Disclosure Of Nonaudit Services Fees: Perceptions Of Investors And Accounting Professionals

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Abstract

This study examines investors' and accounting professionals' perceptions related to the necessity and form of disclosure of nonaudit service (NAS) fees pursuant to the Security and Exchange Commission's Final Rule on auditor independence. A between-subjects design was used to examine participants' opinions as to the need for disclosure of the performance of NAS and the particular form of disclosure that was preferred. The design incorporated four types of NAS (actuarial services, internal audit outsourcing, legal services, and software training), two levels of materiality (40 percent and 3 percent), and three categories of participants (non-Big 5 CPA firm professionals, Big 5 CPA firm professionals, and investors). A larger percentage of investors favored disclosure of NAS fees than either non-Big 5 CPA firm professionals or Big 5 CPA firm professionals. In addition, of those who favored disclosure, investors favored disclosure of the amount of NAS along with the total audit fees, regardless of the amount, while non-Big 5 CPA firm professionals and Big 5 CPA firm professionals both favored disclosure of the amount of NAS alone and only if those services exceeded a specified threshold. The investor results lend support to the SEC's revised auditor independence rules.

1.0 Introduction

Following months of a very public debate, the Securities and Exchange Commission (SEC) issued its "Final Rule: Revision of the Commission's Auditor Independence Requirements" (hereafter, Final Rule) in November 2000. The Final Rule utilizes a two-pronged approach to address issues surrounding auditor independence (SEC 2000). The first prong seeks to control behavior by placing significant restrictions on an audit firm's ability to provide certain nonaudit services (NAS) to audit clients. The second prong intends to inform financial statement users about the business relationship between a company and its auditor by requiring disclosure of the fees paid to a company's audit firm.

Numerous studies have addressed the first prong of the SEC's rule by examining the influence of NAS on auditor independence (e.g., Jenkins and Krawczyk 2001, Swanger and Chewning, Jr. 2001, Lowe et al. 1999, and Pany and Reckers 1988). Substantially fewer studies have examined the issues surrounding disclosure of NAS fees (e.g., Frankel et al. 2002, Glezen and Millar 1985, and Scheiner 1984). In addition, most disclosure studies have been based primarily on markets based metrics. This study instead examines disclosure of NAS fees through an investigation of investors' and accounting professionals' perceptions related to the necessity and form of fee disclosure.

2.0 Disclosure of NAS Fees

In 1978, the SEC issued Accounting Series Release (ASR) 250 which required public companies to disclose fees paid to their audit firm for various services whenever those services exceeded 3% of total fees paid to

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the audit firm. Shortly after the issuance of ASR 250, the SEC determined that the mandated disclosures were not providing useful information to investors. Consequently, ASR 250 was rescinded. The rescission was supported by academic research which reported no evidence that the mandated disclosures had any measurable effect on investors, auditors, or managers (Law and Economics Consulting Group, Inc. 1997).

With the increasing scrutiny of auditor independence, the impetus behind the SEC's decision to again require disclosure of fees information was to provide investors a partial basis upon which to evaluate an auditor's independence. In effect, investors may be better able to evaluate an auditor's independence if they know the nature and scope of the relationship between a company and its audit firm. This thought was clearly salient to the SEC during its deliberations, as evidenced by the SEC's noting in the Final Rule that the SEC Practice Section had stopped publishing information about the provision of nonaudit services by audit firms. Ultimately, the SEC decided that fees disclosure was critical to achieving the goals of increasing and protecting auditor independence. The Final Rule requires public companies to disclose for the most recent fiscal year, the aggregate fees billed for the audit, the aggregate fees billed for financial systems design and implementation, and the aggregate fees billed for nonaudit services.

The mandated disclosure of fees information is opposed by some and supported by others. Opposition to the Final Rule was expressed by the accounting profession. The opposition voiced by KPMG captures the sentiments of many. "It is difficult to understand how the disclosure of non-audit services would enable investors to make an informed decision about auditor independence more capably than the audit committee can using the disclosure required by ISB Standard No. 1" (KPMG 2000, p.1). Recalling the ineffectiveness of ASR 250, the Public Oversight Board's Panel on Audit Effectiveness stated, "Whatever its merits in 1978, when ASR 250 was adopted, disclosure of non-audit services will not suffice today or for the future. ... In repealing ASR 250 in 1982, the SEC noted a lack of 'utility to investors.' The question of usefulness to investors is equally true today. How are shareholders expected to deal with the disclosure? ... Using disclosure to assure independence in fact and appearance is a lot like pushing the string rather than pulling it" (POB Panel 2000, p.124-125).

