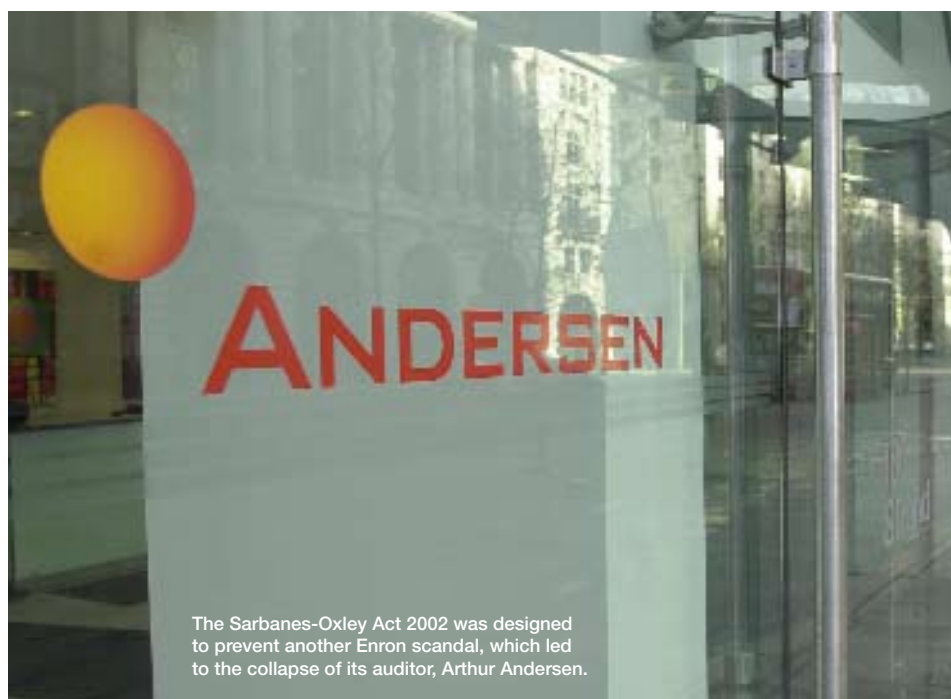


# AUDITING INDEPENDENCE

Should an equivalent law to the Sarbanes-Oxley Act be introduced in the UK? **Raghavan Iyengara** and **Judy Land** think it's worth considering.

**When an auditor supplements its income** by performing a variety of non-audit functions for an audit client, there is a risk that the relationship will become too cozy. The auditor might lose sight of its duty to cast a critical eye over the client's accounts for fear of losing a lucrative revenue source. There is also an inherent conflict of interest whenever the auditor provides management consulting services, because its client is the firm's management team and not the shareholders.

A substantial increase in the proportion of non-audit fees charged relative to audit fees has led to a perceived (and real, according to some studies<sup>1</sup>) impairment of external auditors' objectivity and independence in the assurance function. Corporate scandals in large companies such as Enron (2001) and Tyco (2002) caused investors to lose confidence in audited financial statements. Although the Sarbanes-Oxley Act 2002 (Sox) now prohibits auditors from performing eight specific non-auditing functions for clients listed in the US, no similar legislation has



## 1 Audit and non-audit fees paid by FTSE 100 and S&P 100 companies in 2000-01 by industry

Industry	Number of companies		Audit fees paid (\$000)		Non-audit fees paid (\$000)		Audit fees per \$m of client assets		Non-audit fees per \$m of client assets		Ratio of non-audit fees to total fees	
	UK	US	UK	US	UK	US	UK	US	UK	US	UK	US
Food	9	7	4,297	5,963	12,023	17,574	346	295	772	1,187	0.649	0.757
Textiles/printing	4	3	2,400	3,857	9,300	7,635	423	191	1957	262	0.664	0.514
Chemicals	4	5	2,888	7,117	4,425	11,718	410	499	620	758	0.604	0.567
Pharmaceuticals	4	6	3,762	4,243	15,150	21,121	416	151	754	721	0.639	0.727
Extractive	3	3	5,897	10,402	24,672	32,347	131	354	461	877	0.706	0.701
Durables	7	16	3,970	6,551	8,725	22,244	595	327	1,104	1,054	0.615	0.675
Computers	3	14	690	4,430	904	13,364	613	215	754	506	0.545	0.673
Transport	7	11	2,805	3,023	16,829	13,834	222	79	1,174	406	0.806	0.723
Retail	12	7	1,305	1,723	5,197	4,094	224	164	648	388	0.652	0.642
Services	7	3	3,092	5,403	6,359	16,116	644	190	1,159	233	0.556	0.595
Financial	20	13	4,065	10,914	10,412	24,003	575	31	633	64	0.632	0.635
Utilities	9	7	1,300	3,729	6,979	5,685	107	98	589	146	0.714	0.598
Other	2	2	7,025	18,350	4,400	29,400	231	83	171	135	0.414	0.617
Total	91	97	3,147	5,965	9,517	16,609	397	198	814	555	0.646	0.662

