

**EXTERNAL AUDITOR'S ETHICAL DILEMMA:
PERCEIVED THREAT TO AUDITOR'S RESPONSIBILITY
POSED BY THE AUDITOR'S ALLEGIANCE TO
CORPORATE MANAGEMENT**

Willie E. Gist, CPA, Ph.D
Ohio University

Winifred D. Scott, CPA, Ph.D
Zayed University

Trimbak Shastri, CA, CMA, CIA, Ph.D
University of Louisville

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Abstract

Major accounting scandals and audit failures (such as Enron and WorldCom) during the turn of the century seriously impaired the public's confidence and trust in audited financial statements. This had cast a shadow on auditor independence, integrity and professional conduct, and led to the collapse of Arthur Andersen (AA), one of the then Big-5 public accounting firms. Some have argued that auditors align their interest with that of corporate management instead of investors and the general public because audit fees are paid by management. This leads to the following question: do auditors appear to compromise their independence and align with their clients' interest rather than shareholders'?

interest? Our examination of audit fees charged by the Big-5 to a sample of companies investigated by the Securities and Exchange Commission (SEC) reveals that auditors (except for AA) appear to recognize engagement risk at an increased level for SEC investigated audit clients. Accordingly, SEC investigated clients are charged higher audit fees than non-SEC investigated clients. However, AA appeared not to distinguish the engagement risk differences between its SEC investigated and non-SEC investigated clients. Results overall suggest that auditors fulfill their professional responsibility of serving the public interest by maintaining client-auditor independence and objectivity. Although the Sarbanes-Oxley Act of 2002 has been implemented, misleading and fraudulent financial reporting persist, which suggests that there is room for improving audit quality. Accordingly, we provide suggestions to strengthen both audit quality and professional conduct (particularly regarding auditor independence) to enhance the public's confidence in audited financial statements.

INTRODUCTION

Major accounting scandals (such as Enron and WorldCom) and resulting audit failures have focused attention on auditors' independence and objectivity in connection with their examination of clients' financial statements. It is argued that since clients pay auditors' fees (which in some instances exceeded \$100 million a year¹) that auditors, to retain clients, might compromise their

¹ For example to illustrate the magnitude of audit fees: in 2011 General Electric Co. paid to their auditors: \$113.2 million for audit and audit related fees. See

independence and align with their clients' interest rather than shareholders' interest.

To explore whether auditors compromise their independence, we analyze a sample of Fortune 500 companies under investigation by the Securities and Exchange Commission (SEC) for alleged securities laws violations in the pre-Sarbanes-Oxley Act (pre-SOX Act) period to determine whether auditors in examining the financial statements of these companies applied sufficient audit effort appropriately adjusting for audit risk. An actual or probable SEC investigation (SECInv) may signal potential misconduct by a company's management, which is likely to increase auditors' assessment of engagement risk (e.g., due to auditors' exposure to litigation, bad publicity, and potential loss of clients). Increased engagement risk should lead auditors to assess the risk of material misstatement (RMM) at a higher level, requiring the auditor to apply more effort in examining the financial statements of companies under (or likely to be under) SECInv than for audits of similar companies not under (or not likely to be under) SEC investigation.

Auditing standards mandate that auditors comply with rules of professional conduct and that audits be planned and performed to provide reasonable assurance that the financial statements are free of material misstatement, whether due to error or fraud. Both Statements on Auditing Standards (SAS) for non-public companies promulgated by the American Institute of Certified Public Accountants (AICPA) and Auditing Standards (AS) for public companies issued by the Public Company Accounting Oversight Board (PCAOB) are based on generally accepted auditing

Proxy statement (Schedule 14A) regarding Shareowners' meeting dated April 25, 2012:

http://www.sec.gov/Archives/edgar/data/40545/000119312512107087/d301131ddef14a.htm#toc301131_31

standards (GAAS) (AICPA, AU150.02).² Per these professional standards, auditors are not expected to be infallible, and they do not provide absolute assurance about the fairness of financial statements. Reasonable assurance, which is considered a high degree of assurance, is provided by the auditor.

Standard setters expect professional accountants to follow the ethical intent of accounting and auditing standards (Imhoff 2003; Schipper 2003). In spite of professional standards and guidelines by PCAOB and AICPA, some researchers argue that undesirable ethical behavior is promoted due to the existence of potential conflicts of interest between (a) management and investors, (b) management as the audit client and auditor, and (c) investors and the auditor. It is argued that because auditors are paid by management, auditors might compromise their professional responsibility to investors by concluding that materially misstated financial statements are fairly presented (e.g., Staubus 2005; Satava, Caldwell, and Richards 2006). Such situations suggest (and as argued in Staubus 2005) that the auditing/governance system is not designed to serve the investing public because investors do not pay auditors directly for services received.

