

Effect of Sarbanes-Oxley Act of 2002 and SEC Final Rulings on Auditor Independence

By

Hoseoup Lee, PhD, CPA
Assistant Professor, SUNY Institute of Technology

Abstract

Recent final rule on auditor independence by the Securities and Exchange Commission, as directed by Section 208(a) of the Sarbanes-Oxley Act of 2002, bans the auditors performing certain types of nonaudit services to audit client, requires the auditors the pre-approval from audit committee for providing nonaudit services not banned by the SEC rules, mandates the rotation of in-charge and concurring partners every five years, and requires “time-out” period for member of audit engagement team before employed by audit client. This study compares the new rule with the current code of professional conduct and examines the potential impact on audit profession

Keywords

Auditing, Auditing standards, Auditor independence

I. Introduction

With recent accounting scandals, such as Enron, WorldCom, Adelphia, and Global Crossing to name a few, investors have asked “why the external auditors failed to detect financial statements fraud?” Independence (or lack of it) of auditor was identified as a biggest culprit of the recent audit failures. Traditional approach of self-regulation (AICPA enforcing generally accepted auditing standards (GAAS) and the Code of Professional Conduct) was considered failed to properly ensure the quality audit provided in such audit failures. Independence has long been the foundation of audit process, and any erosion of it may create potential dangers to audit quality and reduce the likelihood that the auditor may detect fraudulent financial reporting. Instead of the ineffective self-regulation system, politicians and financial regulators (the SEC) designed a new legislation (Sarbanes-Oxley Act of 2002, or SOA) and a set of corresponding regulations that impact the accounting profession. The SOA and the SEC regulations fundamentally change the way public companies do business and how the accounting profession performs statutorily required audits (Thomson & Lange, 2003). The purpose of this paper is to compare the new regulations with existing rules regarding auditor independence and to examine the implications of the new legislation and SEC rules to accounting profession.

Auditor’s independence essentially gives investors more confidence that financial reporting examined by auditors (independent from management) reflect the accurate picture of operating results and financial position. Auditor independence means that auditors should be objective and free of conflicts of interest in discharging professional responsibilities such as independent audit (AICPA, ET 55 and ET 100). To fairly represent the interest of the public, the auditor must be independent of the client in fact and in appearance. Independence in fact represents the state of auditor’s mind. The auditor must be in mental attitude in all matters

related to audit engagement. Independence in appearance refers to how financial statement users perceive the auditor's independence. If certain activities, relationships, and other circumstances would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence in fact (Siegel and McGrath, 2003). Virtually all accounting firms perform advisory services. If the advisory services are rendered for audit clients, the question of independence surfaces, as to whether the audit firm objectively examines financial statements prepared by management while being compensated by the same management for consulting services. For example, the exact same question emerged with respect to Enron case, when Arthur Anderson received \$25 million in audit fees and \$27 million in consulting fees.

The new rules and regulations are a vindication of the efforts of former SEC Chairman Arthur Levitt to restrict the ability of independent auditors in providing non-audit services to audit clients (Kopel, 2003). Earlier efforts by the SEC and its chairman were partially successful at best with severe resistance by the accounting profession.

II. Provisions of SOA and the SEC rules

Cooling-off period for members of audit team

Both SOA and corresponding 2003 SEC final rules require one-year cooling-off period for any member of an audit engagement team before he/she joins former audit client as an employee. Under SOA, former employees of an audit firm (lead or concurring partners, principals, and audit professionals) are considered not independent when the employees join former audit client as CEO, controller, CFO, and CAO. The SEC rule, however, takes more flexible approach when it applies the function of employment, by banning former member of an

audit team from working for his/her former audit client as accounting or financial reporting oversight role. This cooling-off period intends to prevent an undue influence on audit quality by former boss or colleague.

Prohibited non-audit services

Both SOA and SEC rule list various services that an audit firm is not allowed to provide to its audit clients. Most banned services are related to consulting or advisory services that might create conflict of interests for independent auditors (Banham, 2003). However, the prohibited service is not new. A similar set of services was banned by the 2000 SEC rule. Table 1 summarizes the differences in provisions for auditor independence. The banned non-audit services in SOA and 2003 SEC rule include:

- (1) Bookkeeping or other services related to the accounting records or financial statements of the audit client - The auditor is considered not independent when he/she provides bookkeeping services for audit client. It involves with an inherent conflict of interest, since an auditor supposedly examines accounting records or financial statements prepared by him/herself for its appropriateness.
- (2) Design and implementation of accounting information systems - This is another example of creating inherent conflict of interest, since an auditor is required to evaluate the effectiveness of accounting system that he/she designed or implemented. Installing a computerized accounting system for client was immensely popular consulting services in many big accounting firms. Since the 2000 ban, various consulting arms of big accounting firms have been sold.
- (3) Appraisal and valuation services – Appraisal, valuation, or any services involving a fairness opinion of contribution-in-kind report for audit clients, unless it is reasonable to conclude that the results of these services will not subject to audit procedures during audit.