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been enacted in the UK. The main aim of Sox was to restore investor confidence by correcting weaknesses in corporate governance and improving internal control mechanisms over financial reporting. But critics have questioned the efficacy of the changes required by Sox and the extra compliance costs the law has introduced.

From 2001 (the year before Sox was enacted) to 2006, legal compliance costs for audit clients in the US rose by 171 per cent while auditors' fees increased by 271 per cent over the same period, according to a 2007 survey by law firm Foley & Lardne ([www.snipurl.com/dg7jg](http://www.snipurl.com/dg7jg)). These numbers contrasted sharply with audit fees in the UK: audit fees paid by FTSE-100 companies increased by less than one per cent between 2003 and 2006. Clearly, the costs of auditing in the US have increased much more quickly because of the compliance demands of Sox – so much so that it's obvious that audit costs in the US are significantly higher in absolute terms today than they are in the UK.

The increasing number of audit failures and accounting restatements in the US has highlighted issues relating to audit and non-audit fees. These same issues may also be pertinent to UK firms. We wanted to address whether the audit and non-audit costs in large companies were significantly different in the US relative to the UK before Sox was enacted. To this end, our research aimed to:

- Document the relative differences in audit and non-audit fees in US and UK in both

## 2 Descriptive statistics and tests on sample companies for 2000-01

Variable	UK companies: mean (median)	US companies: mean (median)	Wilcoxon Z (median test: Pearson chi <sup>2</sup> )
Sales (\$m)	12,364 (6,243)	31,180 (17,953)	-6.278* (24.621*)
Assets (\$m)	54,669 (10,430)	90,453 (27,812)	-4.836* (21.809*)
Audit fees paid (\$000)	3,147 (2,250)	5,965 (4,300)	-4.741* (10.308*)
Non-audit fees paid (\$000)	9,517 (4,050)	16,609 (8,000)	-3.568* (10.308*)
Total fees paid (\$000)	12,676 (6,900)	22,495 (13,829)	-3.936* (6.901*)
Audit fee per \$m of client sales	576 (364)	268 (237)	3.673* (12.268*)
Audit fee per \$m of client assets	397 (198)	198 (150)	1.954† (2.130)
Non-audit fee per \$m of sales	2,047 (1,192)	1,033 (769)	3.881* (12.268*)
Non-audit fee per \$m of assets	1,190 (807)	753 (497)	2.201§ (5.4522§)
Ratio of non-audit fees to total fees	0.646 (0.662)	0.662 (0.657)	-0.243 (0.000)

†, § and \* indicate two-tailed significance at the ten per cent, five per cent and one per cent levels respectively.

absolute and relative terms (ie, before and after controlling for client size).

- Determine whether audit and non-audit costs reveal a trend over time.
- Explore the potential policy implications of the results.

First we analysed audit and non-audit costs for 2000-01 – the last year before Sox's enactment – on both sides of the Atlantic.

Our sample comprised 188 organisations: 91 companies in the FTSE 100 and 97 companies in the S&P 100. Table 1 presents the distribution of the sample by industry and the mean values of main audit and non-audit variables in our study. The industry distribution of our sample is similar to that of

prior studies using comparable sample evidence, including those of Frankel *et al*<sup>2</sup> in 2002 and Whisenant *et al*<sup>3</sup> in 2003.

In terms of absolute magnitude, we found audit fees, non-audit fees and total fees to be highest among extractive industries in the case of both UK and US companies. They were lowest in computing for UK firms and in retail for US companies. When we scaled these fees by total assets, they were highest in textiles (UK) and food (US), and lowest in chemicals (UK) and the financial industry (US).