In spite of those who may believe that auditors are likely to be more closely aligned with management (than with investors), results of our study suggest that most auditors do exert greater audit effort to address increased levels of engagements risk in situations involving alleged violations of GAAP and/or fraudulent financial reporting. However, AA appeared not to have distinguished the engagement risk differences between SEC investigated and non-SEC investigated companies and exerted the

² AICPA has issued Clarified Auditing Standards to replace almost all existing auditing standards, which will become effective for the audits of financial statements of non-public companies for the period ending on or after December 15, 2012. The purpose of issuing Clarified Standards is to make U.S. generally accepted auditing standards (GAAS) easier to read, understand and apply, and to facilitate convergence of U.S. GAAS with International Standards on Auditing.

same amount of audit effort across all audit clients. A concern is that auditors may occasionally succumb to economic incentives/pressures and compromise their public interest responsibility to avert fraudulent financial reporting. Congress, as a result of major accounting scandals (such as Enron and WorldCom), passed the Sarbanes-Oxley Act of 2002 (which established the PCAOB) to protect the public interest by strengthening auditor independence, and to improve the quality of audits. Even in the post-SOX Act environment, PCAOB inspections of audits indicate that (in some situations) auditors do not exercise due care in fulfilling their audit responsibilities.³

In this study, we use audit fees expressed as a percent of assets and of revenues (to adjust for differences in size across companies) to proxy for auditor's effort and hours consumed on an audit. Many studies (e.g., Palmrose 1989, Gist 1994, and Raghunandan 2006) have used audit fees to assess audit effort since audits are labor intensive and audit hours information is not publicly available. Non-audit service fees as a percentage of assets (or of revenues) are used as a proxy for the auditors' propensity to compromise their objectivity. The larger the non-audit service fees percentage, the greater the auditors' propensity to compromise their objectivity. It is also important to consider audit and non-audit fees in this study because of possible knowledge spillover when both services are jointly provided by the auditor. For instance, fees for non-audit services could possibly be reduced due to extensive knowledge acquired about the client during the audit, or vice-versa.

We compare size adjusted audit fees and non-audit fees of companies investigated by the SEC for violations of GAAP and/or fraudulent behavior to that of non-SEC investigated companies to ascertain whether accounting firms (a) appropriately consider the

³ For example, see Report on the PCAOB's 2004, 2005, and 2006 inspections of domestic triennially inspected firms, PCAOB Release No. 2007-010, October 22, 2007.

risk of material misstatement associated with an SECInv, and (b) apply sufficient effort in planning and executing the audit according to regulations. For matching with SECInv companies, first we identified non-SECInv companies from the same industry, and then selected two-non-SECInv companies for each SECInv company based on total assets that are nearest to the total assets of SECInv companies. Results, based on analyses of size-adjusted audit fees (as proxy for audit effort or audit hours) for a matched sample of companies, reveal that auditors significantly increased the level of audit effort when their clients were under SEC investigation. This suggests that auditors, generally, do comply with auditing standards and rules of professional conduct in fulfilling their responsibilities.

The remainder of this paper is organized as follows. In section two, professional responsibility and public trust are discussed. In section three, we discuss SEC investigations, followed by sample data and analysis in section four. The conclusion is provided in section five along with suggestions to enhance auditors' professional responsibilities.

PROFESSIONAL RESPONSIBILITY AND THE PUBLIC TRUST

Investors, creditors and other stakeholders rely on the objectivity and integrity of the external auditors who are required to comply with the AICPA's Principles of Professional Conduct.⁴ The Principles of Professional Conduct convey that in serving the public interest, CPAs should behave by doing what is right and just (ET Section 53), and be impartial, intellectually honest, and free of conflicts of interest (ET Section 54). To maintain objectivity and be free from conflicts of interest in discharging professional

⁴ ET (Ethics) Section 53 Article II Public Interest; ET Section 54 Article III Integrity; ET Section 55 Article IV Objectivity and Independence, <http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/sec50.aspx> (Accessed November 27, 2012)

responsibilities, the external auditor must be independent in fact and in appearance (ET Section 55). The AICPA uses these principles as the framework to codify rules of professional conduct. To ensure the public's confidence in the objectivity and integrity of external auditors, auditors should adhere to the rules of the Code of Professional Conduct. The PCAOB and SEC Ethics Rule 3520 are consistent with Ethics Rules 101 and 102 of the AICPA Code of Professional Conduct.⁵

Public trust in the judgment and reputation of the external auditor plays an important role that adds value and credibility to published financial statements (Rezaee 2004). Sometimes auditors are faced with the ethical dilemma of succumbing to economic incentives/pressures and scheming opportunities for personal benefit. The external auditor (as a CPA and member of the AICPA) is expected to uphold his/her professional responsibility, to honor the public trust, and to demonstrate commitment to professionalism in accordance with the Code of Professional Conduct issued by the AICPA.⁶ CPAs have similar professional responsibilities under state law since they are licensed to practice by State Boards of Accountancy.

