rule (SEC 2000b) stated:

> "In the Proposing Release, we stated the burden would fall primarily on one-quarter of registrants because only one-quarter of registrants receive non-audit services from their accountants in any given year. Some commenters disagreed. While it may be true, these commenters suggested, that *only twenty-five percent of registrants receive non-audit services in any given year*, a larger percentage receives non-audit services in some years and not others."

Footnote 212 of the final rule, which was inserted at the end of the paragraph above, noted:

> "Because we believed that it would have been useful to have additional data concerning the revenue mix of accounting firms, as well as the extent to which fees to audit clients for non-audit services exceed fees for audits, we solicited comment on revenue data. In addition, SEC Commissioner Isaac C. Hunt, Jr. informed the Big Five firms that these data would help the Commission in its deliberations. . . . However, no data were submitted by any of the five firms."

Three of the Big 5 firms (Arthur Andersen, Deloitte and Touche, and KPMG) and the AICPA were strenuously opposed to the SEC's actions related to non-audit services, while the chairman of the SEC had expressed his strong preferences for some actions that would curtail the supply of non-audit services to public audit clients. Viewed in this light, pointing out that a much higher proportion of audit clients purchased NAS could have been counterproductive for the AICPA or the Big 5.

Final SEC Rules

After a contentious debate with the AICPA and some accounting firms, the SEC finally acted to restrict the supply of some non-audit services by incumbent auditors to their SEC audit clients. The SEC adopted a two-pronged approach in response to concerns about the impact of non-audit services on auditor independence. First, it proscribed certain types of non-audit services. With one exception (outsourcing of internal audit services), the list of proscribed services mirrors the existing requirement under the SECPS rules for member firms. Second, the SEC required public disclosure of the audit and non-audit fees paid to the incumbent auditor. More specifically, companies are now required to disclose audit fees, financial information systems design and implementation fees, and all other fees in their annual proxy statements.

Given the above discussion, we believe it is useful to examine the proportion of SEC registrants that purchase non-audit services from their auditors and the relative magnitude of those purchases. Our focus is based upon the assertion that financial statement users will find this information useful in forming assessments about an auditor's independence. For example, Robert Ryan, the Chief Financial Officer of Medtronic Inc., noted:

> "An important consideration in evaluating independence is the magnitude of the fee of the non-audit service provided both in absolute dollars and compared to the audit fee. . . It's fair to say that the larger the fee for the consulting service, the more likely independence, actual or perceived, will be impaired" (SEC 2000c).

DATA AND RESULTS

The new SEC rules about the disclosure of audit and non-audit fees became effective for proxies filed on or after February 5, 2001. We examined all proxies filed with the SEC between February 5, 2001 and March 16, 2001 (information posted on EDGAR up to March 19, 2001). To obtain data about company size and other financial characteristics, we identified those companies that also had filed the relevant 10-K.

There were 319 companies that had filed their proxy and 10-K statements by our cut-off date. However, only 265 of these companies provided the required data about audit and non-audit fees. Thus, there was a non-compliance rate of 17 percent for the required disclosure. The non-disclosing companies were significantly smaller in size (median total assets of $23 million compared to $448 million for the disclosing companies) and were more likely to be audited by the non-Big 5 (53 percent versus 15 percent of the disclosing companies).

Frequency of non-audit services purchases

Only 11 of the 265 companies (4 percent) in our sample reported that they did not purchase any non-audit services from their incumbent auditor. When we partitioned the sample by type of auditor, the results were as follows:

- Nine of the 41 companies (22 percent) audited by non-Big 5 audit firms did not purchase any non-audit services from their incumbent auditor.
- *Only two of the 224 companies – or less than 1% - audited by the Big 5 audit firms indicated that they did not purchase any non-audit services from their incumbent auditor.*[5]

Recall that throughout the rule-making process, the SEC had asserted that about 75 percent of the Big 5 audit firms' clients did not purchase non-audit services from their auditor.

Magnitude of non-audit service fees

Fifty-one percent of the companies in our sample (134/265) reported that the magnitude of total non-audit fees paid to the auditor was greater than the audit fee. When we partitioned the sample by type of auditor, the results were as follows:

- Eight of the 41 companies (20 percent) audited by non-Big 5 audit firms indicated that the non-audit fee was greater than the audit fee.
- *More than 56 percent (126/224) of the companies audited by the Big 5 audit firms indicated that the non-audit fee was greater than the audit fee.*[6]

Recall that throughout the rule-making process, the SEC had asserted that less than five percent of the Big 5 audit firms' clients had non-audit fees greater than the audit fee.

