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The Evolution of the Auditor and Auditing Profession: The Impact of the Sarbanes-Oxley Act of 2002

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Executive Summary

The Sarbanes-Oxley Act of 2002 (SOX) was arguably the most influential piece of legislation passed to affect the accounting profession. The mandatory regulation caused a great deal of change for audit firms and the professionals who work there. As a result of this legislation, auditors have found their roles increasing in responsibility and importance. Auditor's competence and capability in adhering to their duty to the public interests are crucial to the restoration and maintenance of confidence in the profession. SOX was passed to not only protect investors and public trust in organizations and audit firms, but also to improve the overall audit quality of financial statement audits. Over the past nearly two decades since SOX was enacted, the auditor and auditing profession has evolved. The public's perceptions of auditors and the profession have improved as a result of major legislation such as the Sarbanes-Oxley Act of 2002. This paper explores the evolution of the auditor and audit profession over the course of three different time periods to understand the function of the auditor.

This paper is broken down into four major components. First, this paper explores what led to the need for reform in the auditing world. It discusses the large scandals and audit failures in the profession that prompted the passage of SOX. Next, this paper examines what exactly the Sarbanes-Oxley Act is. It examines the legislation and highlights the major reforms and restrictions it enacted on the auditing profession. Then, it discusses how SOX is doing at meeting its goals and objectives. This paper includes a discussion on how the audit profession looks years after the passage of such an influential regulation. Finally, the paper addresses the modern-day auditor and audit profession. This paper also discusses how the public views the role of the auditor and how SOX contributes to public perceptions. The goal of this paper is to

examine the evolution of the auditing profession from a period of disappointment and unethical behavior to its current state of performance.

Pre-SOX Period: The Need for Reform

The Sarbanes-Oxley Act of 2002 was enacted as a result of large corporate scandals. Failures and scandals in the business world and auditing profession at the start of the twenty-first century largely disappointed the public. As a result, investors were relying on inaccurate financial information and making decisions based on deception. Investors lost money due to major investments in unethical companies and the public lost trust and confidence in the auditors responsible for uncovering misstatements. One look at the state of the business world during the pre-SOX era and it was questionable as to how anyone could believe in the auditors and/or the profession. Major change was needed to demonstrate to the public that scandal to such a large magnitude would not happen again. In July of 2002, the United States Congress passed the Sarbanes-Oxley Act in hopes of restoring the profession and the companies to the level of integrity the public needs for its confidence. However, the passage of such reformative legislation did not come without a dire need for change. This section of the paper discusses the increasing state of unethical behavior that large companies and audit firms found themselves in that led to some of the most unforgettable scandals and failures in the history of the business world.

During the latter half of the twentieth century, audit firms and the accounting profession underwent drastic changes that impacted their work and their clients. The major audit firms who dominated the profession faced a variety of mergers reducing what was once the Big 8 down to the Big 5. The Big 5 then consisted of Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG, and Price Waterhouse Coopers. Clients and the public looked to external auditors to be a second set of eyes to ensure honest and reliable financial information was being produced in accordance with the US Generally Accepted Accounting Principles (GAAP). Auditing was the largest revenue-producing service accounting firms offered to clients up until around the 1980s. During the late 1970s and 1980s, the entire industry saw a shift as consulting services began to become an increasingly more important way of producing revenue for audit firms.[1] Large accounting firms formed competitive branches where audit clients began to pay for their consulting services as well. The two major branches were operating on a fine competitive line as audit services struggled to remain on top.

The consulting sector of audit firms offered a new form of service for their clients. Rather than providing reports on financial information, consulting offered clients innovation and design on how to raise increase their bottom line.[2] Consulting services were much different from audit services, and clients were eager to enhance their companies in new ways. Computer technology was a hot commodity at the time, and firms seized the opportunity to offer consulting services on how to digitize company processes in the 1980s.[3] As consulting began to provide new revenue opportunities for audit firms, auditing struggled to remain the number one priority to these firms. It was crucial during a time of growth in consulting that accounting firms keep their auditing services their main focus as this service line offered the public and investors the reasonable assurance they needed to make educated decisions. Clients were paying top dollar for the services rendered by the Big 5. Big audit firms charged premium audit fees for their services as they believed clients were paying for their name, reputation, and expertise.[4] Given the large

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[1] "Arthur Andersen: An Accounting Firm Fails." *Gale Business Insights: Global Case Study Collection*, (June 2014): 1.
[2] "Arthur Andersen," 1.
[3] "Arthur Andersen," 1.
[4] Cheryl Linthicum, Austin L. Reitenga, and Juan Manuel Sanchez, "Social Responsibility and Corporate Reputation: The Case of the Arthur Andersen Enron Audit Failure," *Journal of Accounting and Public Policy* 29, no. 2 (2010): 162.

sense of responsibility on audit firms to deliver a premium service, when the public learned of audit failure in the early 2000s, the confidence, trust, and reputation of large audit firms in the accounting profession was tarnished.

