Accounting firms cautiously maneuver in the new audit environment – a note

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Abstract

Purpose – This paper seeks to discuss the effect that the Sarbanes-Oxley Act (SOA) had on both the nature of the external audit function and overall audit quality. Additionally, it aims to discuss how audit firms maneuvered through the newly regulated environment, and what their strategic actions are for the future.

Design/methodology/approach – This discussion is based on interviews conducted with auditors from nine public accounting firms located in Northeast Ohio, United States of America. The sample consisted of five national and four regional firms, and the interviewees included mostly partners and a few senior managers.

Findings – The increased oversight and workload resulting from the SOA requirements has changed the nature of the external audit function to more compliance type work, and the environment has created much anxiety for the auditors. The new reform has significantly impacted the audit environment in terms of: scope of services; client assessment procedures; management and audit committee relationships with the external auditor; audit firm personnel management; and the long-term outlook of the profession. The details of these impacts are discussed throughout the paper.

Research limitations/implications – This paper provides detailed insight as to how the SOA impacted the audit profession. Hopefully, such an understanding will benefit future research in measuring the costs and benefits of the new reform. Lastly, a future research showed further examine the effect that the SOA has had on overall audit quality.

Originality/value – This paper summarizes the insightful comments obtained in structured interviews with several leading audit professionals. The sample was judged to be highly knowledgeable of the changing audit environment caused by the SOA. With an improved understanding of its impacts, regulators, practitioners, and academics can better assess the effectiveness of the SOA.

Keywords External auditing, Auditors, Corporate governance, Quality

Paper type Research paper

Initiated by perhaps the most extraordinary accounting scandals in history (e.g. Enron, WorldCom), the Sarbanes-Oxley Act (SOA) represents the most significant reform of the public accounting profession since the Securities Acts of 1933 and 1934. With the objective of restoring public confidence in the financial reporting system, the SOA places a high level of responsibility on both the public audit firms and publicly listed companies. With the dust still settling from the initial public filings under the new regulations, the beleaguered audit firms are positioning for the future.

The SOA has created a tumultuous environment for the public audit firms. Public companies must now assess the effectiveness of their internal control systems, and

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external auditors must attest to this assessment. These requirements coupled with amplified oversight from regulators and investors resulted in a steep learning curve for the audit firms. The public audit firms found their resources stretched to the limit in meeting the overwhelming workload resulting from the Act. In addition, these firms were under an unprecedented level of oversight from the newly created Public Company Accounting Oversight Board (PCAOB) and newly enabled audit committees of the companies under audit. The increased oversight and workload has apparently changed the nature of the external audit to more compliance type work and the environment has created much anxiety for the auditors, but the overall impact that the SOA has had on audit quality is an empirical question.

This paper examines the SOA impact on the type of work performed in external audits. Furthermore, we discuss how audit firms maneuvered through the newly regulated environment, and what their strategic plans are for the future. Our discussion is based on interviews conducted with auditors from nine public accounting firms located in Northeast Ohio, USA. The sample consists of five national (including all the Big 4 firms) and four regional firms, and the interviewees included nine partners and two senior managers[1]. We judged our sample to be highly knowledgeable of the changing work environment caused by the SOA. Each interview lasted approximately 90 minutes and covered how the SOA has impacted the public audit firms in the following areas: scope of services, client assessment, relationships with the client and audit committee, and personnel management. Lastly, we asked the auditors for their views on the long-term outlook of the public audit profession.

This study contributes to the stream of research that examines the effects that increased regulation has on professional judgment and overall audit quality. Previous literature analyzes certain behavioral attributes (e.g. compliance vs judgment) that drive audit quality, and how an exogenous force, such as significant regulation, impacts the delicate balance of these attributes. Power (1997, p. 39) states that:

> ... there are concerns that the financial audit will become an ever more proceduralized "regulatory compliance" product, as each new crisis pushes it in this direction, at the expense of a credible space for "professional" judgment.

Likewise, Francis (1994) argues that the inevitable new regulations following accounting scandals lead to highly structured and standardized audits that lessen auditor subjectivity. The author develops a neo-Aristotelian argument that scientism and technocratic rationality (i.e. structured audit methodologies) limits the auditor's subjectivity and practical reasoning capabilities in performing audits, and as a result lessens the quality of audits. Hatherly (1999) suggests that when faced with a combination of regulatory and fee pressures, audit firms tend to displace their judgment from the discretionary audit work toward the desire to make their audits more efficient (cost effective). In sum, the academic literature suggests that because of the uncertainty surrounding the audit function in regards to its objectives, methods, costs, and benefits, quality audits require some level of professional judgment by the auditor; and a regulated environment hinders this professional judgment and in turn overall audit quality. We find that the SOA has indeed increased the compliance type work performed on external audits suggesting a possible decrease in auditor professional judgment. However, this is only one of several changes resulting from the Act, and we call on future research to determine the overall effect that the new regulation has on audit quality.