⁵ ET Section 100 – *Integrity, Independence, and Objectivity*: ET Section 102 – Integrity and objectivity. In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others. ET Section 101–Independence. a member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council. <http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/sec100.aspx>. A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period. SEC Rule 3520, Part 50-Ethics, Section 3 Professional Standards. http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx#rule3520.

⁶AICPA Code of Professional Conduct: <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx>

AICPA members providing auditing and other attestation services should be independent in fact and in appearance. The concept of independence requires that the auditor perform his/her work objectively without having any bias in reaching conclusions about the audit, and that the public perceives the auditor as such. Independence is so fundamental to ensuring that an audit has value that it is one of the basic standards of Generally Accepted Auditing Standards (SAS 1, AU 220)⁷ and, as referred to above, a key principle in the AICPA's Code of Professional Conduct (AICPA 2009). According to AU 220.01 (SAS 1), "the auditor must maintain independence in mental attitude in all matters relating to the audit." The SEC (Rule 33-7919, SEC 2002)⁸ also requires auditors to maintain independence from their audit clients.

In addition to the concept of independence, the concept of due audit care requires external auditors to exercise due professional care (SAS 1, AU 230)⁹ when providing professional services. Due professional care dictates that the auditor exercises the same degree of care as other professionals in similar circumstances. In exercising due care, the auditor is expected to maintain an attitude of professional skepticism, which requires a questioning mindset. Due care also requires the auditor to remain alert to risk of material misstatement, and to exercise professional judgment in planning and completing the audit. An auditor's failure to act with due care might be construed by others that the auditor has violated auditing standards and acted negligently.

⁷ Statement on Auditing Standard (SAS) 1, Auditing Section (AU) 220, Independence:

<http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00220.pdf>

⁸ Also see, SEC Release on *Strengthening the Commission's Requirements Regarding Auditor Independence* (Release No. 33-8183, January 28, 2003):

<http://www.sec.gov/rules/final/33-8183.htm>

⁹ Due Professional Care in the Performance of Work, SAS 1 (AU 230):

<http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00230.pdf>

Generally, auditors follow a series of phases in planning and executing an audit of financial statements according to auditing standards, as illustrated in Figure 1, below.

Figure 1:
 Illustration of Phases in Financial Statement Audit

AUDIT PHASES	AUDIT PROCESS STEPS
PHASE I	<ul style="list-style-type: none"> • Determine engagement objectives, establish understanding with the client and overall audit Strategy, audit timing, staffing, overall materiality • Obtain understanding about the client’s business, assess which accounts could be materially misstated and require more audit focus and develop audit plan
PHASE II	<ul style="list-style-type: none"> • Obtain an understanding of internal controls; determine their adequacy and appropriateness to address threats to reliable financial reporting. Test controls where necessary and determine the operating effectiveness of internal controls. • Based on internal control effectiveness, plan what actions to take and what audit procedures to perform to ensure that the management prepared financial statements are free of material misstatement due to error or fraud and that they are in accordance with generally accepted accounting principles (GAAP).
PHASE III	<ul style="list-style-type: none"> • Take actions and perform audit procedures as planned • Accumulate all errors and misstatements based on audit for review and evaluation. • Evaluate whether the financial statements are free of material misstatements (qualitatively and quantitatively) according to GAAP. • Document all important actions taken and procedures performed including recommendations of adjustments to be made by management
PHASE IV	<ul style="list-style-type: none"> • Have the audit work reviewed by quality control group or other audit professionals in the firm (not assigned to the engagement) to ensure the reliability of audit conclusions. • Issue the auditor’s communication(s)
Auditor’s	All of the above steps should be completed with competence,

state	integrity, independence, and with due professional care
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SEC INVESTIGATION AND DUE AUDIT CARE

Around year 2000, accounting scandals arising out of fraudulent financial reporting were plentiful, which had shaken the public's trust of management's integrity and auditor's independence and professional judgment. Major scandals and audit failures led to the passage of the Sarbanes-Oxley Act of 2002 (SOX Act), which introduced significant changes in the areas of corporate governance, and management's and auditor's responsibilities in financial reporting matters. The SOX Act (Section 101) established the Public Company Accounting Oversight Board (PCAOB) in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies. PCAOB's responsibilities include: (1) registering public accounting firms that issue audit reports, (2) issue/modify rules and standards relating to preparation of audit reports, (3) inspect registered public accounting firms, (4) enforce compliance with the SOX Act and PCAOB rules/standards, and (5) appropriately sanction for violations.

The SEC investigates those companies that seemingly are involved in accounting irregularities and securities laws violations. An SEC investigation begins with a private informal process (date unobservable) as the Division of Enforcement gathers additional information. The informal investigation proceeds into a public formal investigation (date observable) if the SEC determines that fraudulent financial reporting or other violation of securities laws has occurred and that an enforcement action may be necessary; otherwise, the private informal process is closed (Masella III and Cronin 2009).