The need for regulation and reform in the audit profession came after news of a large audit failure became public. Capturing the public attention through a variety of audit failures was Big 5 audit firm Arthur Andersen. Arthur Andersen appeared to remain a solid staple in the profession until the early 1990s. Andersen was no exception to the pattern of increasing their consulting sector. Andersen formally split their branches to run their auditing division under Arthur Andersen & Company and their consulting division under Andersen Consulting.[5] Following the split, Arthur Andersen began to find themselves in some hot water with clients. The firm was accused in the early 1990s of flawed auditing by multiple clients which caused a reevaluation by the firm on how to better meet audit client's needs.[6] Part of the issue was that auditing was taking a back seat for the firm due to consulting's success in driving up revenues. The firm needed to reassess its operations to reach a healthy balance between the two divisions. The business world was changing yet again as deregulation progressed in the audit sector and companies were testing the boundaries of GAAP to raise their bottom line.[7] Auditors' responsibilities were increasing as they tried to decipher whether companies' accounting practices fell within the parameters of GAAP while also competing to remain objective as consulting services blurred the lines of independence. Arthur Andersen struggled to maintain auditor objectivity as they experienced the success of consulting on their bottom-line.

[5] "Arthur Andersen," 1.
[6] "Arthur Andersen," 1.
[7] "Arthur Andersen," 1.

The turn into the twenty-first century led to the collapse of the auditing profession. As the business world began to crumble, auditor scrutiny became prevalent and brought to light many issues with Arthur Andersen's work. The public learned of major scandal and fraud committed by high-profile companies which Arthur Andersen audited. The companies included Waste Management, WorldCom, and most famously Enron.[8] Arthur Andersen played a role in the perpetration of fraud by these companies due to faulty audit work. The first of the three major audit failures Arthur Andersen was a part of was the Waste Management scandal of 1998. News broke that Arthur Andersen was responsible for signing off on Waste Management's financial statements while knowing they were in fact materially misstated.[9] During this pre-SOX era, audit firms were doing what they needed to do to keep their important revenue-driving clients happy. For Arthur Andersen's audit of Waste Management, this came in the form of allowing high thresholds of misstatements to be considered material. In reality, Arthur Andersen knew the misstatements in Waste Management's financials were material and led to the deception of investors. During the pre-SOX era, companies were pressing the lines of GAAP interpretations as deregulation placed the responsibility on the auditor to decipher if decisions fell in the realm of GAAP. Andersen failed to properly decipher the misstatement threshold in hopes of keeping their client satisfied. Arthur Andersen's role in the Waste Management failures shed light on deficiencies in the regulation of the auditing profession; however, it was Andersen's role in the Enron scandal that led to the collapse of the firm and a rock bottom point for the profession.

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[8] "Arthur Andersen," 1.

[9] Charlie Cullinan, "Enron as a Symptom of Audit Process Breakdown: Can the Sarbanes-Oxley Act Cure the Disease?," *Critical Perspectives on Accounting* 15, no. 6 (2004): 859.

Enron was a complex company for the auditors of Arthur Andersen's Houston office. The company was involved in a variety of markets and operated in such a way that business fraud was able to flourish. Enron utilized Special Purpose Entities (SPEs) to fraudulently raise revenue by selling services to its own SPEs and improperly recognize the transaction as revenue.[10] Arthur Andersen failed to address the improper accounting treatment with Enron. In fact, Arthur Andersen's audit team assigned to Enron was involved in working with Enron to hide losses from investors. David Duncan was a partner at Arthur Andersen assigned to the Enron audit who overruled staff members' concerns on problematic accounting practices.[11] Andersen issued an unqualified opinion on Enron's financial statements despite engagement team member's concern for their GAAP interpretation. As a result of Arthur Andersen's role in the fraud, Enron was able to get away with improper accounting practices and disclosures in an effort to appear more profitable to investors. Once the SEC investigation of Enron began, Arthur Andersen took action to attempt to cover their tracks in the perpetration of fraud.[12]

Following the disclosure that the SEC would be investigating Enron, Arthur Andersen went into a panicked state. In the days following, the Houston office shredded and disposed of e-mails and documents that alluded to their knowledge and role in the fraud.[13] At this point, the firm and SEC knew it would be a long way back for Andersen to regain public trust. While Enron was collapsing Arthur Andersen, it was Andersen's role in the WorldCom scandal of 2002 that ruined any hope for a rebound back to a respected place in the accounting world. Around the same time, news broke of yet another scandal in which Arthur Andersen failed to correct WorldCom's aggressive GAAP interpretation. WorldCom was incorrectly classifying its assets;

[10] "Arthur Andersen," 1.
[11] Cullinan, "Enron as a Symptom of Audit Process Breakdown," 859.
[12] "Arthur Andersen," 1.
[13] "Arthur Andersen," 1.

in turn, the company was overstating its revenue.[14] The WorldCom and Arthur Andersen scandal further uncovered the need for guidance on proper GAAP interpretation as auditors may lack the necessary competence to exercise professional judgement. Other Arthur Andersen clients faced the repercussions of their auditor's actions as they began experiencing negative returns just days following news blasts of Andersen's unethical behavior.[15] Companies were being punished through negative returns as a result of their auditors. The negative effects ethical clients faced showed the interconnectedness of the auditing profession.