In support of the required fees disclosure, Penn, Schoen, and Berland (2000) found that 89% of investors surveyed felt that it is important to know if a company's auditor also provides other services to the company, regardless of the level of service provided. They concluded, "Investors are looking for as much credible information as possible when making investment decisions." Given the differing perceptions of members of the accounting profession and investors, it is important to observe the reactions of both groups to the Final Rule disclosure requirements.

Auditor independence may be a more salient issue when a client generates a substantial amount of revenue for an office or practice area (Wallman 1996). Disclosure of NAS and the related fees may be necessary only when such fees are material. Perhaps, the magnitude of NAS fees is more relevant when they represent a larger proportion of the total fees paid to the auditor. Pany and Reckers (1988) investigated whether the *extent* of MAS (0 percent, 25 percent, 60 percent, or 90 percent of the audit fee) affects the decisions of bank loan officers and financial analysts. However, they found that the level of MAS influenced only two of the 15 requested decisions (i.e., a loan decision and a 12-month investment-safety decision). Notwithstanding this research, the influence of materiality on the perceptions of investors and professionals has not been investigated. Consequently, this study explores how the relative materiality of NAS fees influences the desirability of various forms of fee disclosure.

3.0 The Study

A between-subjects design was used to examine disclosure preferences of investors and accounting professionals (I & P). Participants read a hypothetical case in which a CPA firm provided one of four types of NAS to an audit client.[1] The four types of NAS were actuarial services, internal audit outsourcing, legal services, and software training. The first three services were limited or prohibited in the Final Rule. The NAS were presented as representing either a material or immaterial portion of the total client fees (40 percent compared to 3 percent). At the end of the case, participants were asked to indicate which of several statements agreed with their opinion regarding the need to disclose the performance of NAS by the CPA firm. Finally, they were asked to complete a background questionnaire.

The study was completed by a total of 323 non-Big 5 CPA firm professionals, Big 5 CPA firm professionals, and investors.[2] The non-Big 5 CPA firm group consisted of 139 practicing professionals, while the Big 5 CPA firm group consisted of 83 practicing professionals. The average age of the non-Big 5 CPA firm group was 45.2 years, while the average age of the Big 5 CPA firm group was 30.7 years. The average number of years of education for each CPA firm group was 17.6 and 17.2 years, respectively.

The investor group consisted of 32 individuals belonging to local civic organizations and 69 individuals enrolled in a graduate business program at a large public university.[3] The investor group's average age was 37.3 years, and the group had an average of 17.5 years of education. Both investor subgroups indicated a similarly high level of involvement in making their own personal investment decisions (i.e., average rating of 73.8 on a scale where 75 indicated participation "most of the time"). In addition, both subgroups had experience reading financial statements and financial publications.[4]

4.0 Results

Participants' opinions as to the need for disclosure (or non-disclosure) of the performance of NAS were examined. The initial analysis, presented in Panel A of Table 1, compared the percentage of participants in each group favoring disclosure of the performance of NAS to the percentage of participants favoring no disclosure. An overwhelming majority of investors, 92.6 percent, favored disclosure, while only 47.8 percent of the non-Big 5 CPA firm professionals and 44.3 percent of the Big 5 CPA firm professionals favored disclosure ($X^2_{2,306} = 58.92$, $p<0.001$). Similar results are obtained when disclosure preferences are examined separately for participants who evaluated cases with a material portion of NAS fees (Panel B of Table 1: $X^2_{2,153} = 34.26$, $p<0.001$) and an immaterial portion of NAS fees (Panel C of Table 1: $X^2_{2,151} = 24.67$, $p<0.001$). In addition, Chi-Square analysis controlling for type of participant indicated that the percentage of each participant group favoring disclosure did not differ significantly across materiality levels.

