SARBANES-OXLEY AND THE FUTURE OF ACCOUNTING
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Sarbanes-Oxley and the Future of Accounting

Following the Enron debacle, massive public pressure led the United States government to enact the Sarbanes-Oxley Act of 2002. While this act was intended to protect investors and improve the accuracy and reliability of corporate disclosures, it also contained provisions which could have a major impact on the public accounting profession in the United States. It is possible that these effects could extend to Australia, where the public accounting profession is also subject to scrutiny following revelations of corporate misconduct. This paper explores the provisions of the Sarbanes-Oxley Act relating to the accounting profession, the reaction of the profession and possible ramifications for public accounting in Australia.

The collapse of Enron and others had the immediate effect of unleashing a crisis of confidence in the public accounting profession. This crisis was exacerbated by the need for major American companies to restate their earnings and by the revelation that Arthur Andersen had destroyed documents relevant to the Enron investigation. While the accounting profession in the United States moved to protect the profession's image, the continued disclosure of questionable accounting activities led the US government to react.

A number of bills targeting accounting reform were proposed or introduced into congress or the various state legislatures. California provides an example of a state legislature rushing accounting reform legislation into law: on 23 August 2002 the governor, Gray Davis, signed three bills affecting accountants doing business in California, including one providing that the California State Board of Accountancy must be composed of a majority of non-accountants from January 2003.

Federal legislation included bills to be introduced into congress by Senators Michael Enzi and Paul Sarbanes and Representative Michael Oxley. While the Enzi proposal lapsed, congress passed both the Oxley and the Sarbanes bills. Because of the continuing revelation of accounting scandals, the imperative was to resolve the differences between these reform bills. This led to a joint committee to resolve conflicts between the profession-friendly Oxley bill and the more rigorous Sarbanes bill; the result was the Sarbanes-Oxley Act.

On 30 July 2002, President Bush signed into law the Sarbanes-Oxley Act, formally named the Corporate and Auditing Accountability, Responsibility and Transparency Act. The president said: "This law says to corporate accountants: the high standards of your profession will be enforced without exception; the auditors will be audited; the accountants will be held to account" (Scoop World 2002). The act's longer title of "An act to protect investors by improving the accu-

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racy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes" encapsulates its broad reach.

The act requires eight studies to be carried out, with reports to be made to congress. Three of these reports may have a lasting impact on the accounting profession. They relate to the adoption of principle-based accounting, the consolidation of public accounting firms since 1989, and the effect of mandatory rotation of registered public accounting firms in respect of auditing engagements. These proposed reforms are likely to bring the US more in line with the international and Australian situations. Arguably, international auditing standards are principle-based, and Australia is virtually harmonised with international standards. However, while Professional Statement F1 (CPA and ICAA 2002) and CLERP 9 mandate auditor rotation, audit firm rotation appears to have little support in Australia. CLERP 9 (formally known as "Corporate Disclosure – Strengthening the Financial Reporting Framework"), released in September 2002, is part of the current round of reform proposals initiated by the minister for financial services and regulation. The federal treasurer has indicated that legislation based on the CLERP 9 proposals will be introduced into parliament after a period of public discussion (Costello 2003).

THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Title 1 of the act provides for the establishment of a new regulatory body, the Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public companies offering securities to the public and related matters.

The board consists of five financially literate members appointed by the Securities and Exchange Commission in consultation with the Federal Reserve chairman and the secretary of the treasury. Two members must be or may have been certified public accountants. However, if one of these is the chairperson, then he or she must not have practised for at least five years.

PCAOB members are generally appointed for five-year terms and may not serve more than two terms. As full-time appointments, they may not have any concurrent employment or engage in any professional or business activity. To preserve their independence from the accounting profession, members must not receive any money from a public accounting firm other than fixed continuing retirement benefits. The SEC can remove board members from office where there is good cause.