The profession needed to make a change as the actions of one firm could tarnish the trust in the profession as a whole, which is what happened for many years to come following these years of enormous scandal. Investors lost billions of dollars from the lack of due diligence by the auditors. Auditors during this period faced immense responsibility to offer the proper discretion on GAAP interpretations. Each time they fell short, the public lost trust in the work they were performing. Auditors were self-regulated and failed to remain loyal to the public as consulting pressures took over. The firms that dominated the profession, primarily the Big 5, were losing sight of their loyalty and pressured their auditors to satisfy clients who provided a lot of revenue to the firm. Ultimately, this version of the auditor would not suffice at meeting the needs of the public. Arthur Andersen fell due to their unethical behavior, the Big 5 became the Big 4, and it was evident that it was time for a new era of regulation and legislation in the accounting profession.[16]

Implementation Period: The Sarbanes-Oxley Act of 2002

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[14] Cullinan, "Enron as a Symptom of Audit Process Breakdown," 860.
[15] Linthicum, Reitenga, and Sanchez, "Social Responsibility and Corporate Reputation," 175.
[16] Cullinan, "Enron as a Symptom of Audit Process Breakdown," 860.

A glimpse of hope for the business world finally broke the news after years of disappointment and collapse with the passage of one of the most significant pieces of legislation to ever affect the accounting profession. In July of 2002, the US Congress passed the Sarbanes-Oxley Act (SOX) in an attempt to restore the business world to a place of integrity. After years of deregulation in the accounting profession and immense responsibility being placed on auditor discretion, SOX provided the necessary regulation and guidance to reshape the business world. From the outset, the legislation was mandatory and must be followed by all public companies. SOX addresses deficiencies in both public companies and public accounting firms and hopes to correct areas of weakness in order to regain investor confidence. SOX includes nine different sections of mandates. This section of the paper will discuss the goals that SOX attempts to meet. While SOX contains guidance on a wide variety of issues, this paper will focus on only a few of its major provisions that aid in the illustration of the evolution of the auditor and audit profession including the creation of the Public Companies Accounting Oversight Board (PCAOB), restrictions on services that inhibit auditor independence, and the guidance on Internal Controls over Financial Reporting (ICFR).

The Sarbanes-Oxley Act of 2002 was passed to meet a variety of objectives. After the immense scandals by large companies and accounting firms, the public looked at the business world through disappointed and skeptical eyes. It was evident from the disastrous effects on investors that the auditing profession was not performing as intended. To combat these perceptions, SOX aims at protecting the public and restoring investor trust in companies.[17] Auditor's loyalty should always lie with the public. Unfortunately, the auditors involved in the large corporate scandals of the early 2000s failed to do their duty in the eyes of the public. As a

[17] Darryl Lee Brown and Keith T. Jones, "Audit Experience, Accounting Education and Perceptions about the Efficacy of Sarbanes-Oxley and the PCAOB," *Journal of Accounting & Finance (2158-3625)* 11, no. 2 (2011): 58.

result, investors paid the price by losing billions of dollars. One of the main objectives of SOX is to make investors and the public feel protected so they can regain confidence in financial reporting. Another objective is to improve audit quality through auditor independence efforts.[18] Auditing took a back seat to non-audit services in the late twentieth century, and in return, the quality of audits was compromised. SOX attempts to bring auditing back to the forefront of the firm's priorities. Given the period preceding this legislation, one of SOX's main goals, in conjunction with improved audit quality, is to reduce fraud.[19] As a whole, SOX tries to improve the clarity of communication among the auditors, the financial information they audit, and the users of this information. SOX allows users to believe in auditor's work through improved audit quality by requiring increased independence measures.

In order to meet these objectives, SOX needed to restructure the world of auditing. One of the first ways it does so is through the creation of the Public Companies Accounting Oversight Board (PCAOB).[20] Prior to SOX, audit firms were self-regulated. The self-regulation was not succeeding at holding auditors accountable. Therefore, the PCAOB was created to keep public companies and auditors in check. It is unique from any prior regulatory measure in place to oversee the work of auditors. The PCAOB is a separate, non-profit corporation that is given the legal power to superintend public auditors.[21] It is an innovative way to regulate public auditors that was drastically different from any measure implemented in the past. It is intended to create and adopt standards on auditing, provide quality control over audits through inspections, monitor ethical measures of auditors to public companies, and discipline audit firms when necessary.[22]

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[18] Brown and Jones, 58.
[19] John C. Coates, "The Goals and Promise of the Sarbanes-Oxley Act," *Journal of Economic Perspectives* 21, no. 1 (Winter 2007): 97.
[20] Cullinan, "Enron as a Symptom of Audit Process Breakdown," 860.
[21] Coates, "The Goals and Promise of the Sarbanes-Oxley Act," 98.
[22] Cullinan, "Enron as a Symptom of Audit Process Breakdown," 861.

The creation of an oversight board helps auditors and companies operate with the mindset that they are being watched and inspected. This entity is designed to remain separate and independent from audit firms. The make-up of the PCAOB board includes five members; two members of the board must be auditors to offer the necessary expertise on the audit process needed to properly set standards and inspect audit reports, and three members are independent of the accounting profession.[23] The design of the board helps rebuild the trust lost by the public by ensuring that the watchdog of the profession is not only qualified but objective and independent. The PCAOB helps meet the objective of improved audit quality by setting standards that audit reports must meet.