Scope of services

The SOA restricts the external auditor from providing the following services to their audit clients: bookkeeping or other services related to the accounting records or financial statements of the client; financial information system design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit. In addition, many boards of directors, apprehensive in the new environment, mandate even more restrictive limitations on services that their company's auditor may perform[2]. Despite losing revenues in these service areas, all of the sampled firms reported operating beyond full capacity this past year. The primary reason for the surge in workload stems from the SOA's Section 404 requirements.

Section 404 attestation work clearly dominated the resources and focus of the public accounting firms over the past several years. Section 404 requires the external auditor to attest on management's assessment of the effectiveness of the company's internal control over financial reporting. The steep learning curve and the increased workload associated with fulfilling the Section 404 requirements not only caused all of the sampled accounting firms to operate at 100 percent capacity (or greater), but also required auditors to perform procedures which were perhaps less captivating than the traditional audit procedures. Not surprisingly, a major concern among the firms is now employee morale and retention after such a difficult year.

In addition, the public audit firms exhausted significant resources toward training their employees on Section 404 requirements. A partner noted that every attestation partner and manager of the firm attended a five-day training seminar on Section 404. Furthermore, many partners engaged in a weekly webcast call to discuss the various issues surrounding the new requirement. Similar training seminars and tutorials were offered to lower level audit personnel throughout the entire firm. The partner noted that these efforts were global and not just restricted to the US practice, because the firm's foreign offices are often called to meet the Section 404 requirements for multinational Securities and Exchange Commission registrants.

The second- and third-tier firms that were not overly involved with public audits picked up significant consulting work in the Section 404 compliance area[3]. Independence concerns restricted the external auditor from providing implementation guidance to their clients even though many of the clients were ill equipped to handle this daunting task. Often, these companies turned to the non Big 4 accounting firms for consultation in meeting the Section 404 requirements. The Section 404 consulting work is expected to diminish as the learning curve lessens and companies implement their own compliance processes. However, the interviewees do not foresee a significant decrease in demand for their overall consulting services due to additional opportunities being discovered while performing the initial Section 404 work.

Client assessment

The high demand for attestation services allowed the Big 4 firms to reevaluate their client portfolios. The Big 4 firms terminated many of their smaller and by their judgment riskier engagements, causing a windfall for the second-tier firms. All of the Big 4 firms reported a reduction in the number of overall clients but an increase in the number of hours worked. The second-tier firms that performed public audits in the past were in an excellent position to accept the recently dropped Big 4 clients.

The over abundance of work has also caused public accounting firms to shift from traditional revenue generating objectives to risk management. Most of the interviewees noted significant changes to their firm's client assessment policies and procedures. The process has become much more robust and sophisticated compared to prior years. For example, one firm utilizes a customized software program that takes the user through a decision tree when assessing the potential risks of a client. Various risk areas are considered, including past reporting problems, the composition and expertise of the board of directors, budgeting techniques, attitude toward the audit team, implementing their code of conduct, and attitude toward internal controls. In addition, the firms reported that background checks on client management are more extensive in both breadth and depth than in years past. Background checks are now performed on all top executives including the chief executive officer, chief operating officer, chief financial officer, and chief accounting officer, and members of the board of directors. Such profiling is judged to be highly effective.

Overall, the intensified assessment procedures resulted in the Big 4 firms significantly reducing the number of clients. Prior to the SOA, it was unfathomable to imagine a Big 4 firm dropping a client because of staffing concerns. In the post-SOA environment, however, such an act has become quite common. In addition, the audit clients are relying on far more consultants than in the past. Therefore, if a client uses a third party to outsource an activity, the audit firm must assess its independence to both the client and outsourcer.