The PCAOB was to provide for the mandatory registration of auditors within 350 days of the date of commencement of the act. Applications for registration must include details of the fees received by public accounting firms for audit services, other accounting services and non-audit services. Audit firms are required to provide annual reports (or at more frequent intervals if so required) updating the information provided in their applications. Subject to the need to protect proprietary information, these reports are to be available to the public.

Additionally, the board is required to:

- establish auditing quality control and independence standards (s103), although for this purpose it may adopt standards proposed by accounting bodies;
- review the work of public accounting firms in regard to their compliance with the requirements of the act (s104). Such reviews are to be annual in the case of firms undertaking more than 100 audits annually and not less than once every three years in other cases. Special reviews may be ordered at any time. The reports generated by such reviews are to be made public. No longer will inspections be firm-on-firm and remedial, as with the former peer review program;
- investigate violations of, *inter alia,* professional standards and failure to properly supervise auditing personnel (s105). Investigations could lead to disciplinary action by the board;
- conduct disciplinary proceedings, which must be in private unless otherwise ordered by the board and consented to by the parties (s105). The board has the power to –
    - suspend or revoke the registration of public accounting firms;
    - temporarily or permanently bar any person from associating with public accounting firms;
    - impose civil penalties of $100,000 for natural persons or $2 million for others. In the case of intentional or knowing conduct, these maximums become $750,000 and $15 million respectively;
    - censure;
    - require additional professional education or training.

While previously accounting firms were able to delay disciplinary proceedings where the matter was the subject of litigation, thus negating their effectiveness, this is no longer the case.

These requirements will apply to foreign public accounting firms where they audit companies listed on US stock exchanges, or subsidiaries of American companies. The extra-territorial application of this law is being opposed, at least in Europe and particularly in Germany (Anon. 2002). The European Union financial commissioner went so far as to threaten that if the US proceeded with this requirement, the EU would require US firms to be registered in all EU member countries. Subsequently, the PCAOB stated that it would require foreign firms to register by 26 April 2004 (accountingweb.com).

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Importantly, the funding of the PCAOB, unlike the Public Oversight Board (POB), is not under the control of the profession. The start-up expenses (estimated at between $US25 million and $US50 million) come from SEC appropriations and are to be repaid by the accounting profession (Labaton 2002). Subsequent funding is to come from two sources: fees levied on public accounting firms for registration plus annual fees to cover the cost of reviewing their applications for registration and the requisite annual reports; and annual accounting support fees levied on issuers of audit reports. The fees are based on a formula established by the PCAOB.

AUDITOR INDEPENDENCE

There has been much debate about the effect on auditor independence of the provision of non-audit services to an audit client. Critics (for example, Mautz and Sharaf 1961, Flint 1988, Mitchell and Sikka 1993, Heritage 2000) have questioned whether auditors could really be independent if they provided non-audit services to audit clients. The legislature, given the amount paid to Andersen for the provision of non-audit services to Enron, agreed with the critics. Consequently, the Sarbanes-Oxley Act prohibits a range of non-audit services, bringing the US into line with international and Australian practice.

The prohibited activities are:

- bookkeeping or other services relating to the accounting records or financial statements of the audit client;
- financial information systems 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; or
- any other service determined by the PCAOB as impermissible.

The provision of any other non-audit services by a registered public accounting firm to an audit client requires the pre-approval of the client's audit committee except where, subject to certain conditions, the fees for the services amount to not more than 5% of total fees paid to the auditor by the client. Under section 201, the PCAOB has the power to exempt public accounting firms from these provisions on a case-by-case basis where it is in the public interest to do so. Such approvals are subject to review by the SEC.

Another aspect of the question of auditor independence is long-term relationships between an auditor and client. The Sarbanes-Oxley Act has addressed this issue by requiring the rotation of the lead or coordinating audit partner every five years. While this section (203) applies only to individuals, the comptroller-general is required to conduct a study into the effect of the mandatory rotation of auditing firms. Like the Australian Professional Statement F1, the act initially required rotation every seven years but this was reduced to five years, a period also recommended by CLERP 9.