Auditor independence was largely compromised as the consulting sector of accounting firms rapidly grew as a source of revenue. One may conclude that as revenue from non-audit services increased and firms began having an internal battle for client revenue between divisions, audit quality became compromised. SOX implementation helps promote auditor independence measures. One of the ways in which the legislation strives to do so is by placing restrictions on non-audit services offered by firms to audit clients. SOX outlines the scope of acceptable non-audit services that firms can provide and issues disclosure requirements for audit fees and any non-audit services provided.[24] Transparency with the public is crucial for improving investor confidence and trust. The profession needed guided restriction on the fine line they were previously walking between prioritizing audit work and offering non-audit services that were proving to drastically increase their revenue. Two of the new restrictions SOX implemented include banning the design of a client's information system and restricting audit firms from

[23] Coates, "The Goals and Promise of the Sarbanes–Oxley Act," 98.
[24] Betty Chu and Yunsheng Hsu, "Non-Audit Services and Audit Quality --- the Effect of Sarbanes-Oxley Act," *Asia Pacific Management Review* 23, no. 3 (2018): 201.

auditing clients whose internal personnel were former employees of the audit firm during the preceding audit cycle.[25] Both of these situations run the risk of compromising auditor independence as they would be in the position of auditing their own design and/or working with former coworkers who may know too much about the audit process. Non-audit services blur the lines of independence as client-firm relationships become more dependent on one another to raise revenue. The restrictions SOX places on these services aim to keep a clear boundary in place for auditors to improve their quality of work and remain independent from clients.

To fully meet the objectives in place, SOX needed to address issues from the inside out. Internally, many companies lacked the proper controls and disclosures to reduce the risk of fraud. SOX mandated legislation around companies' Internal Controls over Financial Reporting (ICFR) and the roles both management and auditors must play in ensuring proper control systems are in place and disclosing any areas of weakness.[26] SOX does not outline the proper control system to put in place or what should be included in an effective control system; there is no one system or template of a control system that would mold to all companies' needs. Rather, SOX legislates on management being held responsible for disclosing that controls are in place and where they might be falling short. External auditors then disclose whether they agree or disagree with management's assertions on controls. The two sections that address ICFR are Section 302 and Section 404. Section 302 requires that management annually and quarterly disclose their perceived effectiveness of internal controls.[27] Within the parameters of Section 302, the testing of controls is not required. Most of the work conducted to meet the requirements of this section happens through discussion with internal client personnel, assessment of designs,

[25] Coates, "The Goals and Promise of the Sarbanes–Oxley Act," 105.
[26] Coates, 102.
[27] Yuping Zhao, Jean C. Bedard, and Rani Hoitash, "SOX 404, Auditor Effort, and the Prevention of Financial Report Misstatements," *Auditing: A Journal of Practice & Theory* 36, no. 4 (2017): 154.

and walk-throughs.[28] Section 404 is more extensive. Section 404 mandates on the testing of controls; management and auditors must annually evaluate both the design and effectiveness of ICFR.[29] Section 404 gets down to the account and assertion level. The audit work under this section is tailored to the company's needs to areas where more testing would be efficient. Both sections strive to meet SOX objectives of improving audit quality and providing investors and the public with trustworthy financial information.[30]

Sarbanes-Oxley is an extensive piece of legislation. The legislation set goals and objectives aimed at righting the wrongs in the business world. SOX was the first step in setting auditors up for success. The guidelines and restrictions help allow auditors to properly do their jobs and not succumb to pressures from their own firms or clients. The passage of SOX helped lay the foundation for the true role of an auditor. Pre-SOX auditors found themselves responsible for much more outside of their job role. Unfortunately, they were unable to succeed due to the added expectations clients and firms placed upon them. This made them appear unable to properly do their jobs. In reality, they were faced with unnecessary pressures and responsibilities that did not allow them to do what they were intended to do. SOX redirects auditor responsibility through regulation and reform to afford auditors the tools and resources they need to perform their duties.

Post-SOX Period: Changes as a Result of the Sarbanes-Oxley Act

The US Congress passing the Sarbanes-Oxley Act of 2002 can only do so much. Once the legislation passed, the duty fell onto the business world and the auditing profession to carry out the regulation accordingly. The legislation is only effective at meeting its purpose if auditors

[28] Zhao, Bedard, and Hoitash, 155.
[29] Zhao, Bedard, and Hoitash, 154.
[30] Zhao, Bedard, and Hoitash, 154.

and business professionals do their part to follow the regulation. Constant reassessment of the business world at large is required to ensure SOX is meeting its goals and objectives. SOX added increased requirements and responsibilities for auditors; firms had to reassess the best use of company resources and make adjustments accordingly. While SOX was a promising piece legislation with high hopes of eliminating fraud and enhancing integrity in business reporting, the legislation still faced its fair share of criticism. Implementation of provisions under the legislation resulted in increased costs for firms. Many companies, audit firms, and investors have questioned whether the benefits of SOX truly outweigh the costs. Assessment of the effectiveness of SOX can be difficult to quantify, however, many studies have completed comparisons to show improvements. This paper will focus on examining trends in the decade post-SOX to assess how SOX is shaping the auditor's role in the audit process. In order to do so, various studies are used to compare pre-SOX data with post-SOX data in order to assess the effectiveness of the legislation. This section of the paper looks at trends and controversy following the implementation of SOX specifically in regard to the restrictions placed on non-audit services and improvements in the ICFR.