(4) Actuarial services – Any actuarially oriented advisory services involving the determination of amounts recorded in the financial statements and related accounts other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during audit.

(5) Internal audit outsourcing services – Under generally accepted auditing standards, the auditor is required to evaluate the effectiveness of internal control system over financial reporting, which creates another example of conflict of interest. For example, Arthur Anderson provided the internal control function for Enron, before it was banned by 2000 SEC rule, and was blamed for not improving Enron's ineffective control system.

(6) Management functions – Acting, temporarily or permanently, as a director, officer, or employee of an audit client or performing any decision making, supervisory, or ongoing monitoring function for audit client.

(7) Human resources – Searching for or seeking out prospective candidates for managerial, executive, or director positions, undertaking reference checks of prospective candidates for executive or director position, and recommending or advising audit client to hire a specific candidate for a specific job.

(8) Broker-dealer, investment advisor, or investment banking services – Acting as a broker-dealer, promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of audit client.

(9) Legal services – Providing any service to audit client that could be provided only by someone licensed, admitted or otherwise qualified to practice law.

(10) Expert services unrelated to audit – Providing an expert opinion or other expert service for audit client for the purpose of advocating an audit client’s interests in litigation or in a regulatory or administrative proceeding or investigation.

Preapproval of providing permitted non-audit services

For services not specifically banned by SOA and SEC rule as listed in the previous section, any permitted services provided by independent auditors other than audit services should be approved by the audit committee of client. Under the SEC rule, such service that traditionally rendered by independent audit firm as tax service should be approved by the audit committee.

Disclosure of audit and non-audit fees

SOA requires that approval of non-audit service by audit committee should be disclosed to investors in periodic financial reporting. SEC final rule also extends the disclosure requirement of audit and non-audit fees paid to independent auditors in the proxy statement (four categories including audit, audit-related, tax, and all other fees). Under the 2003 rule, companies must disclose the fees paid to independent auditor in a category called as “audit-related fees” in proxy statement, in addition existing two categories of fees - audit and non-audit fees. This new category includes audits of company pension plans and due-diligence work of prospective mergers that previously reported in non-audit fees (Weil & Rapoport, 2003).

Audit partner rotation

Both SOA and SEC rule restrict the number of consecutive years (five years) that audit partner can serve for an audit client. The partner rotation rule applies to leading and concurring partners (SOA) or any audit partners who worked for a client (SEC rule). The SEC rule also requires that rotated partner cannot serve back to his/her client without 5-year time-out period. This requirement can incur additional cost to audit firms in terms of bringing new partner to back

up and having the right person with the right experience (Felo and Solieri, 2003), but most big accounting firms have adopted the rule as a quality control measure for many years..

Compensation for sale of non-audit services to audit client

2003 SEC rule prohibits audit firms from paying financial incentives to audit partners or professions based on the sale of non-audit service.

Communication of auditor with audit committee

Both SOA and SEC rule requires timely report by auditor to audit committee regarding (1) all critical accounting policies and practices to be used, (2) all alternative accounting treatments within generally accepted accounting principles for material financial statement items, and (3) other material written communications between auditors and client such as management letter or schedule of unadjusted differences.

Independent oversight board over auditing industry

SOA created public oversight board of auditing industry, or Public Company Accounting Oversight Board (PCAOB). The SEC is required to regulate or oversee the board. Compared to existing oversight board like Public Oversight Board (POB), the new board has strong tools to control the auditing profession, including authority to create auditor independence rulings, auditing standards, and sanction auditors.

III. Conclusion

Both SOA and 2003 SEC final rule fundamentally change the way auditing profession does its business. First, there is a fundamental shift in regulating accounting industry – from the primarily self-regulated environment to public regulation approach. Second, a new set of independence rules and regulations affects the accounting profession directly in performing audit

engagement. Third, new independent public oversight board (PCAOB) now has the direct authority to police audit process, auditing standards, and disciplinary measure on auditors, including (1) registering public accounting firms that issue audit reports for publicly traded companies, (2) establishing auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports, (3) conducting inspections of registered public accounting firms, and (4) Conducting investigations and disciplinary proceedings and imposing appropriate sanctions on audit firms and auditors.

However, the changes in auditor independence required by the SOA and 2003 SEC rule are just a step toward improving the effectiveness financial statement audit. More critical to the success of the audit effectiveness (or preventing audit failures) than just creation of new legislation or regulations is the professional and mental attitude by independent auditors in serving the interest of investing public. Without the dedication of practicing auditors, it is inevitable to experience another wave of financial statements fraud and audit failures. The community of users of financial statements presumes that they have been determined by the certifying independent auditor. The resulting auditor's report should convey a description of economic reality as closely as current communications, economics and accountancy allows (Briloff, 2002).