To overcome possible conflicts of interest, section 206 of the act prohibits a public accounting firm from carrying out the audit of a company where any of its key personnel participated in the previous year's audit.

AUDITING STANDARDS

Section 103 of the act requires the board to establish auditing and other related attestation standards, including quality control and ethics standards, to be used by registered public accounting firms in the preparation and issuing of audit reports. In so doing the board may adopt, in whole or in part, the standards proposed by recognised professional groups or advisory groups authorised under the act. Such advisory groups are not necessarily composed of accountants.

Adopted standards include those requiring:

- the preparation of audit work papers and supporting documentation which are to be retained for seven years;
- the review of audit reports by a second partner;
- concurring approval by a qualified person other than the person in charge of the audit;
- a description in the audit report of the auditor's testing of the client's internal controls; and
- a report of findings and an evaluation of the internal controls.

Auditing standards include quality control standards that address:

- the monitoring of professional ethical and independence issues;
- procedures for consultation within the firm on accounting and auditing matters;
- the supervision of audit work;
- the hiring, professional development and advancement of personnel;
- the acceptance and continuation of auditing engagements;
- procedures for internal inspections; and
- any other matter which may be required by the board.

The PCAOB also establishes such independence standards as it considers necessary or appropriate to protect the public interest. Initial standards are those proposed by accounting groups; the board cooperates with these groups in the standard-setting process and evaluates this process annually.

The provisions of the act relating to standards do not apply to small and medium-sized non-registered accounting firms (s209). However, this section

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requires the various state registering authorities to make an independent assessment of the appropriate standards that should apply.

ACCOUNTING STANDARDS

Under section 108, the SEC is authorised to "recognise, as 'generally accepted' . . . accounting principles" those established by any accounting standard-setting body that meets the act's criteria. The criteria are that the body:

- is organised as a private entity;
- has a board of trustees (or its equivalent) made up of a majority of persons who are not and have not been for at least two years associated with a public accounting firm;
- is funded in the same manner as the PCAOB;
- can promptly consider changes in accounting standards to reflect emerging accounting issues and changing business practices;
- considers the need to keep standards current to reflect such changes and the extent of international convergence on accounting standards and the protection of investors; and
- has the capacity to assist the SEC because it is able to improve the accuracy and effectiveness of financial reporting.

Under this section the Financial Accounting Standards Board will continue as the accounting standard-setting body in the US. This board is financed from the annual accounting support fees levied *pro rata* on issuers of audit reports. However, the provisions of this section do not limit the powers of the SEC to establish accounting standards.

STUDIES AND REPORTS

The act requires a number of studies and reports on aspects of the American financial system. Three of these studies relate specifically to the accounting profession, dealing with principle-based accounting, rotation of auditors and the merging of accounting firms.

Principle-based accounting

Although international auditing standards are principle-based, the US has continued with procedural standards. The SEC is to report on the adoption of a principle-based accounting system. Its study will determine the extent to which principle-based accounting exists in the US and the estimated time required to make the change. The feasibility of such a system and its economic consequences will be examined.

Mandatory rotation of auditing firms

The US comptroller-general is to conduct a study and review of the potential effects of requiring the mandatory rotation of public accounting firms, a procedure which is being debated in Australia.

Consolidation of accounting firms

The comptroller-general is also to report on the consolidation of accounting firms since 1989. The report should identify the factors leading to the reduction in the number of public accounting firms capable of auditing large national and multi-national firms, and any problems resulting from limited competition.

