Sarbanes Oxley, Non Audit Services And The Mandatory Rotation of Audit Firms

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Abstract-- Whilst the benefits and potentials of the dual roles assumed by external auditors are emphasized, as well as the need to ensure that safeguards operating to guard against a compromise of objectivity and independence are in place, this paper also highlights the fact that even though such dual roles are appropriate in certain cases – as illustrated by justifications for limitations imposed by the Sarbanes Oxley Act and other relevant and applicable legislation – instances also persist where section 201 of Sarbanes-Oxley, with regard to internal audit outsourcing, may have been over-reactionary and may continue to hinder both companies and their auditors.

Keywords--Independence, objectivity, Sarbanes Oxley Act, FSMA section 166, non-audit services

I. INTRODUCTION

This paper considers the dual roles of external auditors: whether acting in the dual capacity of external auditor and internal auditor (with respect to internal and external audits), does significantly or not significantly, affect the objectivity and independence attributes required in exercising their functions.

It is also important to highlight that a consideration of the dual roles of the external auditor and internal auditor will involve examining whether it is appropriate for the external auditor to incorporate internal audit responsibilities in certain circumstances (as provided for by ISA 610, Using the Work of Internal Auditors, as well as provisions of the Sarbanes Oxley Act which imposes limitations on external auditors’ abilities to perform in a dual capacity - particularly with respect to internal audit outsourcing services). It will consider the impact of the performance in such a dual capacity on the ability of the external and internal audit work to be carried out with the required attributes of objectivity and independence. The structure of this paper is organized as follows. The literature review section recalls the concepts of integrity, independence and objectivity and is aimed at highlighting their significance as ethical values and attributes in the exercise of audit and accounting functions. The section following a view of the methodology then illustrates how the focus within accounting and audit roles have changed over the years, as well as highlights why there is need for a return to, and focus on traditional auditing techniques.

Certain duties and responsibilities which the auditor is capable of undertaking and is permitted to undertake by law, as well as prohibited activities under various legislation will be considered under this section. A consideration of the dual role of the external auditor as a skilled person, as well as safeguards which are in place to ensure that a compromise of independence and objectivity, whilst performing delegated functions, does not occur, will then be undertaken – before a conclusion is derived.

II. LITERATURE REVIEW

A. Non Audit Services and Audit Independence

The APB (Auditing Practices Board) Ethical Standards 1 and 5 (Revised), particularly, are concerned with the integrity, objectivity and independence of auditors. Paragraphs 10 and 13 of the APB’s Ethical Standard 1 (Revised) respectively distinguishes between objectivity and independence. In particular, paragraph 13 states that: “Independence is freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity either is impaired or could be impaired. Independence is related to and underpins objectivity. However, whereas objectivity is a personal behavioral characteristic concerning the auditor’s state of mind, independence relates to the circumstances surrounding the audit, including the financial, employment, business and personal relationships between the auditor and the audited entity and its connected parties.”

Other definitions of independence have been provided as follows (Beattie, Fearney and Brandt; 2001): “the conditional probability of reporting a discovered breach” by DeAngelo; the ability to resist client pressure (Knapp): a function of character - with characteristics of integrity and trustworthiness being essential (Magill and Previts); and an absence of interests that create an unacceptable risk of bias - this definition being provided by the AICPA White Paper definition (AICPA, 1997) which defines independence as an absence of interests that create an unacceptable risk of bias.

The Institute of Internal Auditors (IIA)’s published framework of independence lists seven threats to audit independence (which are similar to those threats faced by external auditors) and these threats include: self-review threat; social pressures; economic interests; personal relationships;...
concentration within the audit market certainly has more positive impacts and consequences for audit independence since there is less choice from the mid-tier audit firms into the audit market generate entry to the audit market. Would the admission of more players in the audit market be welcomed as an interesting matter.

Joint audits, that is, mid-tier firms carrying out joint audits with Big Four firms, as a means of increasing their presence at international level, is considered “the priority step in tackling the concentration issue”. Whether such audits can also facilitate greater levels of audit independence also constitutes an interesting matter.

III. METHODOLOGY

Focus will be placed on the perspective of the external auditor performing internal audit functions - although the paper will also consider to an extent, internal audit concepts, and the internal audit function.

