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## Audit Fees: To Disclose or Not to Disclose?

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# Audit fees: To disclose or not to disclose?

By Khoo Teng Aun and Hwang Soo Chiat

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Investors of listed companies rely on financial statements prepared by management, which must be audited in order to give investors confidence in the financial reports. The collapse of Enron Corporation in the United States has brought the issue of auditor independence and financial-statement reliability to the forefront.

Auditor's independence is the cornerstone of the auditing profession, because without auditor's independence investors would not be able to rely on the so-called "audited" financial statements.

One of the factors that may impair auditor's independence is when auditors undertake non-audit services (NAS) for the client they audit. The dangers that may arise are that NAS may make auditors more financially dependent and may raise the potential conflict of interest, thereby threatening auditor's objectivity (whether real or perceived).

In late 2001, a series of accounting scandals in the US, beginning with Enron (which paid Arthur Andersen US\$27 million in NAS fees and US\$25 million in audit fees), raised concerns across the world on the joint provision of audit and NAS. As a result of these scandals, the Sarbanes-Oxley Act was enacted in the US, which prohibited auditors from also providing most NAS to their audit clients.

Prior to these scandals, Arthur Levitt, then-chairman of the Securities and Exchange Commission (SEC), argued that the substantial growth in NAS which audit firms provide to their audit clients potentially compromise their independence. He also argued that audit firms that provide both audit and NAS tend to allow such clients to adopt borderline revenue-enhancing accounting treatments more readily than when only audit services are provided.

In June 2000, Mr Levitt proposed that corporate SEC pass rules barring auditors from providing NAS to their audit clients. However, he was unsuccessful in his attempt, as the accounting profession argued that there was no evidence that auditor's independence was compromised due to NAS that were performed. As a result, in November 2000, SEC issued a ruling that required companies to disclose separately the audit and NAS fees paid to their auditors in their annual proxy statements.

Currently in Singapore, audit-fee disclosure is not mandatory except for banks as stipulated by the Monetary Authority of Singapore. Prior to the financial year beginning 2003, audit-fee disclosure was mandatory as required by the Ninth Schedule of the Companies Act. In July 2002, the Ninth Schedule was repealed as a consequence of the incorporation of accounting standards (in Singapore, they are termed Financial Reporting Standards, or FRS) in the Companies Act.

One of the purposes of incorporating accounting standards in the Act is to strengthen the legal enforcement of accounting standards. As the relevant FRS 1 (Presentation of Financial Statements) does not require any disclosure of audit fees, henceforth audit fees is no longer a mandatory disclosure item. Although the International Accounting Standards 1 (IAS 1), the equivalent of FRS 1, does not require the disclosure of audit fees, some countries, such as Australia, New Zealand and Hong Kong which also adopt IAS, incorporated the disclosure of audit fees in their local accounting standards.

The non-disclosure of audit fees in Singapore runs contrary to the SEC 2000 ruling on audit fee disclosure. This is inexplicable when one considers that most major capital markets (such as the US, UK Japan, Germany, France and Hong Kong) currently and at that time (except Japan as companies there were only required to disclose audit fees after March 2004) require the disclosure of audit fees. Not only is it mandatory to disclose audit fees in these countries, but it is also a requirement to disclose fees paid for NAS to be provided by the auditor separately.

In some of these countries, a further breakdown of NAS fees is required, such as taxation, information technology and others.

Since 1997, the Singapore Exchange's (SGX) listing manual requires the disclosure of NAS fees paid to an auditor. *The Business Times* reported in 2006 that some of the companies paid very high NAS fees, up to S\$1 million, to their auditors. A current review of the disclosure of NAS fees shows that often a breakdown of NAS fees is not provided.

For the shortlisted companies, the NAS fees were as high as about S\$1 million. The disclosure of NAS fees without the accompanying disclosure of fees payable on audit work may not help an investor much in evaluating the degree of auditor's independence.

### **SGX requirement**

As auditor's independence is an unobservable concept, researchers commonly resort to using the ratio of NAS fees to total audit fees as a proxy of auditor's independence. Such figures are regularly provided by the Financial Director in the UK and Audit Analytics in the US.

The audit committees of companies are required under the SGX listing manual to confirm that they have undertaken a review of all NAS provided by the auditors, and the NAS provided by the auditor would not in audit committees' opinion affect the independence of the auditors.

This to a certain extent, may help investors know the extent of auditor's independence. But it would be much better if disclosure of audit fees is made mandatory so that the investors can evaluate the degree of an auditor's independence.

Spain's Santander Bank, for instance, goes further to preserve the independence of the auditor by not hiring audit firms in which the fees intended to be paid to them or any and all services, are equal to, or more than a certain percentage of the bank's total income during a financial year.

In Belgium, the Corporate Governance Law requires public-listed companies to adhere to a “1 to 1” rule, that is the total fees for NAS, other than the prohibited NAS, cannot exceed the total audit fees. Thus, the former acting chairman of SEC, Laura Unger, argued that the disclosure of audit and NAS fees can serve to strengthen corporate governance.

Companies listed on SGX can voluntarily disclose the audit fees paid to their auditors. *The Business Times* reported last year that about two-thirds of the top Straits Times Index firms disclose audit fees in their financial reports. This shows the importance placed by two-thirds of these companies in disclosing audit fees. In that report a further argument made for the disclosure of audit fees is when auditors are changed, shareholders will know whether the change was because of audit fee or for some other reasons.

Studies by researchers on the possible negative impact of NAS fees on auditor independence show mixed results. Some studies show that the perceived audit quality is impaired when NAS are undertaken by auditors, while some studies show that by providing NAS, cost efficiency may arise. While there is some evidence to suggest that there may be a perceived threat to auditor’s independence as a consequence of NAS fees, there is no strong evidence to support the notion that auditor’s independence may be compromised as a consequence of the auditor’s fees’ dependence on NAS.

Researchers have also suggested that mandatory disclosure of audit fees could lead to fewer instances of “overcharging by auditors” and an increase in the clients’ bargaining power over auditors.

On balance, we are of the opinion that the disclosure of audit fees can provide a more level playing field in Singapore, and would also be consistent with the other major capital markets in the world.