Pre-SOX, audit firm and client relationships were teetering on a fine line. Dishonesty and deception on behalf of the client or audit firm caused a lot of firms to reevaluate their clients and vice versa. The perfect time for a fresh start came following the passage of SOX. The relationship between an auditor and their client is a two-sided relationship. The audit market is a highly competitive market that involves selectivity, strategy, and competitiveness, all of which can compromise auditor independence and audit quality.[31] The passage of SOX caused a shift in the audit market as the restrictions on non-audit services were put in place. It allowed for audit

[31] Marion McHugh III, and Paul Polinski. "Audit Firm Changes Post-Sarbanes Oxley," *CPA Journal* 82, no. 5 (2012): 25.

firms and clients to fresh, and for many companies that came in the form of auditor resignations or client dismissals of auditors. During the implementation of SOX, the Big 4 resignation rates were the highest relative to pre-SOX and post-SOX periods.[32] The rise in resignations alludes to the need for auditors to be selective. SOX increases requirements for auditors such as increased documentation for PCAOB inspection. Audit firms must decide the best usage of firm resources and be reasonable with auditor's time. In the past, resignations from the audit firms and dismissals on behalf of the client usually occurred when conflict arose and an agreement on an issue could not be met. When the firms and clients could not reach an agreement, typically one would walk away from the relationship. However, post-SOX, there has been a decline in both resignations and dismissals.[33] These findings are optimistic about better relationships between auditors and their clients and less controversial disagreements. Rather than audit firms taking on as many clients as possible and offering a realm of services to raise revenue, SOX prompted the audit world to promote selectivity and optimize company resources and auditors' time.

While the restrictions on non-audit services showed positive trends in an improved audit firm and client relationships, these restrictions did not come without controversy. There is an ongoing debate around whether non-audit services actually enhance the audit process versus compromise audit independence. Given the correlation between increased non-audit services and large corporate scandals in the early 2000s, much of the public and investors believed there to be a clear answer to that debate. However, the debate aids in the discussion of the evolution of the auditor and audit profession and is worth mentioning. One side of the argument is congruent with the goals of SOX. Restrictions were placed on non-audit services because auditor independence was being compromised. Audit firms are a business, and businesses can

[32] McHugh and Polinski, 29.
[33] McHugh and Polinski, 26.

only operate when they are producing enough revenue to supply the resources necessary to function. Non-audit services proved to be a successful way for audit firms to increase revenue. As a result, accounting firms were forced to deal with a dilemma and decide whether the audit function should remain the first priority. The auditor's responsibility is to accurate report to the public, but non-audit services can shift an increased level of loyalty to the client. In turn, this placed added pressures on the auditors as clients became more dependent on the auditor's loyalty.[34] On the other side of the debate, critics of SOX believe the restrictions placed on non-audit services are too strict. Critics see non-audit services not only as a valuable way for firms to increase revenue but as a way for auditors to gain a better understanding of the client's system; in return, because they have increased knowledge on where to identify issues, auditors are improving the quality of their audit by more efficiently allocating their time.[35] Non-audit services are believed to allow auditors to complete their work more efficiently and allow firms to more effectively utilize their resources. Both sides of the debate offer relevant arguments. Although, a better understanding of the client environment can be achieved through non-audit services, the auditor's loyalty should always be focused on the public interest. If firms and the public want auditors to successfully perform their jobs, any added pressures that could interfere with their duties should be avoided.

The Sarbanes-Oxley Act mandated that management and external auditors separately assess the effectiveness of ICFR and disclose their conclusions under Section 404. Section 404 is said to require more thorough audit work than Section 302. Therefore, it is believed to be a better judge at discerning the effectiveness of SOX. Section 404 went into effect on November

[34] Chu and Hsu, "Non-Audit Services and Audit Quality," 201.
[35] Chu and Hsu, 201.

15, 2004 for accelerated filers.[36] The two year wait period for the implementation of Section 404 occurred after concerns and pressures were placed on the SEC. Being that Section 404 is more extensive, firms needed to invest more resources and time to effectively carry out the legislation. This caused an economic burden on many firms, especially smaller audit firms who did not pull the same amount of capital as the Big 4. In 2006, two years after Section 404 became effective, a survey conducted of 321 companies concluded that the average compliance cost of Section 404 was around $1.5 million in additional audit fees.[37] Firms faced immense amounts of stress as they needed to invest millions of dollars and time into compliance with legislation that also placed restrictions and required cutbacks on their other revenue-producing services. Unfortunately, for small audit firms, Section 404 did not include cost scaling of requirements to address differences in capital availability based on firm size. Section 404 not only imposed physical costs on audit firms, but it also imposed opportunity costs for auditors as they adjusted to new time-consuming requirements.[38] Auditor responsibility shifted as this area of SOX became increasingly important. A discussion of whether the benefits of Section 404 outweigh the costs was an important debate in the years following compliance. While difficult to quantify, research alludes to Section 404 being crucial to meeting the objectives of SOX.