Auditors are likely to be concerned when a client company violates SEC or other regulations relating to financial reporting

matters. Auditors follow audit steps along the lines outlined in Figure 1. Auditors are likely to apply a relatively higher level of audit effort in the audits of public companies due to higher levels of business/litigation risk (particularly SEC investigated companies) than for public companies not under SEC investigation to ascertain whether the financial statements are free of material misstatements. When auditors perform more extensive audit procedures due to SECInv or other causes (such as ineffective governance, and weak internal controls over financial reporting), they expend more audit hours, which increases audit cost. Consequently, audit fees (which are a function of audit hours and rate per hour) are a reasonable proxy for audit hours/procedures applied by the auditor to obtain and evaluate audit evidence. Studies have found, for instance, that audit fees are significantly higher for companies having material weaknesses in internal controls than for companies with effective internal controls over financial reporting (e.g., Raghunandan and Rama 2006; Foster et al. 2007), indicating that auditors do apply more audit hours/procedures when the potential for materially misstated financial statements exist.

Audit fees will increase as auditors utilize more audit effort to obtain more persuasive evidence when assessed engagement risk is at a higher level than normal. Past studies (e.g., Raghunandan 2006, Gist 1994, and Palmrose 1989) have found higher audit fees associated with heightened audit effort situations.¹⁰ Similarly, in this study, we use audit fees and non-audit fees adjusted for assets as proxies for the amount of effort utilized when providing audit and non-audit services, respectively. Some audit services might influence the amount of non-audit services, and vice-versa. For instance, non-audit services may be needed to help the client navigate an SEC investigation.

¹⁰ Heightened audit effort situations includes those such as when the auditor accumulates more evidence about the accuracy of account balances when internal controls are ineffective or when employing an unstructured rather than a structured audit approach.

The literature has not previously addressed the impact of an SEC investigation on audit fees. The expectation is that audit fees scaled by assets will be significantly higher for SECInv companies compared to non-SECInv companies due to heightened engagement risk associated with alleged regulatory violations. Evidence in the literature does show, however, that SECInv companies are exposed to fines and negative market value adjustments and other costs, such as increased cost of capital, possible decline in future earnings, adverse publicity, and abnormal negative returns (Lyon and Maher 2005; Feroz et al., 2000 & 1991; Dechow et al., 1996; Palmrose 1991).

SAMPLE DATA AND ANALYSIS

This study is based on year 2001 Fortune 500 companies, which represent some of the largest public companies filing proxy statements with the SEC disclosing auditor fees data. Twenty-nine (29) SEC investigated companies (SECInv) were identified. For each SEC investigated company we matched two non-SEC investigated Fortune 500 companies, first by industry and then on the basis of total assets (i.e., nearest in size to the SECInv Fortune 500 company). This resulted in a total of 58 non-SECInv companies. A two to one match provides an adequate sample size for testing our premise and making statistical inferences. Since we identified the SECInv companies based on articles from the news media, it is possible that our sample may not include some of the smaller sized investigated companies. All audit reports issued for the sample companies (i.e., 29 SECInv and 58 non-SECInv) were either standard or unqualified with modification (other than for going concern). In other words, the financial statements of sample companies were considered by the auditors to be fairly stated in all material respects.

All companies were audited by Big-5 CPA firms.¹¹ Arthur Andersen (AA) audited nine of the 29 SECInv companies and nine of the 58 non-SECInv companies. AA ceased to exist in 2002 due to auditor negligence relating to the Enron scandal. However, AA is included in this study for comparison of its audit effort with the audit effort of other firms.

Auditor fees and financial data relating to SECInv and non-SECInv companies are given in Table 1. The data is also shown within auditor group (Big-4 audited companies and AA audited companies) and relates to averages (means) of assets, revenues, audit fees, non-audit fees, and total fees (audit plus non-audit fees paid to the auditor). P-values of t-tests of differences between means are also provided. The first four rows of Table 1 relate to mean comparisons of the 29 SECInv companies to that of 58 non-SECInv companies. Data of companies audited by Big-4 auditors, excluding AA, is presented in rows 5-8 of Table 1: SECInv companies (n=20) are compared to the non-SECInv companies (n=49). Data of companies audited by AA auditors is presented in rows 9-12 of Table 1: nine SECInv companies are compared to nine non-SECInv companies.

¹¹ Big-5 firms: Arthur Andersen, KPMG, Deloitte & Touche, Ernst & Young, and PriceWaterhouseCoopers. After Arthur Andersen ceased to exist, the remaining four firms are labeled as Big-4 firms.