Table 1: Percentage of Investors and Professionals Favoring Disclosure or Nondisclosure for Nonaudit Services

Panel A: Overall Percentages

	Disclosure	No Disclosure
Non-Big 5 CPA Firms	47.8	52.2
Big 5 CPA Firms	44.3	55.7
Investors	92.6	7.4
Overall Average	62.3	37.7

Chi-Square Statistic: $X^2_{2,306} = 58.92$, $p<0.001$

Panel B: Percentages for Material Fees Only

	Disclosure	No Disclosure
Non-Big 5 CPA Firms	49.2	50.8
Big 5 CPA Firms	46.3	53.7
Investors	96.1	3.9
Overall Average	63.9	36.1

Chi-Square Statistic: $X^2_{2,153} = 34.26$, $p<0.001$

Panel C: Percentages for Immaterial Fees Only

	Disclosure	No Disclosure
Non-Big 5 CPA Firms	46.5	53.5
Big 5 CPA Firms	42.1	57.9
Investors	88.6	11.4
Overall Average	57.5	42.5

Chi-Square Statistic: $X^2_{2,151} = 24.67$, $p<0.001$

As a follow-up, participants who favored disclosure were asked to indicate which of four forms of disclosure they preferred. The four types of disclosure were: disclosure of the amount of NAS exceeding a specified threshold, disclosure of the amount of NAS along with the amount of audit fees with the total fees exceeding a specified threshold, disclosure of the amount of NAS regardless of the amount, and disclosure of the amount of NAS along with the amount of audit fees regardless of the total amount. Panel A of Table 2 presents the percentage of participants who favored each form of disclosure.[5] Over 48 percent of investors favored disclosure of the amount of NAS along with the total audit fees, regardless of the amount. However, the non-Big 5 CPA firm professionals and the Big 5 CPA firm professionals favored disclosure of the amount of NAS alone and only if those services exceeded a specified threshold (34.4 percent and 45.7 percent, respectively). These differences are significant using Chi-Square analysis ($X^2_{6,180} = 32.98$, $p<0.001$).

Table 2: Percentage of Investors and Professionals Favoring Different Forms of Nonaudit Service Disclosure

Panel A: Overall Percentage

	Disclose Dollar Amount of Nonaudit Services (NA) if:			
	Amount Exceeds Threshold:		Regardless of Amount:	
	NA Only	NA+Audit	NA Only	NA+Audit
Non-Big 5 CPA Firms	34.4	18.8	25.0	21.9
Big 5 CPA Firms	45.7	20.0	17.1	17.1
Investors	6.9	24.1	20.7	48.3
Overall Average	23.7	21.5	21.5	33.3

Chi-Square Statistic: $X^2_{6,180} = 32.98$, $p<0.001$

Panel B: Percentage for Material Fees Only

	Disclose Dollar Amount of Nonaudit Services (NA) if:			
	Amount Exceeds Threshold:		Regardless of Amount:	
	NA Only	NA+Audit	NA Only	NA+Audit
Non-Big 5 CPA Firms	25.8	9.7	41.9	22.6
Big 5 CPA Firms	52.6	10.5	21.1	15.8
Investors	4.1	22.5	22.5	51.0
Overall Average	20.2	16.2	28.3	35.4

Chi-Square Statistic: $X^2_{6,93} = 28.93$, $p<0.001$

Panel C: Percentage for Immaterial Fees Only

	Disclose Dollar Amount of Nonaudit Services (NA) if:			
	Amount Exceeds Threshold:		Regardless of Amount:	
	NA Only	NA+Audit	NA Only	NA+Audit
Non-Big 5 CPA Firms	42.4	27.3	9.1	21.2
Big 5 CPA Firms	37.5	31.3	12.5	18.8
Investors	10.5	26.3	18.4	44.7
Overall Average	27.6	27.6	13.8	31.0

Chi-Square Statistic: $X^2_{6,81} = 12.56$, $p=0.051$

There is also a significant difference between participant groups when examining only those subjects considering NAS that represented a material portion of total fees (Panel B of Table 2: $X^2_{6,93} = 28.93$, $p<0.001$). However, non-Big 5 CPA firm professionals now favored disclosure of the amount of NAS regardless of the amount (41.9 percent). Investors still favored disclosure of the amount of NAS along with the total audit fees, regardless of the amount and Big 5 CPA firm professionals still favored disclosure of the amount of NAS alone and only if those services exceeded a specified threshold (51.0 percent and 52.6 percent, respectively).