Compliance with Section 404 offered both short-term and long-term benefits to audit firms and companies despite the hefty costs of implementation. While Section 302 increases the emphasis on ICFR, it is not adequate on its own to maximize efforts to improve audit quality and boost investor trust. In the beginning months following the compliance with Section 404, it was

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[36] Jean C. Bedard, Lynford E. Graham, Rani Hoitash, and Udi Hoitash, "Sarbanes-Oxley Section 404 and Internal Controls," *CPA Journal* 77, no. 10 (2007): 34.
[37] Zvi Singer and Haifeng You, "The Effect of Section 404 of the Sarbanes-Oxley Act on Earnings Quality," *Journal of Accounting, Auditing & Finance* 26, no. 3 (2011): 561.
[38] Singer and You, 561.

reported that 95% of companies indorsed their controls effective under Section 302 while reporting control deficiencies through Section 404.[39] Section 404 brings to light deficiencies in the control environment through its extensive testing and documentation requirements. It highlights details that Section 302 does not, namely providing investors with more reliable and relevant information to make decisions. A study published in the *Journal of Accounting, Auditing, and Finance* attempted to evaluate the benefits companies and firms receive by complying with Section 404. The study utilized US-listed Canadian firms who, under Canadian regulation similar to SOX, did not have to comply with similar requirements to Section 404 to act as a control group to firms who implemented compliance with Section 404.[40] The study concluded that earnings reliability and relevance improved as a result of Section 404 procedures as a decrease in abnormalities was occurring at a much faster rate than non-complying firms.[41] The goals of Section 404 include more reliable information for investors and less material misstatements. Both audit firms and companies, through compliance with Section 404, were helping to restore investor and public confidence in financial reporting. Section 404 gives auditors and management the platform to be more transparent in regard to their control environment. In return, investors are given a more holistic view of an organization. In the long run, Section 404 is crucial to more reliable, relevant, and transparent financial information and the rebuilding of firm and company reputation.

The effects of the Sarbanes-Oxley Act greatly impacted auditors and audit firms. When the legislation was published, there was only so much telling as to how it would change the role of the auditor. It was not until years later when reassessments of the business and audit

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[39] Singer and You, 561.
[40] Singer and You, 564-565.
[41] Singer and You, 583.

environment could be conducted that it became clear how auditors and the audit profession were evolving. Not only did assessments of its effectiveness give insight into how effective SOX was at meeting its objectives, but these assessments help to allude how this legislation shaped auditor duties and responsibilities. SOX mandated new restrictions and requirements which adjusted the way auditors allocated their time. The restrictions on non-audit services forced audit firms to be more selective with the clients they continued to work with and the new clients they accepted.[42] These restrictions forced audit firms to remove some of the added pressures they placed on auditors to issue opinions on financial statements that would keep their important, revenue-producing clients satisfied. SOX's restrictions opened a new door for auditors to more effectively perform their duties by, through indirect means, more clearly defining their role and allowing them to work toward the goal of improving audit quality. The increased legislation on ICFR is one of the components of SOX that evolved auditor's responsibility the most. ICFR is crucial to meeting the initiative of improving investor and public trust, and sections of SOX such as Section 302 and 404 require more detailed work on behalf of auditors. It is an area in which auditors must dedicate considerable time to perform the necessary procedures and testing required to disclose their opinion on the effectiveness of the control environment of their client. This section required audit firms to invest resources, capital, and time appropriately as a result.[43] The compliance with these sections and SOX as a whole pointed audit firms and auditors in the direction of what is most important.

The Role of the Auditor and Audit Profession

Being an auditor and working within the audit profession is an important role with a large level of responsibility. People base major financial decisions on the financial statements which

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[42] McHugh III and Polinski, "Audit Firm Changes Post-Sarbanes Oxley," 26.
[43] Singer and You, "The Effect of Section 404," 561.

auditors express their opinions. Auditors and the profession have come a long way since their role in the large corporate scandals of the early 2000s. The Sarbanes-Oxley Act of 2002 helped set auditors and audit firms up for success; SOX helps auditors and firms remain focused on fulfilling their responsibilities to the public by mitigating added pressures and providing necessary regulation over the profession.[44] However, many people are misinformed about the duties of an auditor. Over time, people have formed perceptions and expectations about an auditor's role and the audit profession in general based largely heavily upon media and news stories. People are often disappointed in the profession because they lack proper education and knowledge of what an auditor is expected to do. The progression of this paper was intended to lay the foundation for how an auditor's role has evolved over three prominent time periods for the profession; the goal is to fill the gap in research on how an auditor's purpose and responsibilities have evolved to the point they are today. The final section of this paper examines the current state of the audit profession. This section contends that the profession will continue to be perceived negatively and disappoint the public unless there is ample knowledge and education on the role auditors play in the business environment. The final section includes a discussion on the lack of public knowledge of SOX, the expectations gap that exists between the public and auditors, and finally, the true role of an auditor and the audit profession.

The Sarbanes-Oxley Act of 2002 drastically changed the profession and business world; this legislation is described as being one of the most significant changes to the accounting profession. One of the goals of SOX is to improve audit quality in order to improve public and investor confidence. The legislation helps redefine the profession and ensure accuracy and integrity for the public interest. However, the public can only judge whether SOX has met its

[44] Brown and Jones, "Audit Experience, Accounting Education and Perceptions," 58.

objectives if they are educated on the legislation and fully understand its design and purpose. There is a deficiency in knowledge by a large portion of the public on what SOX is and how effective it is at meeting its objectives, and in turn, there is a lack of knowledge on the auditor's role in the audit process. Investors are able to recognize that SOX played a role in changing audit responsibilities, in turn, improving the overall quality and integrity of audits.[45] Despite not knowing all the details of the legislation, the name is recognizable and often associated with increased auditor responsibilities. However, it is the extent to which they believe audit responsibilities have changed which is problematic. Audit professionals with post-SOX real-world experience report lower levels of perceived improvement in audit quality than auditors with no audit experience.[46] Experienced professionals, while still believing SOX has improved audit quality, are more realistic in deciphering how significant the improvement is. While it is important that investors and the public understand that SOX is acheiving its purpose, the overconfidence of investors may lead to another period of disappointment. If investors associate SOX with improving audit quality through increasing auditor responsibilities, investors may be much more likely to place all the pressure on auditors to meet their desired improvements in audits.[47] Without adequate knowledge of SOX and the role of an auditor, investors risk believing that auditors are performing responsibilities that they are not. Familiarity of SOX and the audit process needs to be a priority for investors as well as the public because the reach of the business world processes can affect everyone. When investors are not fully aware of audit process regulation, the gap in the expectations for auditors and the audit profession widens.