Further Analysis

Table 1 provides a detailed breakdown of the non-audit fee ratios for clients of different audit firms, and for companies of different sizes. Some of the interesting results are as follows:

- Sixty-five of the 224 companies (29 percent) audited by the Big 5 had non-audit fee ratios that exceeded 2.00, but only three of the 41 companies audited by the non-Big 5 had such high non-audit fee ratios.
- For clients of four of the Big 5 firms, the median non-audit fee ratio was greater than 1; the median non-audit fee ratio was only 0.37 for clients of non-Big 5 firms.
- The median non-audit fee ratio increases with company size. The non-audit fees are higher than audit fees for 79 of the 165 companies (48 percent) with total assets greater than $200 million.

The increase in non-audit fee ratio with company size suggests that the monetary importance of NAS fees to audit firms is much higher than that suggested by the overall sample medians. Thus, the overall mean (median) non-audit fee ratio for the sample of 265 companies is 1.97 (1.02). However, total audit fees paid by our sample companies were $225 million, whereas total non-audit fees paid by those same companies equaled $574 million. Thus, the overall non-audit fee ratio when examining the total dollar amounts is 2.56 ($574/$225).

Comparison with Some Prior Studies

Table 2 provides data from some prior studies that examined non-audit purchases by companies from their incumbent auditor. All of the prior studies listed in the table examined the period from 1978 through 1981, the last time audit fees and non-audit fees were required to be disclosed.[7] The last row of the table provides the results from the current study. Whether it is the median (mean) non-audit fee ratio, or the proportion of companies with non-audit fee ratio higher than 50 percent, the numbers from the current study are an order of magnitude higher than the results reported in prior studies. Parametric and non-parametric tests indicate the difference between time periods in terms of the relative magnitude of NAS fees is significant ($p < .05$). Clearly, the non-audit services environment has changed dramatically in the past two decades. We interpret the results as indicating that additional research related to non-audit services is

needed and that recent evidence on a variety of issues related to non-audit services would be a worthwhile endeavor to pursue.

Financial Information Systems Design and Implementation

The SEC initially proposed to prohibit the performance of financial information systems design and implementation by auditors to their SEC audit clients. However, in the final rules, the SEC relented and did not prohibit such non-audit work by auditors. Instead, the final rules required companies to disclose in their proxy statements the fees paid for such non-audit work as a separate line item. The SEC (2000b) noted that "when the information systems consulting fees become large relative to audit fees, auditor independence may be at risk."

Given the above, we also examined the number of companies which engaged their auditors for such non-audit work. Only 34 of the 265 companies (13 percent) indicated that they had non-zero amounts for financial information systems design and implementation (FIS) fees.

Considering only the 34 companies that reported engaging their auditor FIS work, the median ratio of FIS fees alone relative to the audit fee was 1.02. In other words, for 17 of the 34 companies, the FIS fees alone were greater than the audit fees.

Examining the absolute magnitude of the fees indicated that $127 million of the total $574 million received by auditors for non-audit work came from FIS fees. Thus, fees received for financial information systems design and implementation alone amount to 56 percent of the total audit fees ($127/$225) received from our sample of companies.

These results indicate that while the frequency of financial information systems design and implementation by auditors for their SEC audit clients was low, the magnitude of such fees

was generally quite large. This suggests that the SEC's special emphasis related to financial information systems design and implementation work was well warranted.

SUMMARY AND CONCLUSIONS

During the recent rule-making process related to non-audit services, the SEC relied on statistics provided by the firms to the SECPS in describing the magnitude of the non-audit services "problem." However, the SECPS data are incomplete for the non-audit services debate because they provide information only about a subset of non-audit services, namely management consulting services. Results from our analysis of proxy statements filed by companies under the new SEC rules indicate that only about four percent of companies did not purchase non-audit services from the incumbent auditor, as opposed to the 75 percent estimated by the SEC. Further, 51 percent of the companies paid non-audit fees that were greater than the audit fee, as opposed to the "less than five percent" estimated by the SEC.

Together, the above findings suggest that the SEC may have vastly underestimated the magnitude and frequency of non-audit services. Conversely, others who believe the joint supply of non-audit services leads to improved audits could argue that the SEC action has significantly harmed a far greater proportion of audits than was estimated under the rule-proposal. This would be especially true if public perception of auditor independence reduced the frequency of non-audit services, and that such a reduction would lead to an audit quality reduction.

One interpretation about the confusion regarding non-audit fee categorization, as well as the SEC's underestimation of non-audit fee frequency and magnitude, is that the SEC was concerned only about one type of non-audit services, namely management advisory services. We believe this explanation is unlikely for the following reasons.

First, the SEC referred to non-audit services throughout the proposing release and the final rule. Second, the SEC sought to (and did) ban certain types of non-audit services that clearly cannot be labeled as management advisory services. In particular, one of the SEC's greatest concerns was in the area of internal audit outsourcing, as evidenced by the special attention given to this issue in the final rule; internal audit outsourcing does not appear to be commonly categorized as a management advisory service. Finally, if the SEC was concerned about the economic impact of non-audit fees on auditor independence, there is no reason to believe that revenues from services such as internal audit outsourcing or litigation support would have a different impact on auditor independence compared to revenues from management consulting services.

