A Thesis
Entitled

The Sarbanes-Oxley Act:
Effects on Public Accounting Firms
By
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Abstract

To improve corporate governance and audit work procedures, the Sarbanes-Oxley Act of 2002 was quickly passed. The legislation not only strengthens the internal control within the public companies, but also exerts the pressure on public accounting firms. Under strict regulations, public companies will pay higher audit fees for audit firms so that to meet new act’s requirements, thus increase the companies’ operating costs. Though companies’ internal control will be improved a lot in post-SOX environment, many managers and experts think Act’s costs may exceed its benefits. In this paper, reasons of increase of costs and benefits will be analyzed through exploration of SOX provisions.
Appreciation and Acknowledgment

This thesis is dedicated to my advisor Dr. Alex Petkevich, in appreciation of the support and advice he has given me throughout my academic endeavors. I would also like to express my gratitude to Professor Flom. I learned a lot from her class.
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Through 2001 to 2004
Introduction

Enron Company had been the Top 7 in U.S. Fortune 500. But its false account problem and sudden bankruptcy raise the attention from public and government to companies’ internal supervision and auditing system. Under the impact of this scandal, Sarbanes-Oxley Act (also called SOX) was quickly enacted to be used to reduce the amounts of similar scandals effectively.

There is no doubt that this Act will significantly affect companies, but its influence on public accounting firm didn’t catch most people’s eyes. In fact, through the research, SOX Act not only change audit firms’ work scope and procedures, but also change their fee structure, especially for the Big 4 which dominate the auditing market, their reflection to the Act is much stronger.

Audit fee accounts for a large proportion in a company’s operating cost, so it is necessary to research changes occurred to accounting firm’s cost and charges.
Section 1: Brief of Sarbanes-Oxley Act

Origin

Before 2002, the U.S. capital markets have suffered a series of financial scandals. A number of corporate giants include Enron, Tyco International, WorldCom have admitted financial frauds and corruption, which caused great uproar in U.S. capital market. And a group of large companies were abandoned by the investors and declared bankruptcy finally. Frauds of these enterprises not only cheated investors, but also took a heavy toll themselves. At the same time, their behavior seriously damaged capital market order and negatively affected American’s economy. These enterprise frauds’ purposes and means are different. Among them, Enron’s financial fraud is the most typical and influential. This is because Enron Scandal was the starting point of big storm of US capital markets accounting scandals and also because, from setup to bankruptcy, Enron had always drawn the attention of the public eye. The most important reason is that Enron Scandal drove one of the Big Five auditing firms
in the world—Arthur Andersen collapsed.

Therefore, “to protect investors by improving the accuracy and reliability of corporate”, and “to restore public confidence in financial statement”, Sarbanes-Oxley Act was passed in 2002 for all U.S. public company boards, management and public accounting firms.

**Purpose**

The creation of SOX is the reflection of high-level financial scandals in which a number of Fortune 500 companies were involved. So, SOX’s goal is to strengthen the responsibility of public companies to protect the benefits of public company’s investors from the violation of corporate executives and relevant institutions. And SOX empower SEC to oversight the corporate governance and ensure transparency and accountability by implementation of SOX compliance. Its internal logical thinking is that improving the timeliness and accuracy of financial report and public disclosure in order to prohibit deceit to give investors
correct information to make right decisions. Also, strengthening the responsibility of company executives’ financial report and providing external auditor independence will help improve the quality of financial report and information disclosure. Under SOX, corporate sector should work with transparency and provide full disclosure of information as and when required. It offers investors protection through the anti fraud provisions.