[45] Brown and Jones, 62.
[46] Brown and Jones, 62.
[47] Brown and Jones, 63.

Therefore, this places undo blame on auditors when companies fall short and audits misrepresent financial position.

The expectations gap is a large problem in the misconception of the auditor. The expectations gap refers to the gap between the expectations set by the users of financial information and the expectations set by auditors.[48] Investors and the public who utilize audited financial information to make educated decisions have an expectation for what is considered to be satisfactory in the responsibilities of auditors and the procedures and results of the audit process. Auditors, however, have different expectations for the work they complete throughout the audit process and what is considered to be satisfactory. The gap forms as a result of knowledge deficiencies in investors about what an auditor is expected to do during the audit process.[49] As the gap widens, investor confidence and trust in auditors diminishes. The expectations gap has been an ongoing phenomenon for years. Users of financial data expect auditors to act with their upmost integrity, competence, and capability to issue a fully accurate and independent opinion assuring the users that the financial information that is free of material misstatements.[50] While auditors should always complete their audit work with their upmost integrity, competence, and capabilities, the audit process is not black and white. Investors who do not fully understand the audit profession and the work and professional discretion that auditors must exercise during an audit usually have unrealistic expectations.

The roles and responsibilities of an auditor are important to the function of the economic world. An auditor's role in society, defined by the American Institute of Certified Public

[48] Ahmad A. Toumeh, Sofri Yahya, and Walid Zakaria Siam, "Expectations Gap between Auditors and User of Financial Statements in the Audit Process: An Auditors' Perspective," *Asia-Pacific Management Accounting Journal* 13, no. 3 (September 2018): 104.
[49] Toumeh, Yahya, and Siam, 104-105.
[50] Toumeh, Yahya, and Siam, 104.

Accountants (AIPCA), is defined as "commitment to objectivity, integrity, competence; excellent performance on behalf of clients, employers, and the public; and accountability for the highest professional and business ethics."[51] An auditor adds to society by serving as a moral compass, directing companies' financial information and disclosures in an ethical direction. Their loyalty lies with the public, not the client or their respective firm, as they issue opinions with the public and investors' best interests in mind. As a result of SOX, auditors audit both a company's financial data and the internal control environment that they produce this data within. Auditors do not provide one hundred percent assurance that financial information is free from material misstatements. No auditor has the time to test every single transaction made by a company; it is unrealistic. Rather, auditors provide reasonable assurance.[52] When investors believe auditors' opinions ensure them of complete accuracy, they are contributing to the expectations gap and holding auditors to a standard they will never be able to meet. Auditors only test a sample of transactions. Based upon the results from the procedures and testing conducted on the sample, auditors are able to issue an opinion with reasonable assurance on whether financial statements are free from material misstatements.[53]

Auditors are required to exercise professional skepticism and judgment on accounting practices and treatment that need GAAP interpretation. While SOX and other regulations have reduced some of the responsibilities of auditors to properly discern interpretations, accounting and auditing have grey areas that require professional judgement.[54] Auditors offer the necessary competence and capability to determine if practices are in accordance with GAAP. An auditor's

[51] Richard H. Kravitz, "Auditors' Responsibility for Detecting Fraud," *CPA Journal* 82, no. 6 (June 2012): 26.
[52] Cullinan, "Enron as a Symptom of Audit Process Breakdown," 854.
[53] Cullinan, 854.
[54] Kravitz, "Auditors' Responsibility for Detecting Fraud," 29.

job is not to specifically seek out fraud or illegal activity within a company.[55] An auditor's role is to express an independent and objective opinion on whether a company's financial information provides a proper depiction of the company and is free from material misstatements.[56] Setting incorrect expectations makes auditors appear that they failed at their job when news hits the media about fraudulent behavior on behalf of companies. Companies have their own duties to operate ethically and accurately. Management's manipulation of accounting policies and perpetration of fraud can disrupt and taint the audit process.[57] Unfortunately, companies acting unethically is never going to go away. However, auditors improve audit quality when they uncover fraudulent or illegal behavior through the audit process of testing and procedures and accordingly issue an appropriate opinion.[58]

The audit profession as a whole is often misunderstood. Audit firms are businesses that need revenue to effectively provide the necessary resources to operate. Like any business, audit firms place pressures on their employees to keep clients satisfied, so revenue continues to grow. This puts auditors in a tough place because unique to most other professions, the audit profession has a duty to the public versus their company or their clients.[59] SOX helps restrict some of the pressures that firms place on their employees by imposing restrictions on services to keep auditors independent from their clients. This keeps the profession on track to prioritizing auditing and the public. Investors and the public need to keep in mind that an audit firms' greatest assets are their employees. Auditors and employees at accounting firms are human; with a human-operated business, there is always going to be a risk of human error. The public often