Client relations

External auditors experienced heightened tension when dealing with their clients over the past year. The increased tension is the result of a variety of factors, including an increased perception of independence, higher audit fees, the overwhelming Section 404 compliance work, greater reporting responsibility with minimal guidance, a more diligent and probing audit committee, and a skeptical financial market. All these factors contributed to a financial reporting environment characterized by strain, skepticism, and anxiety among auditors, audit committees, and management. The past year found the external auditors hesitant to provide Section 404 compliance advice to clients because of independence concerns stemming from the SOA scope of services restrictions and the lack of authoritative guidance in this area from the PCAOB. Furthermore, clients often felt antagonized by their auditors when being drilled about the detailed documentation and testing surrounding Section 404. The interviewees considered the tense auditor/client relationship to be extreme, and hope that better communication will result from relaxed tension during upcoming audits.

The interviewees did suggest that the clear lines of responsibilities established for the external auditor, the audit committee, and management by the SOA has improved the overall financial reporting quality of publicly listed companies. Companies have recognized the importance of internal controls and financial reporting, and many organizations have significantly improved their financial reporting function. Audit committees have raised their financial literacy levels and are meeting longer, asking tougher questions, and increasing the dialogue with the external auditor. With a de-emphasis on growth and an increased level of scrutiny from governing bodies (e.g. PCAOB, audit committees, financial markets), audit firms have significantly increased the scope and depth of their financial statement audits as well.

The Section 404 compliance costs for publicly listed companies are expected to significantly decline in the second year mainly because the documentation and the testing process for internal control systems are now in place. Audit firms, however, are not expecting a significant year-two decline in Section 404 attestation costs. The Section 404 attestation function will gain some efficiency, but the overall level of attestation work is not expected to decline significantly. The external auditors foresee a potential conflict with audit committees who are anticipating a coming reduction in fees despite the permanency of the attestation work.

Personnel management

The Big 4 accounting firms were not adequately staffed to handle the Section 404 work. The firms tapped several sources for qualified personnel, including the second-tier firms, internal audit staffs of companies, and their own foreign offices. One firm even leased a dozen employees from three local firms to help assist in the Section 404 testing. Despite all these efforts, the firms were still severely understaffed to handle the workload.

Public audit firm personnel experienced long hours and significant travel this past year. Not surprisingly, employee morale and retention are now critical issues for the audit firms. Several partners expressed concern about the ability to attract the best and brightest for positions that involve performing tedious internal control test work and demand many hours and much travel. A partner stated that despite his firm having a financially good year, the partner group unanimously agreed that they cannot put the staff through another year like the last one. The firm is "rightsizing" their practice to hopefully lessen the strain on their staff for the upcoming year.

Partner evaluations have shifted from a revenue-generating (rain maker) focus to a quality and risk management focus. That is, partners are being rewarded for managing client risks and creating an inviting work environment for their staff. Evaluations are also apparently shifting from individual to group assessments. Partner evaluation groups differ among the accounting firms and include office, industry and service inputs.

The outlook for the future

The public audit firms' immediate strategic plans center around how to adequately meet the demands of the ongoing Section 404 attestation work. Currently, all the firms are competing for the same scarce resource: experienced public auditors, with a particular need for IT specialist auditors.

Although the Section 404 consulting work is expected to decline, the second- and third-tier firms are still planning for considerable consulting service growth in the future. The SOA scope of services restrictions coupled with the demise of Andersen that reduced the Big 5 to the Big 4 has created numerous consulting opportunities for the non-Big 4 firms. Large companies typically engage a Big 4 firm as their auditor, and often hire one or more of the remaining Big 4 firms to provide other services for the company. Such an environment severely restricts the external audit market for large companies and makes the act of changing audit firms quite costly. In order to maintain a viable external audit market, large companies are calling upon the non-Big 4 accounting firms for non-audit services. The second-tier public accounting firms anticipate a significant opportunity to provide these services to large public companies in the future.

The interviewees expressed deep concern that the increased personal risks associated with public accounting will increasingly drive away high quality personnel. Several experienced partners wondered who would want to accept leading roles in the highly subjective and closely scrutinized public reporting environment of today. The interviewees noted that otherwise qualified candidates are declining CFO and partner positions. When asked, "would you do it all over," partners were unsure as to whether or not they would begin a career in public accounting in the current environment. Several partners stated that they "feel like a cop for the government," and that is a role that they never signed up for.

Similarly, audit committees may have difficulty attracting qualified people to fill their directorship positions. Again, the partners questioned the desirability of assuming the risk of sitting on a public company's audit committee in today's environment. Several of the partners interviewed expressed no desire to sit on audit committees upon retiring from their firm. One partner summarized the general view by stating "Why would I ever want to subject myself to those risks during my retirement? I'll find another way to give back to the profession."