A. Changing Roles of Internal and External Auditors and Post Enron Consequences: Why A Return to More Traditional Auditing Techniques is Required

As well as evidence which suggests that the internal auditor’s role has changed in recent years to one of a consultant nature, in contrast to that of a policing role, evidence has also been provided to support the fact that the external auditor’s role changed during the nineties from that synonymous to a watch dog to a less vigilant and scrutinizing role (Cunningham; 2006). Such evidence which include:

- Firstly, the widening scope of audit firm services beyond the audit function - which has resulted in relationships which have affected audit firms’ independence, secondly, increase in accounting irregularities during the 1990s which have arisen in the form of widespread premature revenue recognition and other forms of creative accounting, and thirdly, evidence of auditor ability to influence audit quality and liability risk.

Traditional auditing techniques focus on internal controls and demonstrate the auditor’s thorough reputation as compared to the lax and complacent attitude which has been evidenced through recent increases in creative accounting practices and the widespread use of off balance sheet instruments as illustrated in the case of Enron. For this reason, a return to and focus on traditional auditing techniques, as well as auditing techniques which focus on internal controls is a much needed move - whilst also supporting audits which also take into consideration, strategic and operational controls. Such a stance would be greatly facilitated in cases where an external auditor is able to undertake certain permitted internal audit responsibilities.

A return to traditional auditing techniques is also advocated for, since, as will be illustrated in the following section, it has been argued that many Post Enron reforms, notably the Sarbanes Oxley Act, do not go far enough in their efforts to address the issue of independence – primarily through the prohibition of particular non audit services.

B. Limitations On the Use of Internal Audit Work and the Assumption of Internal Audit Roles - As Performed By External Auditors

In order to prevent or avoid situations where over reliance on internal audit work could result in a compromise of the external auditor’s objectivity, certain safeguards serve to assist in “clarifying the circumstances where the work of the internal audit function cannot be used and therefore is prohibited.” Such instances, as provided for by the ISA 610 (Revised), paragraphs 14] are as follows: 11

- Where the function’s organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- Where the function lacks sufficient competence; or
- Where the function does not apply a systematic and disciplined approach, including quality control.

According to Paragraph 9 of the INTERNATIONAL STANDARD ON AUDITING 610 (REVISED), the

5 See European Commission, “Ownership Rules of Audit Firms and their Consequences For Audit Market Concentration” at page 88
6 European Commission, Study on the effects of the implementation of the "acquis" on statutory audits of annual and consolidated accounts including the consequences on the audit market (2011) at page 6 of 9
7 J Stewart and N Subramaniam, at page 13
9 see L Cunningham, page 24
10 see L Cunningham, pages 24 and 25
11 See [ISA 610 (Revised), paragraph 14] and IFAC, "Basis for Conclusions, Prepared by the Staff of the IIAASB” ISA 610 (Revised), Using the Work of Internal Auditors, and ISA 315 (Revised)
12 USING THE WORK OF INTERNAL AUDITORS
external auditor’s sole responsibility for the audit opinion expressed, is not reduced by the external auditor’s use of the work of the internal audit function.

Paragraph 24 also expressly states that the following information should be included in the audit documentation - where the external auditor incorporates the work of the internal audit function:

- Evaluation of whether the function’s organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; the level of competence of the function; and whether the function applies a systematic and disciplined approach, including quality control.
- The nature and extent of the work used and the basis for that decision; and
- The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

C. Outsourcing and Co Sourcing of Internal Audit Services

As highlighted in the previous sections, there are certain duties and responsibilities which the external auditor is capable of undertaking and permitted to undertake by law. Under the Sarbanes Oxley Act, the prohibition of the external auditor’s capacity to perform dual roles in respect of performing certain non-audit services which include internal audit outsourcing services, is highlighted.

Section 201 of the Sarbanes Oxley Act of 2002 lists certain prohibited services which do not lie within the scope of practice of external auditors of U.S public companies. These prohibited services are based on three primary criteria, namely: i) An auditor cannot function in the role of management; ii) An auditor cannot audit his or her work; and iii) An auditor cannot serve in an external advocacy role for the client. Internal audit outsourcing services constitute one of the services listed as prohibited and even though the provision of such services by external auditors to their clients is no longer permissible, it is reported by Ernst and Young (2006) that public accounting and specialist firms provide these services to non-audit clients.

