The effects of sox on audit firms essay

Business, Accounting

Independence of outside audit firms has been an ongoing issue for a long time in the US corporate world. The fundamental problem arises for the lack of clarity about whom does the audit firm really works for, the shareholders or the client company. According to Anandarajan et all (2008), this lack of clarity has resulted in auditor's independence being impaired. In the US, the client hires, pays, and fires the auditor and therefore, the culture of the auditors serving at the pleasure of the client still remains.

As DeAngelo (1981) explained in his article, an important aspect of the loss of auditor independence is that auditors refrain from reporting detected material misstatements in audited financial statements, thereby failing to perform their duty to warn. Another aspect of the issue relates to the provision of non-audit services by auditors to their clients. As Lai (2003) said, this allegation receives much impetus in recent years because non-audit revenue has out-grown audit revenue to become a much more dominant source of public accounting firms' total revenue. After the recent financial scandals involving large firms like Enron and Worldcom, concern regarding auditor independence has climbed to a height. This triggered the adoption of the Sarbanes-Oxley (SOX) Act which passed into law on July 30, 2002.

The effect of the Sarbanes-Oxley Act has been far reaching from corporate governance to auditor independence rule in the US and abroad. In January 2003, the SEC adopted numerous rules to implement the requirements of the Sarbanes-Oxley Act that changed some fundamental aspects of the outside audit firms. Such as: Nonaudit services Under the act, all US publicly traded companies are required to disclose the amount and the nature of fees paid to their outside independent auditors in their annual proxy statement or

the 10K filing. These disclosures allow the investors or anyone else to evaluate the fee structure proportion for audit and non-audit services indicating the auditor's independence. Another requirement of the Act is that an audit committee must approve all nonaudit services where the total payment for this category is less than five percent of total fees amount. The Act prohibited nine particular nonaudit services that would potentially impair the auditor's independence.

They are: •Bookkeeping or other financial statement services. •Financial system design and implementation. •Appraisal or valuation services of assets and others.

•Actuarial services involving accounts that could be audited. •Internal audit related to the accounting controls and financial systems. •Performing any decision making or supervisory function for the client. Advocating in litigation or regulatory proceedings.

Partner rotation: The Act requires certain partners on an audit team to be rotated after no more than five to seven years consecutively. This depends on the partner's involvement in the audit process where an audit partner is defined as a member of the audit team with significant responsibility of decision making on auditing, accounting, and reporting of the financial statements. However, certain small audit firms are exempt from this requirement. Audit team engagement: According to this Act, and audit firm would not be considered independent if certain members of the audit company had been members of the client company within one year before the audit process. This would be considered as a significant indication of

impaired independence of the engaged audit team. Additional compensation: The Act prohibits any audit partner to receive compensation based on the procuring engagements with the client company for services other than audit, review, and attest services.

This would be considered as a contingency fee which is prohibited under the Act. Audit committee approval: Under this Act, the client company's audit committee has to pre-approve all audit and nonaudit services provided by the outside audit firm. This committee has now more authority in hiring and firing the auditors. Supplementary provisions of the Act have been adopted to establish management code of ethics for greater independence of the audit firms. However, the implementation of these provisions may further provide struggle between auditor's independence and the management satisfaction. A research by Lai (2003) shows that after the Act, auditors are more likely to issue modified audit opinion and their clients are more likely to be associated with lower discretionary accruals. Considering this fact as a measure of auditor independence, Lai's study suggests a positive association of the passing of the Act and improvement of auditor independence.

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