POSSIBLE EFFECTS ON THE AUSTRALIAN PROFESSION

The immediate effect on the Australian accounting profession comes from the extra-territorial operation of the registration provisions of the act. This will extend the PCAOB's regulatory model to Australian-based accounting firms that audit the financial statements of firms listed on US stock exchanges or which are subsidiaries of such companies. These include the Australian market leaders BHP-Billiton and Telstra, which have dual listing and have created sufficient concern for the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation to issue its Audit and Assurance Alert 13 "The Implications of the Sarbanes-Oxley Act 2002 (U.S.) for Auditors and Their Clients". The SEC and the board (subject to the approval of the SEC) have the power to exempt firms, either conditionally or unconditionally, from these provisions. There is no evidence at present of any criticisms by Australian firms of this provision. However, in Europe, where the impact will be much greater, there are increasing complaints. The IFAC suggested in a submission to the SEC dated 10 January 2003 that an undertaking by foreign audit firms that they are complying with the IFAC's code of ethics should be an alternative to registration under Sarbanes-Oxley. Should the SEC agree, exemption would apply to Australian firms as Professional Statement F1 mirrors the IFAC code.

In Australia, the current round of reform proposals began with a report to the minister for financial services and regulation, titled "Independence of Australian Company Auditors. Review of Current Australian Requirements and Proposals for Reform", by Ian Ramsay in October 2001 (the Ramsay Report). Report 391 of the Joint Standing Committee on Public Accounts and Audit, the "Review of Independent Auditing by Registered Company Auditors", followed in August 2002. In September 2002 the paper "Corporate Disclosure – Strengthening the Financial Reporting Framework" (otherwise known as CLERP 9) was released. CLERP 9 (at 12) specifically stated that "the final implementation of reforms will need to take account of any relevant recommendation of the HIH Royal Commission, work being undertaken by the Joint Committee of Public Accounts and Audit (JCPAA), and developments overseas. The United States has recently introduced significant legislative reform in the area . . ." A similar caveat concerning possible implications from Sarbanes-Oxley is contained in the Canadian Institute of Chartered Accountants exposure draft on independence standards issued in September 2002. While Canada is in a special situation because of its geographical relationship and economic dependence on the United States,

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this does indicate a more general concern about the implications of Sarbanes-Oxley in international accounting circles. The relevant recommendations contained in the report of the HIH royal commission (released on 16 April 2003) were broadly consistent with the proposals contained in CLERP 9.

Obviously the Big 4 and other international accounting firms will alter their practices in the US to comply with the provisions of the act. Given that these firms are multinational service providers, it is highly likely that the changes will be implemented throughout all of their offices, including those in Australia. This will have an effect on the practices and cultures of those firms.

The perceived lack of independence where one firm provides auditing and consulting services to a client was one of the questions addressed by the Sarbanes-Oxley Act. One way of overcoming this is by dividing an accounting firm into two independent entities – one providing only auditing services, the other consultancies. This was the path being followed by a number of the then Big 5 accounting firms. It follows that, if this process is followed in Australia, this country will see the creation of a number of firms providing only external auditing services.

Whether such a division will be effective remains to be seen. As noted in CLERP 9 (at 32) such action "may have little effect on the reality or perception of auditor independence" for the following reasons:

- the audit-based firms retain some non-audit services after disposal of their non-audit arms;
- the audit partner may still have a financial or career interest in cross-selling non-audit services. Deloitte, the last of the Big 4 to take action in this regard, is separating auditing and consulting by means of a management buyout, the partners remaining owners of the consulting arm in a different capacity; and
- Andersen rebuilt a consulting business having previously spun off its consulting division.

However, consulting provides increasing financial rewards and it will be difficult for such firms to maintain complete separation. In the case of Andersen, the acrimonious split of the firm into two was followed by the accounting firm re-establishing consultancy services in opposition to the former Andersen Consulting. Neither is the complete divorce of the two functions a viable alternative for smaller firms – nor is it necessary. Separation of auditing and consulting functions can be achieved by having one firm carry out the external audit of a company while an independent firm provides the consultancy services. There is some evidence that this may be happening in Australia: Deloitte Touche Tohmatsu resigned as the external auditor of the Smorgon Steel Group Limited in the expectation that it would continue to provide consulting services to that company (Smorgon 2002). Should this practice become general, accounting firms will have to decide whether they will continue to carry on the external auditing function or resign so that they can remain as consultants. Given the limited number of audit firms, this may have the effect of permitting lower-ranked firms to gain more lucrative audits as the external audit of an organisation is passed from the Big 4 to second-tier or even smaller firms. However, smaller firms will face problems with compulsory rotation of auditors.