Table 1: Descriptive Data (Means) & p-values for t-tests Comparison of Means											
1	Column #2	3	4	5	6	7	8	9	10	11	12
Row #		number	Assets (in millions \$)	Revenues (in millions\$)	Audit fees (in 000\$)	Non-audit (in 000\$)	Total fees (in 000\$)	Audit fees % of assets	Audit fees % of revenues	Total fees % of assets	Total fees % of revenues
1	SECIInv vs. Not Investigated ¶										
2	All SEC INVESTIGATED COMPANIES	29	153,130	33,603	9,092	19,505	28,597	0.024%	0.039%	0.078%	0.126%
3	All COMPANIES NOT INVESTIGATED	58	82745	19,430	3,988	10,707	14,695	0.013%	0.024%	0.041%	0.083%
4	Difference between means: p-values of (one-tailed) t-tests				p <0.01*	p <0.01*	p <0.005*	p <0.01*	p <0.01*	p <0.05**	p <0.05**
5	Big4 Audited Companies										
6	SEC Investigated companies	20	201,748	37,526	10,470	24,732	35,202	0.024%	0.041%	0.086%	0.146%
7	Non-SEC Investigated Clients	49	95,092	21,391	4,182	11,778	15,960	0.010%	0.023%	0.035%	0.079%
8	p-Values of (one-tailed) t-tests				p <0.01*	p <0.01*	p <0.01*	p <0.01*	p <0.01*	p <0.01*	p <0.01*
9	AA Audited Companies ¶										
10	SEC Investigated companies	9	45,089	24,886	6,029	7,889	13,918	0.025%	0.035%	0.061%	0.081%
11	Non-SEC Investigated Clients	9	15,521	8,756	2,933	4,872	7,806	0.027%	0.034%	0.077%	0.105%
12	p-Values of (one-tailed) t-tests				p <0.05**	p <0.10***	p <0.05**	ns	ns	ns	ns

* Significant at p < 0.01
 ** Significant at p < 0.05
 *** Significant at p < 0.10
 ns: Not significant p > 0.10

Note: Non-audit fees as percent of assets and revenues are not given above: Non-Audit fees of SECIInv companies as a percent of assets and of revenues are significantly higher (respectively at p <0.05 and p <0.10) than non-audit fees of non-SECIInv companies as percent of assets and of revenues

¶ While we match 1 SECIInv to 2 non-SECIInv at the company level as shown in rows 2 & 3 (29 SECIInv & 58 non-SECIInv), this does not result in a 1 to 2 match at the audit firm level (rows 6 & 7 for Big 4, or rows 10 & 11 for AA). As a result, AA audited companies consist of 9 SECIInv and 9 non-SECIInv.

Much of the variability in audit fees can be explained by total assets of a company. This is the reason for total assets being widely used in the literature to measure scale or size of the audit (e.g., Hay, Knechel, and Wong 2006; Gist 1994). Audit fees included in the table are expressed as a percent of assets to facilitate comparison of audit fees across different sized Fortune 500 companies. SEC investigated companies (mean assets of \$153 billion) are much larger than the matched non-SEC investigated companies (with mean assets of \$83 billion). It may be that the SEC targets larger companies. Lynch et al. (2011) and Pulliam (2002) discuss the SEC's Enforcement Division's heightened level of focus on larger companies.

Applying a higher level of audit effort than normal in connection with the audits of SECIInv companies would be consistent with auditing standards, which require the external auditor to obtain more persuasive evidence when the assessed level of risk of material misstatement of a company's financial

statements (e.g., SECInv companies) is at a heightened level. Using audit fees as a proxy for audit effort, we expect that after scaling by size, audit fees paid by SECInv companies will be significantly higher than the audit fees paid by non-SECInv companies. Our expectation is supported by the data and analysis in the first four rows of Table 1: the average audit fees for SECInv companies at 0.024% of assets are about 85% higher than that for non-SECInv companies at 0.013% of assets [i.e., $(0.024\% - 0.013\%)/0.013\% = 85\%$].¹²

Total auditor fees include fees for both audit and non-audit services (see note to Table 1). Fees for non-audit services range from 54% to 74% of total auditor fees for SECInv and non-SECInv companies. Non-audit fees paid by the SECInv companies at 0.054% of assets (0.087% of revenues) is significantly higher than non-audit fees paid by non-SECInv companies at 0.028% of assets (0.059% of revenues) at $p < 0.05$ ($p < 0.10$). It may be argued that providing non-audit services to audit clients might have, in some audits, impaired the auditor's objectivity and compromised independence.

¹² We also use a regression model similar to the model employed in prior audit fees studies (Davis et al. 1993; Palmrose 1986; Simunic 1980). Results of our regression analysis (details of which are not provided here) indicate that auditors charge an audit fees premium to companies under SEC investigation. Audit fees paid by a company is the dependent variable, and an independent SEC test variable (SECInv) is assigned a value of '1' if the company is under investigation, otherwise SECInv is assigned a value of '0'. Other independent variables measuring client characteristics of size (total assets), risk (total debt and return on assets), complexity (merger activity and number of subsidiaries), industry membership (regulated versus non-regulated), and non-audit service fees are included in the model to control for differences in these client factors on audit fees. Because the relationship between audit fees and total assets is not strictly monotonic, the natural logarithm of these variables is used in the model as in the prior literature. The model has a very good fit to the data as indicated by its explanatory power of 70.8 percent. The SEC test variable is positive and significant at $p\text{-value} < 0.01$, indicating that auditors charge an audit fees premium to companies under SEC investigation compared to companies not under SEC investigation, *ceteris paribus*.