Reference

AICPA. 2002. Code of professional conduct (ET 55). AICPA Professional Standards, vol.2. Adopted in 1988 and amended in 1992 and 1997

Banham, Russ. 2003. Period of adjustment. Journal of Accountancy (February), 43-48.

Briloff, Abraham. 2002. Accountancy and society: a covenant desecrated. The CPA Journal (December), 11-12.

Felo, Andrew and Steven Solieri. 2003. New laws, new challenges: Implications of Sarbanes-Oxley. Strategic Finance (February) 31-34.

Kopel, Jared. 2003. The SEC's new auditor independence rules. Insights the Corporate & Securities Law Advisor (March), 2.

The SEC. 2000. Final Rule: Revision of the commission's auditor independence requirements. www.sec.gov.

The SEC. 2003. Final Rule: Strengthening the commission's requirements regarding auditor independence. www.sec.gov.

Siegel, Arthur and Susan McGrath. 2003. Recognizing and addressing conflicts of interest. CPA Journal (April), 6.

Thompson, James and Gerard Lange. 2003. The Sarbanes-Oxley Act and the changing responsibilities of auditors. Review of Business (Spring), 8-12.

The US Congress. 2002. Sarbanes-Oxley Act. H.R.3763. www.findlaw.com.

Weil, Jonathan and Michael Rapoport. 2003. The Wall Street Journal (January 22), C1.

Table 1
Major provisions of auditor independence requirements

	Old AICPA ethics rules	SEC final rules of 2000	Sarbanes-Oxley Act of 2002	SEC final rules of 2003
1)Financial interest in audit client	Restriction of financial or investment interest for all partners and their family members	Financial interest restricted only to those who can influence the audit	N/A	N/A
2)Employment at audit client by former auditors (“cooling off” period)	N/A	No “cooling off” period required	1-year period for those participated in audit to work as CEO, controller, CFO, CAO	1-year period for working in accounting or financial reporting oversight role
3)Prohibited scopes of (non-audit) service provided to audit client	N/A	1) bookkeeping; 2) financial information systems; 3) appraisal; 4) actuarial; 5) internal audit; 6) management functions; 7) human resources; 8) broker-dealer; 9) legal; and 10) expert services	1) bookkeeping; 2) financial information systems; 3) appraisal; 4) actuarial; 5) internal audit outsourcing; 6) management or human resources; 7) broker or dealer; 8) legal and expert; and 9) any other services set by the SEC	Same as 2000 final rules
4)Preapproval of providing permitted non-audit services	N/A	N/A	Preapproval of audit committee is required for providing non-audit services	Preapproval of audit committee is required for providing non-audit services (including tax service)
5)Disclosure of audit & non-audit fees	N/A	Required to disclose the fees from audit and non-audit services in proxy statement	Approval of non-audit service by audit committee should be disclosed to investors in period reports	Same as Sarbanes-Oxley Act and extend 2000 disclosure rule

	Old AICPA rules	SEC final rules of 2000	Sarbanes-Oxley Act of 2002	SEC final rules of 2003
6) Audit partner rotation	Not required, but implemented in various large audit firms as a part of quality control process	N/A	5-year limit on lead and concurring partners providing audit services for a client	Rotation after 5-year service & 5-year time-out period for all partners on the audit engagement team
7) Role of audit committee in audit engagement	N/A	N/A	Approval of audit & permitted non-audit services	Same as Sarbanes-Oxley Act
8) Rewards for sale of non-audit services to audit client	N/A	N/A	N/A	Audit firms are prohibited to paying financial incentives based on the sale of non-audit services
9) Auditor's Communication with audit committee	Under GAAS, but not independence rules	N/A	Timely report of 1) all critical accounting policies; 2) alternative accounting treatments & disclosures; and 3) management letter	Same as Sarbanes-Oxley Act
10) Expanded disclosure of audit engagement	N/A	Proxy disclosure on 1) fees billed for services rendered by auditor; 2) compatibility of non-audit service with independence; and 3) employment of leased personnel	N/A	Proxy statement disclosure of paid fees in categories including 1) audit fees; 2) audit-related fees; 3) tax fees; and 4) all other fees

	Old AICPA rules	SEC final rules of 2000	Sarbanes-Oxley Act of 2002	SEC final rules of 2003
11)Independent oversight of auditing industry	Self regulation including Public Oversight Board (POB); Independent Standards Board (ISB)	N/A	Public Company Accounting Oversight Board (PCAOB)	Same as Sarbanes-Oxley Act