During the hearings about the new rule, there were many opportunities in which partners and CEOs of the leading audit firms could have cleared up the confusion. In addition, the SEC specifically requested comments about the data included in the proposing release. However, with one exception, none of the Big 5 firms or their partners who testified before the SEC attempted to clarify this issue; some, in fact, repeated the SEC's erroneous assumptions.[8]

In this paper, we take no position about the benefits or costs associated with the joint supply of non-audit services by auditors to their SEC audit clients. However, our results do indicate that there are significant discrepancies between the numbers cited and relied upon by the SEC during the rule-making process and the data disclosed by the SEC registrants under the new rule. At a very minimum, these results put the non-audit services issue in a different light and suggest that further empirical research related to non-audit services is a necessary and worthwhile endeavor.

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Table 1
Non-audit fee ratios

Panel A: Frequencies, by audit firm

	Ratio of non-audit fees to audit fees					
Audit firm	0	0.01 to 0.50	0.51 to 1.00	1.01 to 2.00	> 2.00	Median
AA	0	8	11	12	11	1.19
DT	1	5	11	8	6	0.89
EY	0	14	14	18	14	1.14
KPMG	0	9	3	9	7	1.18
PWC	1	12	9	14	27	1.68
Non-Big 5	9	17	7	5	3	0.37
Total	11 (4%)	65 (25%)	55 (21%)	66 (25%)	68 (26%)	1.02

Note: The percentages do not add up 100 due to rounding.

Panel B: Frequencies, by client size as measured in total assets

	Ratio of non-audit fees to audit fees					
Company Size	0	0.01 to 0.50	0.51 to 1.00	1.01 to 2.00	> 2.00	Median
< $200 million	9 (9%)	40 (40%)	26 (26%)	15 (15%)	10 (10%)	0.50
$200 ml. - $1 bl.	1 (1%)	18 (28%)	12 (18%)	20 (31%)	14 (22%)	1.07
> $1 billion	1 (1%)	7 (7%)	17 (17%)	31 (31%)	44 (44%)	1.84

Table 2
Comparison with Prior Studies

Study	Median (Mean) nonaudit fee ratio	Percent of companies with NAS ratio > 50%
Scheiner and Kiger (1982)	NA	11.3%
Glezen and Millar (1985)	NA (0.30)	NA
Beck et al. (1988)	0.20 (0.31)	13.0%
Parkash and Venable (1993)	0.17 (0.24)	9.9%
Current Study	*1.02 (1.97)*	*71.3%*

Notes:
1. Glezen and Millar (1985) provide data for three separate years (1979 through 1981) and the mean ranges from 29.2% to 30.7% for the three years.
2. Beck et al. (1988) provide data for two years (1978 and 1979), but we take the higher of the two (1978) for the purposes of this study.

NOTES

[1] One Big 5 auditor (Ernst & Young) actually recommends its audit clients to disclose an additional category of called Audit Related Fees in order to more accurately depict the "total audit relationship" (Ernst & Young 2001).
[2] ASR No. 250, which required disclosure of non-audit fee ratios, was repealed in 1982. One of the reasons offered at the time of repeal was that similar data would be available with the SECPS. However, the SECPS's definitions for the categories of fees were different from the definitions used by the SEC under ASR No. 250 (and under the new rules). Note that there are two other differences between the SEC's required disclosure about non-audit fees and the data available from reports filed with the SECPS. First, the SEC data are at the company level while the SECPS data are at the audit firm level. Second, data filed with the SEC are filed under a different legal environment, and are subject to legal and/or monetary penalties.
[3] Management advisory services (MAS) are consulting activities that may involve providing advice and assistance concerning an entity's organization, personnel, finances, operations, systems, or other activities...the MAS department may be divided further into areas of specialization such as small-business consulting, management information systems development, litigation support services and actuarial/pension services (Messier, 2000).
[4] Footnote 583, inserted here, noted "while we recognize that the set of firms that may purchase such [non-audit] services may change from year to year, we have received no evidence to suggest that the fraction of companies that may actually purchase such services in any given year is different from our estimate."
[5] Parametric and non-parametric tests indicate the difference between auditor groups in terms of the frequency of NAS fees is significant ($p < .05$).
[6] Parametric and non-parametric tests indicate the difference between auditor groups in terms of the relative magnitude of NAS fees is significant ($p < .05$).
[7] Each of these prior papers aggregated all non-audit fees per ASR 250 when calculating their non-audit fee to audit fee ratio.
[8] The one exception was Deloitte and Touche's appendix to the comments on the proposed rule, submitted to the SEC (available at http://www.sec.gov/rules/proposed/s71300/deloit1b.htm). However, DT did not provide data about the proportion of its clients that purchased (a) no NAS or (b) high levels of NAS such that the NAS fee exceeded the audit fee, or (c) the average or median magnitude of the NAS fee ratio for its SEC audit clients.