Regulators and legislatures appear to believe that providing substantial non-audit services to audit clients could adversely affect auditors' professional judgment in planning and executing audits. This is because that for some engagements, there were auditors that had received non-audit services fees that were much more lucrative than the fees from the audit, and were tempted to compromise their objectivity in detecting and reporting a material misstatement. To remove such temptation and strengthen the auditors' objectivity, the legislature included section 201 of the SOX Act prohibiting auditors of public companies from providing certain non-audit services (e.g., bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information system design and implementation; internal audit outsourcing). To further enhance auditor independence and objectivity, the SOX Act requires that the audit committee (made up of independent members of the Board of Directors), not management, make both the auditor selection and compensation decisions.

For the Big-4 firms' audit clients (rows 5-8, Table 1), we find that SECInv companies paid significantly higher audit fees as a percentage of assets and as a percentage of revenues (at the 0.01 level) than that paid by the non-SECInv companies. In contrast, the audit fees at 0.025% of assets charged by AA to its nine SECInv companies (rows 9-12, Table 1) are lower than the 0.027% of assets charged to its nine non-SECInv companies. This difference is not statistically significant ($p > 0.10$), which indicates that audit fees paid to AA by its SECInv clients are similar to those paid by its non-SECInv clients. Likewise, similar results for AA are provided when audit fees are scaled by revenues. Results for total fees as percent of assets (revenues) charged by AA to its SECInv clients at 0.061% (0.081%) are lower than total fees as a percent of assets (revenues) at 0.086% (0.146%) charged by Big-4 firms to their SECInv clients. These results suggest the following: (a) Big-4 firms applied significantly greater audit effort to perform the audits of riskier SECInv companies compared to the audits of

their non-SECInv companies, whereas (b) AA did not appear to have differentiated between the riskiness of SECInv and non-SECInv companies, and applied relatively equal audit effort across all clients. A caveat may be in order as any inferences drawn should be used with caution because of small sample sizes (and larger samples are likely to be more representative and might have produced different results).

Table 2 reports the data according to whether companies were being investigated for revenue related or other types of violations. Panel-A (rows 1-4, Table 2) provides means for revenue related and other types of violations of SECInv companies for comparison with the means of all non-SECInv Companies. Panel-B (rows 5-8, Table 2) contains p-values of t-tests for various comparisons (e.g., in row 6: p-values of comparisons of means between 15 revenue related violations and 14 other types of violations; in row 7: p-values of comparisons of means between 15 revenue related violations and 58 non-SECInv companies; and in row 8: p-values of means comparisons between 14 other types of violations and 58 non-SECInv companies).

Table 2: Descriptive Data (Means) by Nature of Violation & p-values for t-tests Comparison of Means											
PANEL - A: SEC INVESTIGATED COMPANIES											
Row #	Reason for SEC Investigation	n	Total Assets (in millions \$)	Revenues (in millions\$)	Audit fees (in 000\$)	Non-audit (in 000\$)	Total fees (in 000\$)	Audit fees % of assets	Audit fees % of revenues	Total fees % of assets	Total fees % of revenues
1	Revenue Related	15	43,990	29,332	7,742	18,735	26,477	0.033%	0.044%	0.115%	0.152%
2	Other	14	270,065	38,180	10,538	20,330	30,868	0.015%	0.034%	0.039%	0.098%
3	All SEC Investigated Companies	29	153,130	33,603	9,092	19,505	28,597	0.024%	0.039%	0.078%	0.126%
4	All non-SEC Investigated Companies	58	82,745	19,430	3,988	10,707	14,695	0.013%	0.024%	0.041%	0.083%
PANEL - B: p-Values for t-tests Comparison of Means											
6	Revenue Related violations vs. Other violations (two-tailed t-tests)	15 vs. 14			ns	ns	ns	p < 0.10***	ns	p < 0.10***	ns
7	Revenue Related violations vs. All non-SECInv Companies (one-tailed t-tests)	15 vs. 58			p < 0.01*	p < 0.05**	p < 0.05**	p < 0.01*	p < 0.01*	p < 0.01*	p < 0.01*
8	Other violations vs. All non-SECInv companies (one-tailed t-tests)	14 vs. 58			p < 0.01*	p < 0.05**	p < 0.01*	ns	p < 0.05**	ns	ns
* Significant at p < 0.01											
** Significant at p < 0.05											
*** Significant at p < 0.10											
ns: Not significant p > 0.10											

An examination of SEC's Accounting and Auditing Enforcement Releases (AAER) in 2001 and 2002 shows that of the 29 SEC investigated companies in our sample, approximately 50% were being investigated due to revenue recognition related issues (such as the recording of fictitious revenue, and premature revenue recognition) and the remaining investigations related to various other reasons such as valuation, sham transactions, conflict of interest, price manipulation, disclosure, and aiding/abetting illegal acts. Prior studies (e.g., Lynch et al. 2011; Loebbecke et al. 1989) have shown that revenue-related violations are more frequent than other types of violations.