Table 2 summarises the differences in the size of client and the amount of fees paid in the UK and the US. We used a Wilcoxon rank-sum test to test for significant

## 3 Average audit and non-audit fees paid by the sample companies to the big five auditors in 2000-01

Auditor	Mean audit fee (\$000s)		Mean non-audit fee (\$000s)		Mean audit fee per \$m of client sales		Mean non-audit fee per \$m of client sales		Mean audit fee per \$m of client assets		Mean non-audit fee per \$m of client assets	
	UK	US	UK	US	UK	US	UK	US	UK	US	UK	US
Arthur Andersen	1,958	3,517	5,706	8,837	1,413	263	4,473	852	884	267	2,178	935
Deloitte & Touche	3,762	8,319	6,928	18,156	280	317	784	1,200	183	192	565	701
Ernst & Young	3,020	3,681	8,281	9,094	943	248	2,147	714	797	160	1,810	437
KPMG	3,726	9,370	9,553	15,534	380	320	1,763	821	202	208	727	538
PwC	2,960	6,325	11,109	22,907	482	250	2,023	1,246	335	193	1,198	918

differences in the audit and non-audit fees and other variables between UK and US companies. On average, US businesses were almost twice the size of their UK counterparts in terms of sales and total assets.

Accordingly, US companies paid substantially higher fees to their auditors. But, once we controlled for client size by scaling the fees by sales and total assets, we discovered that UK companies paid their auditors proportionately larger audit and non-audit fees.

Next we partitioned the data into fees paid by firms to the corresponding big five auditors (see table 3, previous page) and scaled the audit and non-audit fees by client size. In the cases of Deloitte & Touche and KPMG we found no significant transatlantic differences, on average, in audit or non-audit fees when adjusted for client size. For the other three firms – Arthur Andersen, Ernst & Young, and PwC – when audit and non-audit fees were scaled by sales, their UK clients paid them significantly more than their US clients. When audit and non-audit fees were scaled by total assets, only Ernst & Young showed a significant transatlantic difference in both, while PwC showed a significant difference only in audit fees. Table 4 shows non-audit fees charged by each of the big five in 2000-01 as a proportion of total fees.

Another important issue we considered was whether the level of US audit and non-audit fees after Sox differed significantly from the situation before the law was enacted. Since Sox prohibited certain types of non-

#### 4 Non-audit fee ratios for the big five auditors in 2000-01

Auditor	Ratio of non-audit fees to total fees	
	UK	US
Arthur Andersen	0.643	0.623
Deloitte & Touche	0.615	0.603
Ernst & Young	0.586	0.642
KPMG	0.631	0.636
PwC	0.680	0.716

#### 5 Pre- and post-Sox audit fees and permitted non-audit fees in the US

Year	Mean audit fees (\$000)	Wilcoxon Z	Mean permitted non-audit fees (\$000)	Wilcoxon Z
2001	6,727	-	13,383	-
2002	8,718	-7.42*	11,296	3.76*
2003	10,760	-7.59*	8,815	4.90*
2004	16,455	-7.96*	7,413	6.17*
2005	17,251	-7.79*	5,624	7.34*
2006	18,450	-7.78*	5,717	6.88*

\* indicates two-tailed significance at the one per cent level.

audit services, we determined whether permitted non-audit fees after Sox were significantly larger or smaller relative to the same non-audit fees before Sox. For the sake of completeness, we also compared audit fees pre- and post-Sox. Table 5 shows the absolute magnitude of the audit and non-audit fees respectively.

Overall, it is safe to conclude that, while non-audit fees have declined, audit fees have soared in the US since the enactment of Sox.

We believe that our findings are interesting and revealing. For example, sweeping regulatory changes in corporate governance and corporate audits were enacted via Sox as a direct result of fraud, mismanagement and accounting shenanigans. But no similar steps were taken in the UK, despite the fact that both audit and non-audit fees were substantially larger, in terms of client size, in the UK relative to the US. Based on the

evidence provided about the relative size of audit and non-audit fees, British regulators may want to reconsider the consequences of non-enactment of a statute similar to Sox.

Our analysis provides a telling insight into comparative costs of audit and non-audit services in the UK and the US. Concerns about the excessive amount of non-audit work performed by external auditors – and the concomitant impairment of auditor objectivity and auditor independence – should be high on the regulators' agendas.

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