[55] Kravitz, 27.
[56] Toumeh, Yahya, and Siam, "Expectations Gap between Auditors," 104.
[57] Kravitz, "Auditors' Responsibility for Detecting Fraud," 27.
[58] Kravitz, 27.
[59] Kravitz, 30.

loses confidence in the profession when auditors make errors. However, these errors are inevitable. The auditing profession cannot operate without risk. While the profession works diligently to provide their auditors with the resources, tools, and training necessary to diminish the probability of error, audit risk is never going to go away completely. If investors and the public want auditors to better plan the audit process to prevent errors and detect fraud, audit firms have a responsibility to provide the proper training and tools for the auditors.[60]

The audit profession assigns much of the revenue and profit they earn from their services into tools such as software development and training that allows auditors to perform their jobs more efficiently and accurately. The revenue is derived from services rendered to clients. The profession walks a fine line with its desire to satisfy clients and increase revenue while, at the same time, minimizing pressures on auditors to satisfy clients through compromised integrity.[61] Because audit firms are structured through a hierarchical system, the partners at the firm have added pressures to maintain revenue from their clients while upholding their reputation.[62] In turn, they place pressure on inexperienced, young staff who frequently are the individuals performing audit process procedures. The audit profession is still new relative to other professions; the profession lacks an agreed upon global accounting framework to aid the structuring of firms' duties and responsibilities.[63] With firms adding new service lines, the profession is still navigating new territories and balancing their divisions.

No legislation can ensure auditors are competent and capable of meeting their purpose. While the Sarbanes-Oxley Act of 2002 helps guide and restrict the profession to operate at its maximum capabilities, the profession is responsible for hiring ethical auditors and investing in

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[60] Kravitz, 29.
[61] Lynn E. Turner, "Reforming the Auditing Profession," *CPA Journal* 90, no. 2 (February 2020): 50.
[62] Turner, 50.
[63] Kravitz, "Auditors' Responsibility for Detecting Fraud," 26.

training its employees. The auditing profession has its own duty to constantly enhance their auditors' competence and capabilities by providing them with the necessary resources and environment to accomplish the duties of an auditor.[64] Despite the large strides over the past two decades, the audit profession still faces criticism. The criticism affects the credibility and trust the audit profession has worked diligently to restore.[65] The public scrutinizes the profession for failing to reform the industry based upon recommendations by regulatory bodies that were offered years ago. Audit firms face judgement for ongoing issues with independence, transparency, independent governance, and quality.[66] While the profession has experienced great reform, investors and the public continue to push the profession to address problems within these areas to better meet the needs of financial users.

Conclusion

The goal of this paper was to lay the foundation for a discussion of the role of the auditor and what the audit profession is expected to accomplish. The audit profession has made great strides over the previous two decades. The profession entered into the 2000s with the collapse of one of its five largest accounting/audit firms. The public and investment community lost their trust and confidence in the profession as a whole as a result of the large corporate scandals and audit failures occurring at that time. With the rise of new revenue-producing services secured by accounting firms, auditors were placed in the middle of a revenue versus independence dilemma and lacked the tools to properly remain independent and objective. The profession needed reform and regulation if it had any hope of restoring the public trust. To help minimize fraudulent reporting practices and material misstatements, the US Congress passed the Sarbanes-

[64] Kravitz, 29.
[65] Turner, "Auditors' Responsibility for Detecting Fraud," 49.
[66] Turner, 49-50.

Oxley Act of 2002. The legislation mandated many stipulations on the business world and the audit process. SOX is designed to eliminate fraud and misrepresentation of financial data. The regulations and guidance offered under SOX expanded auditors' duties and responsibilities and imposed more stringent interorganizational controls.

The implementation of SOX allowed for a reassessment of the audit profession and the provision for stricter financial governance and controls. Years following the passage of SOX, assessments on its effectiveness have shown the progression of the audit profession and the work and responsibilities of auditors. While SOX was proving to be successful at meeting its objectives, the lack of knowledge on SOX's legislation by the general public has been detrimental to the perceived success and reputation of the auditor. This paper discussed how public misconceptions about auditors can set auditors up to fail; the public is unrealistic in their understanding of the auditors' responsibilities and therefore frequently has unrealistic expectations and misunderstandings. The auditor's role and accuracy are important to the firm, the investor, and the general public, but in many instances, due to lack of understanding, the expectations of the outsiders are excessive. Audit firms operate as businesses, and therefore, the profession has a duty to enable their auditors to be as successful as possible by extensively training them to fulfill their role in the business environment. The pressure exerted on the auditor from multiple entities makes it difficult to please the public, the investor, the client, and the firm simultaneously. The profession continues to undergo criticism and pressure to reform in order to better demonstrate to the public that there are proper checks and balances in place to ensure the integrity of financial information. A fundamental objective of this paper was to better understand the role of the auditor and the auditing profession. For preservation of public trust, the auditor constantly examines the effectiveness of interorganizational controls the ensure the accuracy and integrity of financial statements. In conclusion, the credibility of the auditor and the audit process will be based on the perception of the independence of judgement and the track record of their accuracy.

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