The following are several propositions offered by the interviewees about the long-term impact of the SOA:

- The SOA has improved the overall quality of financial reporting but whether the benefits outweigh the costs is questionable. The problem is how to measure quality. Once Section 404 implementation moves from project to process status, and is ingrained throughout companies, management may begin to recognize the value of the SOA.
- The audit function within national public accounting firms has been reestablished as the primary service of the firm. Most of the interviewees believe that this is a permanent change. Additionally, several of the partners foresee public accounting firms evolving into audit-only firms because the regulated environment creates an audit service that is far removed from the other services provided by these firms. The new audit-only firms would still require specialists (e.g. tax, valuation and information systems), but only for support of the audit and not as separate services. New firms may emerge to provide the consultative type work (e.g. tax and information systems).
- The level of collaboration among the Big 4 accounting firms has greatly increased over the past years. The competition barriers have fallen in favor of a "circle the wagons" mentality. By opening communication lines, the Big 4 firms are working together to satisfy the spirit of the Section 404 requirements. A partner noted that he is no longer apprehensive when a competing firm is hired by a client for consultative services, but rather applauds the client's desire to get it right.
- Audit fees are not likely to decline significantly in the post-implementation stage. While our interviewees suggest that fees may decrease slightly because of improved audit efficiencies, a dramatic decrease is not likely.
- The internal control requirements of the SOA have already trickled into non-public companies. For example, debt covenant requirements are becoming

increasingly linked to Section 404 compliance, even for private companies, and the SOA corporate governance concepts are finding their way into not-for-profit entities.

- Public auditors will rely on internal control test work from a properly structured internal audit department. The work of an internal audit department that is independent of management operations was judged to be ideal for the Section 404 attestation work.

Conclusion

The SOA has significantly impacted the public accounting profession. The Act, particularly the Section 404 attestation requirements, bestowed significant work and responsibility on the accounting firms. The abundance of work and public oversight caused the firms to move from a revenue generating to a risk management focus. As a result, the firms decreased the number of clients while still operating at full capacity this last year. The permanency of the SOA suggests that the attestation service will maintain its prominent role within the firms.

The second-tier firms experienced a windfall of new attestation and consulting work resulting from the SOA. The purged clients of the Big 4 firms typically engaged a non-Big 4 firm as their auditor. From the perspective of the second-tier firms, these were relatively large engagements. In addition, the independence concerns of the Big 4 firms resulting from the new scope of service restrictions created a plethora of Section 404 and other consulting opportunities for the second-tier firms.

An overarching concern for all the firms is staffing. The partners recognized that the past year took its toll on their staff accountants. The partners wonder how they will attract the best and the brightest to an environment that offers: long hours, much travel, tense client relationships, tedious work, restricted consulting opportunities, and heightened risk. The firms are working diligently to create an attractive work environment for their staff. Hopefully, in the near term, the firms will effectively maneuver through the post SOA environment and provide the much needed attestation and consulting services to the public companies while still maintaining an attractive career path for high quality accountants.

The audit firms have been overwhelmed with compliance work associated with the Section 404 requirements. According to Hatherly (1999), the combination of regulatory and fee pressure will cause audit firms to displace their judgment from audit work to finding ways to make audits more efficient (less costly). Furthermore, Francis (1994) suggests that employee and partner dissatisfaction at the large audit firms is indicative of an environment with very little professional autonomy. The interviewees expressed a deep concern about the low employee morale at their firms, and several partners questioned the attractiveness of pursuing a career in today's public audit environment. These expressions of dissatisfaction may be construed as the effect that compliance type work has in diminishing the professional judgment of the auditor, and thus perhaps lowering the overall quality of audits. However, several other common responses, such as an increase in audit firm collaboration, a reestablishment of the audit function as the primary service within public accounting firms, and a better communication between auditors and audit committees, suggest an increase in overall audit quality. We call on future research to examine the relation that these various elements have on the overall quality of the external audit.

Notes

1. One of the interviews involved three partners. The remaining interviews were all with one firm representative.
2. For example, Walt Disney Company, Bristol-Myers Squibb Company, and Apple Computer Incorporated have all set limits on their auditors' scope of services (Byrnes *et al.*, 2002). The auditors in our sample observed these restrictions from several of their clients as well.
3. The tiers refer to the common accounting firm groupings based upon size and geographic scope and are not intended to make inference as to audit quality.

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