With the Sarbanes-Oxley Act providing for fines of up to $US25 million, there could be an impact on professional indemnity insurance premiums in the US. This could affect the Australian profession, as the insurance companies operate globally and could increase premiums throughout the world. However, Australia will not follow the Sarbanes-Oxley reforms totally. While there is some similarity between those reforms and the CLERP 9 proposals, the federal government does not accept the need to establish a separate oversight board. This was recommended in the Ramsay Report, but the government has opted to expand the oversight function of the Financial Reporting Council.

There has long been a concern about the effect of the provision of non-audit services on auditor independence. In the US, the SEC expressed its concern as long ago as 1957 in its annual report (POB 2002, p. 24) and soon thereafter Mautz and Sharaf (1961, pp. 228-9) pleaded that "for the good of the profession, auditing must be recognised as a specialty separate from the remaining functions of public accountants". There is no evidence that the provision of such services has impaired auditor independence. Some argue that the provision of non-audit services assists the auditor in understanding the company and hence improves the quality of the audit (Campbell 2002), although concerns continue. Such concerns are reflected in the Ramsay Report, JCPAA Report 391, CLERP 9 and Professional Statement F1 as well as the Sarbanes-Oxley Act.

The Australian government proposes to leave the question of independence largely in the hands of the profession (through its Code of Professional Conduct), with oversight by the Financial Reporting Council. Audit committees, however, may be required to disclose in annual reports that they are satisfied that the provision of the non-audit services referred to in Professional Statement F1 is compatible with auditor independence (the non-audit services listed are similar to those prohibited under Sarbanes-Oxley).

Arguably, the prescriptive approach to independence taken in the US does not work. For example, it was found that PricewaterhouseCoopers had breached the SEC's Independence Code on 8,064 separate occasions (Ravlic 2000, p. 21). This gives support to the principle-based approach taken by the IFAC and endorsed by the Australian profession in Professional Statement F1. The same approach to professional ethics has been adopted by the EU, New Zealand, Hong Kong, Singapore and Canada and is being considered by other countries (IFAC 2003). Indeed, Sarbanes-Oxley mandates an investigation

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into the possible adoption of a principle-based approach in the US.

In the US the rotation of auditors was proposed to be mandatory after seven years. Sarbanes-Oxley reduced this to five years. In Australia both the Ramsay Report and Professional Statement F1 propose rotation every seven years. CLERP 9, on the other hand, recommends a five-year rotation. Some, for example ASIC and Shanahan (JCPAA 2002, p. 109), consider that rotation of lead auditors is not sufficient to ensure independence and recommend audit firm rotation instead. This is also a matter for investigation and report under Sarbanes-Oxley, and is a possible outcome in that country.

CONCLUSION

The Sarbanes-Oxley Act provides a watershed for the accounting profession in the US. If, in practice, its implementation follows the course proposed by the legislators, the profession will no longer control its own affairs in that country. Not only will an independent body oversee the practice of auditors and discipline any breaches, but auditing standards could be set by persons outside the profession. There is some evidence that the accounting lobby has taken steps to ensure that the act is implemented in a manner favourable to the profession. However, the reform advocates are acting to ensure that the act is implemented in a way that meets their agenda.

The act may have implications for the Australian accounting profession. Immediately some auditing firms may be required to register with the US Public Company Accounting Oversight Board in order to continue to audit American companies or subsidiaries. Undoubtedly it will also affect the culture and practices of the international accounting firms (including the Big 4) and those practices could be adopted by their Australian branches/affiliates.

Sarbanes-Oxley reflects the deep concern in the US about auditor independence. The measures proposed in the act have advocates in this country as well. Australian auditing firms undoubtedly will take note of these measures and may take steps to separate the provision of audit and non-audit services to clients.

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