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The association between audit committee and board of director effectiveness and changes in the nonaudit fee ratio

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Abstract

Investors and the US SEC are interested in the impact of nonaudit fees on the economic bonding between auditors and their clients and in the role of audit committees in monitoring this economic bonding. The results of this study show a negative association between audit committee effectiveness and changes in the nonaudit to audit fee ratio, suggesting that effective audit committees generally minimize the nonaudit fee ratio in order to enhance auditor independence. In addition, the results of this study suggest that effective Board of Directors also limit increases in the nonaudit fee ratio, possibly due to their own concerns over auditor independence.

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Notes

[1] For example, in 1990, 71% of Big 5 auditors's revenues were from audit service fees, while 12% were from consulting services. However, by 1998, 48% of auditors's revenues were from auditing fees, while 32% were from consulting services. The SEC (2000b) also indicated that the percentage of Big 5 audit clients that paid MAS fees in excess of audit fees did not exceed 1.5% until 1997, but by 1999, 4.6% of Big 5 audit clients paid MAS fees in excess of audit fees, an increase of over 200% in 2 years.

[2] The SEC issued a final rule implementing Sarbanes–Oxley Section 407, which requires a public company to disclose that it has at least one ‘financial expert's on its audit committee or, otherwise, to explain why it does not.

[3] According to the Blue Ribbon Committee (BRC) (1999), financial expertise is demonstrated by employment experience in accounting or finance, a CPA certification or comparable experience, including a position of CEO, or other senior executive with financial oversight responsibilities. Following Abbott et al . (2004), we define an expert as a Director who is a CPA, investment banker, or venture capitalizt, or who served as CFO, vice-president of finance, controller, treasurer or CEO.

[4] When I define audit committee effectiveness with a committee of fully independent members where at least one member is financially expert, the results are qualitatively the same, but are statistically less significant.

[5] I also examined the effect of the auditors's industry specialty. Industry specialty is measured as the percentage of client sales audited in each two-digit SIC industry or an indicator variable used in Palmrose (1986). While these alternative measures themselves are insignificant, the results of other variables are qualitatively the same.

[6] Industry classification is based on the two-digit SIC code categories used by Frankel et al . (2002) and Ashbaugh et al . (2003).

[7] The sample mean (median) nonaudit to audit fee ratio in fiscal year 2000 is 1.7152 (1.1981), which is similar to what the SEC found in its study of 563 proxy statements in 2001 (see ‘SEC's Unger calls Andersen Fraud Case ‘Smoking Gun's, by CFO.com staff, CFO.com, 25 June 2001).

[8] When the continuous variables are not winsorized, the statistical implications and the conclusion remain the same. However, some of the explanatory variables are less significant and lowers the goodness of model fit (adjusted $R^2 = 0.0495$).

[9] In fact, eliminating one or both of these variables improves the statistical significance of other variables.

[10] The third highest correlation is between SIZE and INDGROW ($\rho = 0.25$). Neither the multicollinearity indicators (Variance Inflation Factors and Condition Index) nor the heteroscedaticity indicators (White and Breusch–Pagan test scores) indicate significant problems.