Main content

Compared to former regulations such as the Securities Act of 1933 and 1934, Sarbanes-Oxley seems much stricter. It mainly includes the following contents:

Section 101 through Section 103 establishes a new regulatory body called Public Company Accounting Oversight Board to oversight public company professional auditing. PCAOB is responsible for monitoring the public company executives, accounting firms and certified public accountants. This board consists of five full-time
financially educated members, and two of them must be CPAs but the rest of them must not be accountant and truly represent the interests of public. PCAOB has the power to register public accounting firms, conducting inspections, enforce compliance of the act and set the budget and manage the operations of the board. It doesn’t provide service as US government department or agency. Besides the responsibility for keep an eye on companies, PCAOB also has duties include enacting or adopting professional accountant group’s auditing standards, quality control standards and ethical principles, etc. If PCAOB consider these standards appropriate, it will maintain close cooperation with the designated accounting experts who are responsible for producing standards. And PCAOB has the right to supplement, modify and abolish these standards and finally PCAOB has to submit annual report to SEC according to the rule made. PCAOB will undertake annual inspection for public accounting firms with more than 100 public company clients, and other accounting firms will be conducted an inspection every three
years. But, PCAOB and SEC may conduct special inspection at any time.

Section 201 and 203 deal with auditor independence that means auditors should be independent in all matters relating to the audit work. The Act bans accounting firms to provide a list of banned non-auditing services for clients. Audit partners and review partners must rotate every five years. If the company’s chief executive, chief financial officer, chief accounting officer and other senior managers worked in an accounting firm in the previous year, the accounting firm will be banned to provide legal audit service for this company.

Section 404 deals with management’s assessment of Internal Controls, which requires “each annual report of an issuer to contain an internal control report”. Under this provision, CEO and CFO must guarantee that the financial report submitted to SEC is “fully comply with the securities and exchange act, and fairly reflect the financial position and operating results in all major aspects”. And the
financial report must reflect all of the major adjustments made by accounting firm, and annual and quarterly report must disclose major transactions and other relationships between company and unconsolidated entities which has great impact on current or future company’s financial position.

Besides the main contents listed above, SOX Act also states the increased punishment level of illegal behavior and reinforcement of investigation on auditing standards by the General Accounting Office (GAO).
Section 2: The Effect on Cost of Accounting Firm

Reach of Sarbanes-Oxley Act truly hits accounting firms. Due to its exceedingly strict rules and regulations, accounting firms not only have to provide service to their client with more caution, but also bear the huge risk.

Because of Enron and other large companies’ accounting scandals and its public accounting firm—Arthur Anderson’s bankruptcy before 2002, SOX pay more attention to the operation standard of accounting firms.

The most significant change in post-SOX environment is the mandatory plan that public accounting firms undergo regular inspections by the PCAOB. PCAOB take the responsibility of accounting firms oversight whether they fully comply with the auditing standards, quality control standards, ethical standards and independence standards.

Likewise, accounting firms not only do the simple “auditing” work as before, they also play a role in supervising the company’s internal control when they preparing and issuing the financial statement. Once they find
a fraud happened to this company, they should reflect the problem to SEC in time. In order to finish the task well, SOX also states that accounting firms are required to maintain for at least seven years all audit work papers and documentation to support auditors results and employees of issuers and accounting firms are extended “whistleblower protection”.

In the Sarbanes-Oxley, the provisions of auditor independence account for a large proportion. The formation of this provision is closely related to the Enron Event. Arthur Andersen audit firm provided Enron audit services as well as quite a lot non-audit services. And the non-audit service fee ($27 million) was higher than that of audit service ($25 million). So, some experts thought these huge non-audit service charges affected the CPA audit independence. SOX listed nine non-audit activities that auditors are prohibited to perform for a client, include bookkeeping, financial information system design and implementation, appraisal or valuation serves, actuarial
services, internal audit outsourcing services, management functions, broker or dealer services, legal services related to audit and other contingent prohibited services that depend on practical situation.

The third most important change is the mandatory audit rotation and its 1-year rule. Mandatory rotation contains two meanings: one is the regular rotation of audit partner; the other is the mandatory audit firm rotation to avoid reducing the audit independence caused by long-term relationship with audit clients. Enron had established for 16 years, during this period, its financial statements were always prepared and issued by Arthur Andersen audit firm. Many people among public doubted that the long-term cooperation relations may negatively affect audit independence. Moreover, many of the Enron employees were former Arthur Andersen auditors, which mean these auditors might have unfair attitude towards Enron and then have biased auditing results. In fact, history has proved the people’s doubt. Arthur Andersen, as one of top five accounting firms
in the world, audited the Enron’s financial statement without either found Enron’s false profits or its large amount of debts. On November 8, 2001, Enron admitted that its financial statements had serious problems. Since 1997, Enron had fabricated its profits in nearly $600 million. Thus, SOX came up with an idea of mandatory audit firm rotation rule. However, this rule is quite controversial. Through GAO’s research, GAO found the mandatory audit firm rotation may not be the most efficient method to strengthen audit independence and improve audit quality, and may cause the cost to this provision exceeds the benefit from it. Therefore, GAO stated that “the CEO, CFO, controller, chief accounting officer or person in an equivalent position cannot have been employed by the company’s audit firm during the 1-year proceeding the audit” as a win-win method.