Section 201 of Sarbanes-Oxley, with regard to internal audit outsourcing, may have been over-reactionary, may hinder both companies and their auditors. Furthermore, various shortcomings of the Sarbanes Oxley Act have been identified which include. The inability of the Sarbanes Oxley Act to address the issue of independence of mind through a focus on actual conflicts of interests faced by auditors; ii) the fact that the Act still permitted audit firms to undertake tax consultancy work – even though it prohibited the same firms from carrying out some non-audit services; iii) that although the Act required rotation of the audit partner, it did not require rotation of the audit firm; and iv) the failure of the Act to address the “very common occurrence” of individual auditors moving from their firms to their clients.

In jurisdictions with developed audit markets, such as the UK and the U.S, the issue of “client switching” and the incidence whereby mandatory audit rotation is not undertaken by certain audit firms is of particular concern. Furthermore, even though the Sarbans Oxley Act is U.S Law, its impact on global audit practices is evident. Two reasons which are attributed to this include: 16

- Firstly, the fact that many multinational companies have a US listing and are therefore directly affected by the Act;
- Secondly, regulators, auditors and companies in many other jurisdictions have adopted similar rules to the Sarbanes Oxley Act – for example, Ethical Standards 5 (as discussed under section A), of the UK FRC’s Auditing Practices Board which prohibits audit firms from undertaking certain types of non-audit work for companies they audit, and requires certain safeguards to be in place to isolate audit from non-audit work.

Is section 201 of Sarbanes-Oxley, with regard to internal audit outsourcing over-reactionary? Could it continue to hinder both companies and their auditors? The following sections relating to knowledge spill-over gains, cost management and financial reporting quality further illustrate why section 201 may not fully serve its purpose.

Knowledge Spillover Gains: Knowledge spillover is the result of accounting firms benefiting from the relationship between the audit and non-audit services offered to their clients. In the case of internal audit outsourcing, the efficiency of financial audits is bolstered because the auditor is able to benefit from knowledge gained during the performance of internal audit functions. The auditor is able to gain a better understanding of the client’s internal controls because the auditor has had close experience with the internal control environment as part of the client’s internal audit function.

Cost Management: Audit firms are not the only party to monetarily benefit from the outsourcing of internal audit. Companies that outsource their internal audit function may reap potential cost benefits as well. In the article “Internal Audit Outsourcing” Aldhizer and Cashell (2003) explain: “For companies, outsourcing the internal audit function offers potential cost benefits. Internal audit outsourcing may reduce overlapping positions and audit effort by creating more flexibility in increasing and decreasing workloads. Additionally, outsourcing allows a company to replace “fixed” cost employees with “variable” fees for services. Finally, a wide range of expertise is available from large firms that would be too expensive for a company to maintain internally.”

(Effective for audits of financial statements for periods ending on or after December 15, 2013).

13 Prohibited services include:
- Book keeping or other services related to the accounting records or financial statements of the client whose statements are being audited;
- Financial reporting systems design and implementation;
- Internal audit outsourcing services.
14 See J Stewart and N Subramaniam, January 2010 at page 17 and Ernst & Young, Trends in Australian and New Zealand Internal Auditing, Third Annual Benchmarking Survey 2006, Ernst & Young, Australia.

16 See European Commission, “Ownership Rules of Audit Firms and their Consequences For Audit Market Concentration” at page 5
Accounting Risk Management and Financial Reporting Quality: An investigation by Prawitt et al. (2011) found evidence that suggested that high quality internal audit functions (regardless of outsourcing) are associated with lower accounting risk. Furthermore, Prawitt et Al. (2003) found that companies that outsourced their internal audit function to their external auditor prior to the passage of Sarbanes-Oxley had lower accounting risk than companies that outsourced their internal audit function to another third-party service provider and companies that maintained their own in-house internal audit function.

Based on an empirical analysis of the relationship between restatements and non-audit fees paid by a client to its external auditor, it was found that companies that were not required to restate their financial statements paid more in internal audit outsourcing fees to their external auditors than companies that did, in fact, have to record material restatements (Prawitt et Al. 2003). This evidence suggests a negatively correlating relationship between the outsourcing of internal audit functions and the occurrence of material financial restatements.

Arguments have also been put forward to bolster the stance that “an outsourced provider may be more independent than an in-house internal audit function since it is difficult for an employee to be truly independent of management, and that on the other hand, there also factors which could affect the objectivity of outsourced providers in the same manner that external auditor independence can be compromised.”17 It is also argued that “regardless of whether external assurance is obtained for sustainability reports (which contain a combination of quantitative18 and qualitative data), that internal audit can play a role in verifying this data for management purposes.”