A GAO study (2002) analyzed restatements by 800 companies from 1997 to 2002, and found that accounting for revenue related matters were the primary reason for 38% of restatements of financial statements. Also, the GAO reported that restatements involving revenue recognition led to greater market losses (estimated at over 50% more) than other restatement types. Analysis in Table 2 shows that audit fees at 0.033 percentage of assets for SECInv involving revenue related matters is significantly higher ($p < 0.10$) than audit fees at 0.015 percentage of assets for SECInv involving other violations.

This result suggests that auditors assess greater risk for companies under SEC investigation with revenues related violations than for companies with other types of violations, and accordingly apply greater audit effort. Further support (in Table 2) for this conclusion is that audit fees adjusted by assets for SECInv companies involving other violations (0.015%) is not significantly different from audit fees adjusted by assets for all non-SECInv companies (0.013%).

CONCLUSION AND SUGGESTIONS TO ENHANCE ETHICAL VALUES AND THE PUBLIC'S TRUST IN AUDITS

SEC investigations of violations of GAAP, fraudulent practices and accounting scandals have created great uncertainty about management's integrity. Despite increased audit effort, when misleading or fraudulent financial reporting is not deterred by audits, the public's confidence in independent audits could seriously be impaired, the auditor could be exposed to potential litigation, and the firm may come to its demise (e.g., Arthur Andersen). Collapse of one or more large public accounting firm(s) is likely to seriously reduce the number of auditors available to provide competitive audit services, and to adversely affect the quality of independent audits, the quality of accounting information, and market efficiency.

Quality of audits and the public's trust in audits could be improved if regulations are geared to increase the number of large audit firms and auditors in the market, and strengthen auditor independence through the following suggestions: (a) requiring joint audits and auditor rotation, (b) providing whistle-blower protection to employees and partners of public accounting firms to deter auditors from taking compromising actions in audits of financial statements, and (c) the PCAOB's monitoring of auditors' compliance with ethical and professional standards. The objective should be to significantly reduce, if not completely eliminate, audit failures, and thereby, improve audit quality.

Joint Audits and Auditor Rotation

One approach to enhance audit quality and auditor independence is through requiring joint audits (e.g., a large company audited by one or more smaller firms jointly with a large audit firm). Each firm will have a vested interest (e.g., avoiding

legal liability for substandard audits) in ensuring compliance with rules of professional conduct and auditing standards. Such joint audits, to some extent, may also fill the void that might be created by potential collapse of another large public accounting firm as in the case of Arthur Andersen. Requiring joint audits should improve audit quality through closer review of audit work by two or more independent firms, and thus, result in fewer violations of regulations and fewer SEC investigations.¹³ Further, requiring joint audits will increase the number of trained professionals qualified to provide quality audit services, thereby enhancing competition in the audit market, which is expanding globally.

Another avenue to strengthen audit quality and auditor independence is through requiring periodic rotation of the audit firm. Currently, the audit partner in-charge of an engagement cannot remain more than five years in-charge of that client's audit. The audit firm has to assign another engagement partner at the end of every five-year period. However, this practice does not involve changing the audit firm. If periodic rotation of audit firm is adopted, then it is likely to reduce bonding between the audit firm and client management, which (auditor bonding with client) could lead sometimes to the auditor compromising his/her integrity. The PCAOB is currently evaluating the feasibility of audit firm rotation.¹⁴

¹³ In Canada, joint audits were required for banks. For example, see auditors report dated November 19, 2002 issued jointly by Deloitte & Touche, and PriceWaterhouseCoopers

http://rbc.com/investorrelations/pdf/cfsusgaap_02_e.pdf

¹⁴ The PCAOB is considering mandatory audit firm rotation. The PCAOB has issued a concept statement for comments. PCAOB Release No. 2011-006, August 16, 2011 (Docket Matter No. 37)

http://pcaobus.org/Rules/Rulemaking/Docket037/Release_2011-006.pdf

To block mandatory audit firm rotation, the House of Representatives, in July 2013, passed Bill H. R. 1564, titled *Audit Integrity and Job Protection Act*: <http://financialservices.house.gov/uploadedfiles/bills-113hr1564ih.pdf>

Whistle-Blower Protection to Employees and Partners of Accounting Firms

Providing whistle-blower protection to employees and other professionals in accounting firms is likely to deter auditors from taking compromising actions in audits. Evidence indicates that “tips” (provided by company employees, customers, suppliers, etc.) is the single most effective technique in detecting all types of fraud (e.g., fraudulent financial reporting and misappropriation of various types of assets) than through other methods, such as engaging internal auditors, and implementing tighter internal control.¹⁵ Had “whistle-blower” protection been available around year 2000, may be one or more employees of Enron might have blown the whistle to regulators or the audit committee. The SOX Act provides ‘whistle blower’ protection to employees of public companies, and requires public companies to establish systems for receiving and handling confidential/anonymous complaints/issues including those relating to accounting and auditing. However, no such protection is accorded employees and professionals, including partners, of the audit firm that audits the company.