In addition to the above, according to SOX Act, choice of accounting firms and audit fee standard are decided by public company management. Managers not only decide the audit service fee of accounting fee but also decide the accounting
firm performance to a certain extent. This is an “inherent profits connection” commonly found between company management and audit firms. Thus, between the company and audit firms, there exists a correlation rather than independence. This phenomenon contradicts the audit independence provision in SOX Act. Faced to the legal or illegal accounting manipulation behavior by companies, in order to get paid, auditors are usually placed in a dilemma and may not express their opinions totally independently. This contradiction is also one of the reasons which lead SOX to controversy after it issued.

To sum up, with the implementation of SOX Act, accounting firms are facing much more severe regulations and higher amount of punishment, they have to increase their workload to effectively control their auditing quality and monitor their client’s internal control. Of course, they also bear much more risk than before. Compliance with Sarbanes-Oxley Act imposes both extra work and new risk on the auditor contributing to the higher cost of the audit firms.
Section 3: The Effect on Fee Structure of Accounting Firms

All Public Accounting Firms

The costs and benefits are always closely linked. In the post-SOX environment, the cost of accounting firms increases because of complying with the new provisions enacted by SOX. Accordingly, their audit fees will increase. A study shows that audit fee levels went up approximately 74 percent in the post-SOX period.

Increase of audit fee is caused by a number of reasons, which can generally be divided into two aspects, one is the cost of increased workload, and the other is auditor’s expected legal liability.

The increased audit effort comes from the complexity of audit engagement to a large extent. In the provisions of SOX, it requires that audit firms retain audit work papers for at least seven years so that to improve public companies internal control structure (Section 103). It also requires accounting firms keep a great and more frequent communication with its clients and auditor committee. The methods of
communication can be written or verbal, and both methods need auditors put more effort to accounting (Section 204). Moreover, accounting firms need to take more procedures to attest the management’s assessment of internal controls and audit results on the financial statements (Section 404).

Auditor’s legal liability refers to the lawsuits typically faced by auditors. The probability of alleged misstatements which include improper or inadequate disclosure and inappropriate valuation, non-discovery of fraud resulting from negligence, delayed completion of audit and inappropriate withdrawal from an audit is the reason leads to the increase of auditor’s legal liability cost. Under the provisions of Sarbanes-Oxley Act, enhanced oversight by PCAOB will significantly improves the maintenance of internal control and the quality of company’s financial statements, thus material misstatement and audit failure are expected to decline. Even though, with the more strict regulations of SOX and higher requirements towards external auditors, the amount of lawsuits faced to public
accounting firms increases rather than decreases with the less probability of audit failure. Furthermore, SOX empowers the accounting firms to play a monitoring role when auditing the company’s financial statement. Accounting firms should take the responsibility to submit the accounting fraud found in company’s financial statements to SEC as soon as possible. This provision highly improves the discretion of SEC and increase the probability of lawsuits and fines imposed by regulatory bodies, thus increase the legal liability cost.

**Big 4**

From original Big 8 to current Big 4, big audit firms have experienced a long history during their development. The current public accounting market consist of a “Big 4” refers to Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers and KPMG. The four audit firms have almost dominated audit market and their audit service has covered most U.S. public companies, even throughout the world. Especially for those global firms, big 4 are always their
audit firms because large companies need Big 4’s technical skills, reputation and experience. And main smaller scale companies would choose smaller accounting firms for services. In view of their different service object, the Big 4’s fee structures are certainly far different from other small audit firms.