The Institute of Internal Auditors (IIA) also recommends a list of factors to be considered when assessing potential outsourcing engagements: available resources, size of the organization, types of outsourcing alternatives, Law, Statute, or regulation (since some companies may be prohibited by statute or regulation from outsourcing internal audit services to their external auditors), taking into consideration an analysis of the advantages and disadvantages of outsourcing, as well as the following: Independence of the external service providers; allegiance of in-house resources versus that of external service provider; professional standards followed by the external service provider; qualifications of the service provider; staffing – training, turnover, rotation of staff, management; flexibility in staffing resources to meet engagement needs or special requests; availability of resources.

There have been further evidence and arguments aimed at bolstering the view that conflicts of interests do not necessarily result from the proportion of non-audit services (NAS) fees compared to the audit fees, but from the fact that by performing two kinds of services, the audit is serving two kinds of clients.21 Even though such arguments have their merits, the fact that an audit firm which derives a significant percentage of its income and means of sustenance from a particular NAS or client, is likely to be influenced and dominated by such dependence, cannot be denied. It is certainly true that an audit firm may be compelled to “rename” a NAS in order to avoid being caught or “captured” by the prohibited list of NAS (as is mandated by section 201 of the Sarbanes Oxley Act). Hence it could be effectively argued that despite the list of prohibited services, section 201 of the Sarbanes Oxley Act may not fully achieve its aims.

D. External Auditors Also Undertaking the Role of Skilled Persons

Section 166 of the Financial Services and Markets Act (FSMA) 2000 deals with the powers of the UK’s financial services regulator, the Financial Services Authority (FSA), to obtain a report by a skilled person (also referred to as a reporting accountant) to assist the FSA in performing its functions under the FSMA 2000. In addition to its powers to appoint skilled persons to carry out certain functions under section 166, sections 167 and 168 of the Act also empower the FSA to appoint competent persons to carry out investigative tasks.

The differences between the roles of skilled persons (also known as reporting accountants) and competent persons, are demonstrated by the bearer of the costs for work carried out by these persons. For work undertaken by skilled persons, the regulated firm (who employs them) bears the cost directly whilst for work undertaken by competent persons, the FSA bears the cost.22 According to Singh (2003), even though skilled persons are usually approved by the FSA, the role is usually performed by auditors of the regulated firm.23 The use of skilled persons’ reports has been controversial and concerns have been expressed in relation to the FSA using a skilled person’s report instead of devoting its own resources to investigating a matter.24 Certain measures have been adopted to safeguard against possibilities of a conflict of interest arising between the auditors of the regulated firm who are commissioned by the FSA as skilled persons but paid by the regulated firm. Chapter Five of the FSA Supervision Manual provides examples of circumstances where the FSA may use skilled persons.

17 For instance, where the audit firm is dependent on a client for a major source of income and would not wish to lose such a client, self-review threats etc; see ibid at pages 17 and 18
18 Furthermore, “where information being verified is not quantifiable, internal auditors could face objectivity threats arising from social pressure and familiarity.” see ibid at page 21
20 see ibid

21 See European Commission, “Ownership Rules of Audit Firms and their Consequences For Audit Market Concentration” at page 166
22 See J Hitchins, M Hogg and D Mallet (2001) at page 295
23 See D Singh, The Role of Third Parties in Banking Regulation and Supervision (2003) at page 9
24 See ibid at page 135
IV. CONCLUSION

It has been demonstrated that certain capacities exist in which the dual role of the external auditor (in undertaking internal audit roles as well as skilled persons roles) could be immensely beneficial to an entity or organization. This arises as a result of the invaluable skills and expertise which such a role provides and incorporates into the audit process. Even where such an exercise of a dual role is prohibited by law or as a result of organizational policies, opportunities exist whereby close cooperation between external and internal auditors could provide for increased scope in implementing and benefiting from each other's work. The opportunities and benefits of drawing on the skills and expertise gained by an external auditor who has acquired so much knowledge by virtue of the exercise of both roles and the experience acquired from having exercised such roles, should not be underestimated.