The Chi-Square analysis results are marginally significant when considering only those subjects for whom NAS represented an immaterial portion of total fees (Panel C of Table 2: $X^2_{6,81} = 12.56$, $p=0.051$). The pattern of disclosure preference is similar to the total analysis - investors still favored disclosure of the amount of NAS along with the total audit fees, regardless of the amount (44.7 percent) and both non Big-5 CPA firm professionals and Big 5 CPA firm professionals favored disclosure of the amount of NAS alone and only if those services exceeded a specified threshold (42.4 percent and 37.5 percent, respectively). Finally, Chi-Square analysis controlling for type of participant indicated only that the percentage of non-Big 5 CPA firm participants favoring disclosure of a particular type differed significantly across materiality levels, as discussed previously. Almost 42 percent of non-Big 5 CPA firm professionals for whom NAS represented a material portion of total fees favored disclosure of the amount of NAS regardless of the amount (41.9 percent), while 42.4 percent of non-Big 5 CPA firm professionals for whom NAS represented an immaterial portion of total fees favored disclosure of the amount of NAS alone and only if those services exceeded a specified threshold.

5.0 Discussion

Participants' disclosure preferences appear to be influenced by the performance of NAS. A significantly larger percentage of investors favored disclosure of fees information than did either the non-Big 5 CPA firm professionals or Big 5 CPA firm professionals. Specifically, investors favored disclosure of the amount of NAS fees along with the total audit fees, regardless of the amount. On the other hand, the Big 5 CPA firm professionals favored disclosure of the amount of NAS fees only if those services exceeded a specified threshold. In contrast, the disclosure preferences of the non-Big 5 CPA firm professionals depended on the materiality of the NAS. Specifically, they preferred disclosure of the amount of NAS regardless of the amount if the services were material, but preferred disclosure of the amount of NAS only if those services exceeded a specified threshold if the NAS services were immaterial in relation to the total fees.

This study's overall result is consistent with that reported by Penn, Schoen, and Berland (2000). That is, investors prefer disclosure of fees information. Moreover, these results lend support to the SEC's revised auditor independence rules that require companies to disclose the fees paid to their external auditors. However, the extent to which the additional disclosures mandated by the SEC are effective at informing investors and other financial statement users is yet undetermined.

6.0 Suggestions for Future Research

There are a number of issues that future research may wish to examine. For example, it is unclear whether, and to what extent, investors utilize the mandated fees disclosures to assess auditor independence. In addition, future research should consider whether the currently required form of disclosure is sufficient to explain the relationship between a company and its auditor. Lastly, future research should also consider whether the extent of the mandated disclosure is adequate. 🕮

Endnotes

1. The CPA firm was portrayed as a large international CPA firm which has audited the company for several years. McKinley, Pany, and Reckers (1985) found that the then Big 8 CPA firms provided audit opinions that were believed to be more reliable than those provided by smaller firms and that such firms were generally viewed as more independent than smaller firms.
2. Members of the investor group completed the cases during regularly scheduled meetings of civic groups or graduate school classes. Non-Big 5 CPA firm professionals completed the cases as part of a continuing professional education conference. Big 5 CPA firm professionals completed the cases in their offices as their schedules permitted.
3. Maines and McDaniel (2000) also used graduate business students as proxies for "nonprofessional investors."
4. T-tests were conducted for each demographic variable obtained from the background questionnaire to ensure that the two "subgroups" of investors were substantially similar. The analyses indicated only two significant differences between the subgroups. First, the average age of the civic group members was greater than the age of the student group ($p < 0.001$). Second, the two subgroups differed in terms of participation in company investment decisions ($p < 0.005$), with the civic group members participating more frequently than the student group members. However, neither group was heavily involved in making company investment decisions (average rating of 27.7 for the civic group and 9.3 for the student group on a scale where "25" indicates participation "rarely").
5. Thirteen of 321 users (4.1%) selected a fifth option that provided that the amount of nonaudit services be disclosed and then allowed an open-ended response to the precise form of disclosure. These users are included in the disclosure group in Panel A of Table 1, but are not included in the Table 2, Panel A analysis. The 13 users included five non-Big 5 CPA firm professionals, four Big 5 CPA firm professionals and four investors

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