Through the research, the average increase in audit fees is 41.75 percent higher for clients of Big 4 compared to clients of smaller audit firms. Why they grow disproportionally? Three reasons can be concluded. Most Fortune 1000 companies choose Big 4 as audit firm not only because they have high reputation, but also they represent the high level of audit assurance. Under the rigorous regulations of SOX, ensuring that companies fully comply with the rules and no fraud in financial statement has been a crucial thing in auditing. Thus, Big 4 will charge a premium for their top audit assurance.

Since Big 4 provide more complex service for large-scale companies, their risk is much higher than small audit firms,
especially the risk from lawsuits and fines by regulators like SEC. And, Big 4 have already have successful enterprises, they will lose more than others when they met litigation risk. Take Enron Scandal as an example. After Enron Scandal, Enron’s trade partner and big financial consortium were seriously affected, such as Duke Group and J.P. Morgan, both of them suffered a lot of loss. But Enron’s bankruptcy caused most impact on Arthur Anderson and led to Arthur’s dissolution directly. Therefore, the pattern of world’s top audit firm became Big 4 from Big 5 and market for large auditors became more concentrated. The less competitive in top audit firms lead to the increase of audit fee.

The promulgation of SOX greatly increase the accounting firm workload and cost, especially for Big 4, which operation is much more complex than small accounting firm, so they will rebuild audit pricing to incent and support the complex audit process. Besides, in the pursuit of complete and accurate audit process, Big 4 invest more heavily in technology and employee training than small audit firms. Because they put
more money in the higher fixed costs, they need to charge higher fees to cover its costs and gain a certain profits. And SOX prohibits nine categories of non-audit services by external auditors to public companies. When audit firms lose revenue from these services, they must increase audit fees to recover their auditing costs with fees for consulting and other services.

Last but not least, fee discount is also an important function for audit pricing. It is said: “a large number of small auditors offering similar products, and a small number of large auditors offering specialized audit services.” Thus, small audit firms are willing to offer more fee discounts to attract new clients and grasp a greater portion of audit market. Conversely, Big 4 illustrated that they are less likely to compete with rivals on audit price. And currently, an increasing number of large companies go into the market, so the demand for Big 4 will continually grow. Now, some Big 4 will not accept some big companies as their audit clients because the risk of providing services for these companies
is too high.

Audit fees increases in the post-SOX period, but conversely, non-audit fees decreased a lot at the same period because of the new scope of limitations of external auditors can provide. From Table 1 and Figure 1, the percentage of audit to non-audit fees decreased 22% from 2002 to 2004 while total audit fees increased 14% during that period. And this trend continued after that.
Conclusion

Since 2002, after the Sarbanes-Oxley Act being enacted, it brought a huge influence to public accounting firms. Because of the severe provisions and higher punishment of Act, accounting firms have to not only complete audit task more carefully and play a more crucial role to supervise the companies’ internal control. Audit firms’ operating process has undergone many changes correspondingly, such as audit firms must keep all audit work documents for at least seven years and experience annual inspection by PCAOB.

The growth of workload also makes the cost of accounting firm increase a lot thus increase the accounting firms’ audit fee in the post-SOX period. Of all the auditing firms, because Big 4 has most complex work and highest risk, Big 4 audit fee increased more than other small audit firms. But, when audit fee increases, the non-audit fee reduced year by year conversely because nine-category non-audit service has been prohibited under SOX Act. But overall, the total costs (include audit and non-audit fee) present a growing trend.
Because the promulgation of SOX is too hasty, some contradictory and imperfect provisions cause controversy among public and most companies. One of the most controversial problems is that the new regulation made public companies spend much more on its auditing and internal control, and these operating costs even exceed the benefits acquired from the new provisions. This phenomenon also put much pressure on numerous companies. Therefore, how to balance the costs and benefits has risen to a new issue for company management in the post-SOX era.
Figure 1

Audit Fee of Big 4 through 2007 to 2009
Table 1

Total S&P 500 Audit Fees

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<th>2003</th>
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<td>N/A</td>
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<td>565.7</td>
<td>652.8</td>
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<td>575.3</td>
<td>652.8</td>
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Reference


www.logitax.hu/English/Sox.pdf