As recommended in chapter five of the Supervision Manual of the FSA, there are certain situations whereby such a dual role may not be warranted, where such dual roles should not be exercised routinely, where such dual role should only be implemented after having considered other alternatives, and more importantly, why such dual role could contribute and generate added value by virtue of the increased expertise or knowledge which such a dual role brings. Where concerns relating to a compromise of independence and objectivity arise, then prohibitions and restrictions imposed by section 201 of the Sarbanes Oxley Act are, to a great extent, justified.

As is particularly the case with external auditors, the reliability of internal controls also plays a huge and crucial role in the audit process - as well as those in charge of those internal controls. Where safeguards such as the segregation of duties and other measures are incorporated into the process to reduce instances or situations whereby such controls could be manipulated, then benefits of having an external auditor serve in a dual role capacity may well extend beyond its stated disadvantages.

Benefits accruing from having a dual role include namely the acquisition of knowledge and expertise gained during the latter stages of the process - which could assist in providing more accurate judgments during latter stages of the process. This is also similar to the position which exists with external auditors: whereby the mandatory rotation of audit firms, whilst serving to ensure that independence and objectivity is not compromised, could also be detrimental where the external auditor leaves the firm shortly/prematurely after having been employed by the firm. In the case of internal audit outsourcing, the efficiency of financial audits is bolstered because the auditor is able to benefit from knowledge gained during the performance of internal audit functions. The auditor is able to gain a better understanding of the client's internal controls because the auditor has had close experience with the internal control environment as part of the client’s internal audit function.

The firm incurs greater costs in employing a new auditor in re acquiring the knowledge which the previous auditor had acquired - having left the firm prematurely. Further, the knowledge which could have been employed by the leaving auditor is not fully maximized in the process.

Up till 2013, there had been no requirement at European level for the mandatory rotation of audit firms – even though some member states had gone further than Article 42 of Directive 2006/43/EC in requiring mandatory audit firm rotation. This however, has changed with mandatory requirement – pursuant to a draft law that would “require public-interest entities such as banks, insurance firms, and listed companies to rotate audit firms every 14 years”(and such period could be extended to 25 years when certain safeguards are put into place).25 Other notable features of the Draft Law also include:36

- Prohibition of “Big Four-only” contractual clauses that require a company’s audit to be done by one of the Big Four accounting firms (Deloitte, Ernst & Young, KPMG and PwC).
- Requirement that auditors of public-interest entities (PIEs) publish audit reports according to international standards and provide shareholders and investors with a detailed understanding of what the auditor did and an overall assurance of the accuracy of the company’s accounts.
- Prohibition of audit firms from providing non-audit services that could jeopardize independence.

Whether the distinction between those non audit services which are not considered to impair independence is effective, logical and justified, constitutes the basis for arguments which counter the basis for prohibition of certain non-audit services – pursuant to legislation such as section 201 of the Sarbanes Oxley Act and Ethical Standard 5 (Revised) of the APB. Partnership engagements between one audit firm providing audit services solely and exclusively, and another firm offering non audit services, provided ethical standards on objectivity, independence and integrity are complied with, may achieve better results – provided other safeguards are well in place. Proposals, legislation and efforts aimed at encouraging partnerships between Big Four audit firms and mid-tier firms are also welcomed, as well as external investments in mid-tier audit firms are welcomed – provided that audit quality is retained.

Even though concerns persist that there would be a constraint in the global growth of EU audit firms (owned by external investors) who collaborate in a “network structure” with U.S auditors – such constraint being attributed to application of U.S rules, as already highlighted in this paper, the Sarbanes Oxley Act has already influenced many countries

25 “The idea of mandatory audit firm rotation also is being explored elsewhere. The UK Competition Commission is considering imposing term limits for large listed companies and will come to a final decision by Oct. 20. In the United States, the PCAOB has been studying the issue of mandatory audit firm rotation for public companies since issuing a concept release that included the topic in August 2011. However, a PCAOB member has also highlighted that many obstacles make adoption of mandatory audit firm rotation unlikely.” K Tysiac, “Europe Takes Step Toward Mandatory Audit Firm Rotation”, Journal of Accountancy April 2013
26 See ibid
by virtue of U.S listing rules' applicability in these jurisdictions. Hence such collaboration as embodied by such network structure should not be considered a threat to the world-wide growth of such firms. Furthermore, rules or covenants could be agreed upon by such firms – where undue restrictions are likely to be foreseen.

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Biography

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