According to rules of professional conduct, ‘whistle-blowing’ by CPAs is not ethical (Mary-Jo Kranacher 2006). Specifically, the confidentiality rule states that confidential client information may not be disclosed without the consent of the client. Regulators could exempt CPAs (and others working in a CPA firm) from violation of the Rules of Conduct for ‘whistle-blowing’ against their own firm. With this exemption, any employee/professional in an audit firm would be free from sanctions and penalties to report violations of ethical and auditing standards by other employees/professionals (including the engagement partner) of their firm.

¹⁵ Association of Certified Fraud Examiners: 2010 Report to the Nations (on Occupational Fraud and Abuse) <http://www.acfe.com/rtn/2010-highlights.asp>

PCAOB's Monitoring of Auditors' Compliance with Ethical and Professional Standards

The SOX Act established the PCAOB to monitor the accounting industry with a view to protect the public's interest and improve audit and financial reporting quality. The PCAOB's responsibilities include issuing standards relating to ethics and auditing, inspecting audit documentation of public accounting firms to ensure compliance with ethical and professional standards, and imposing sanctions for violations of PCAOB's rules or standards. PCAOB issued its first report covering its inspections of audit documentation of about 1,650 audits (for the period from 2004-2007)¹⁶ of the largest public accounting firms that annually audit more than 100 public companies.¹⁷ In addition, PCAOB issued another report covering inspections (for the three years 2004-2006) of about 500 smaller registered public accounting firms that audit less than 100 companies annually. These firms are inspected once every three years and are labeled "the triennial firms."¹⁸

Based on its inspections, the PCAOB observed many audit performance related deficiencies (e.g., revenue recognition, and audits of estimates and fair values), and relatively fewer violations of ethical (e.g., independence) rules. Regarding possible impairment of auditor independence, the PCAOB noted that CPA firms did not have procedures to identify and monitor business relationships, or to monitor whether the firm's joint ventures, alliances, or other business relationships were providing prohibited

¹⁶ PCAOB Release No. 2008-008, December 5, 2008

http://pcaobus.org/Inspections/Documents/2008_12-05_Release_2008-008.pdf

¹⁷ The CPA firms are: BDO Seidman, LLP; Crowe Chizek and Company LLC; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; McGladrey & Pullen, LLP; and PricewaterhouseCoopers LLP

¹⁸ PCAOB Release No. 2007-010, October 22, 2007:

http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf

non-audit services to issuers. Also, CPA firms' partners' performance and compensation were not tied to audit quality.

PCAOB allows about 12 months for the inspected CPA firms to remediate the deficiencies/criticisms. It found that the firms were taking steps to address deficiencies identified in inspection reports. If a registered public accounting firm does not take necessary actions in a timely fashion, the PCAOB imposes sanctions by issuing '*Settled Disciplinary Orders*' (SDOs). SDOs represent the settlements that the PCAOB has reached with the registered firm or their associated person(s), against which the Board has instituted disciplinary proceedings¹⁹ (each SDO could include a firm and/or one or more CPAs in the firm). For the period May 2005 to September 2012, there were about 48 SDOs issued by the PCAOB against firms and/or their CPAs. This indicates that most firms had taken steps to address deficiencies identified by PCAOB, such as, strengthening their quality control system, and implementing staff training programs.

PCAOB sanctions (for not taking appropriate steps to address audit or ethical deficiencies identified) could include suspension of individual registered members from auditing companies, revocation of a firm's registration, and/or monetary penalties. Considering there were only 48 disciplinary orders issued based on several hundred PCAOB's audit inspections, violations of ethical and professional standards by CPAs were very few.

The PCAOB's observations and findings (based on their inspections of audit documentation of public accounting firms) essentially indicate that deficiencies caused by auditors not complying with rules of professional conduct and auditing standards are exceptions rather than the rule. These observations are consistent with results of this study, which revealed that auditors do apply a significantly higher level of effort as indicated by higher audit fees (except in the case for AA) when auditing SEC investigated

¹⁹ PCAOB's Settled Disciplinary Orders from May 2005 to Sept 7, 2012:
<http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx>

companies posing greater engagement risk. Overall, it would appear that auditors generally act independent of management and in the public's interest, seldom compromising professional responsibilities by not being associated with fraudulent financial reporting.

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