

THE EFFECTS OF THE IMPLEMENTATION OF THE SARBANES-OXLEY ACT
ON AUDIT QUALITY:
AN EXAMINATION OF FINANCIAL RESTATEMENTS

by
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ABSTRACT

This study examines how audit quality has changed since the Sarbanes-Oxley Act of 2002 (SOX) passed. First, this research includes information about the accounting profession over the past century. A literature review that considers audit quality and restatements along with the correlation between the two is also included in this paper. Additionally, this paper includes a study that analyzes audit quality based on financial restatements from 1993-2013. The study concludes that substantive quantitative evidence does not exist to indicate that audit quality has improved since SOX passed over ten years ago and addresses implications for various groups of stakeholders.

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INTRODUCTION

This study examines whether regulation of the auditing profession as a result of the Sarbanes-Oxley Act (SOX) of 2002 has improved audit quality, and thereby, financial reporting quality for U.S. companies. Throughout most of its history, the accounting profession has been self-regulated. However, economic and political events around the turn of the century motivated Congress to pass legislation that would regulate the accounting profession. The shift from self-regulation to government regulation affected companies, stakeholders, and accounting professionals. Government regulation intends to protect investors (SOX Sec. 3a). Protecting investors facilitates the operation of capital markets.

Scholars and professionals debate whether audit quality has improved since SOX created the Public Company Accounting Oversight Board (PCAOB) in 2002. To examine this issue, this paper will begin with background information about the accounting profession, proceed with a literature review of articles on audit quality and financial restatements, provide the results of research on financial restatements from 2002-2013, and conclude with implications of the research findings.

HISTORY

According to Fleishman and Tyson (1993) the Industrial Revolution of the late 1800s brought changes to the accounting profession as an increased demand for industrial accounting appeared. In 1887, the American Association of Public Accountants (AAPA) was created; however, it was not until nearly ten years later that the first certified public accountants were licensed (Flesher, Miranti, Previts, 2014). According to Mendlowitz

(2014), certified public accountants (CPAs) are “professional service specialists.”

Beyond performing tax services and basic accounting services, CPAs are consultants to their clients (Mendlowitz, 2014). CPAs, while accountants, take their licensing exams in order to protect the interests of public investors. In general, accountants have the skills and knowledge to keep a company’s books and prepare financial statements, but in order to audit a public company, a person must be a CPA (American Institute of Public Accountants, 2014). Therefore, when the first CPAs were licensed, the audit profession began.

According to the American Institute of Certified Public Accountants’ website, the ACPA underwent two name changes during the 1900s. In 1917, the ACPA was renamed the American Institute of Accountants and in 1957 was renamed the American Institute of Certified Public Accountants (AICPA) (History of the AICPA, 2014). Despite its name changes, the purpose of the institute today is much the same as it was in 1887. Today, “[t]he AICPA's mission is to provide members with the resources, information and leadership that enable them to provide valuable services in the highest professional manner to benefit the public, employers and clients” (AICPA Mission and History, 2014, Mission section, para. 1).

About thirty years after the first CPAs obtained their licenses, the United States experienced the stock market crash of 1929 followed by the Great Depression. According to the U.S. Securities and Exchange Commission (SEC) (2014), confidence in the markets decreased, as did economic stability. Due to the state of the economy in the early 1930s, the federal government created legislation to restore confidence and stability in the market. As a result, Congress passed the Securities Act of 1933, which sought to

increase transparency and deter fraud and misrepresentation of financial information. Just one year later, Congress passed the Securities Exchange Act of 1934. This act went one step further than the Act of 1933 and created the Securities and Exchange Commission (U.S. SEC, “The Investor’s Advocate”, 2014).

Congress created the SEC for three primary reasons: “to enforce the newly-passed securities laws, to promote stability in the markets and, most importantly, to protect investors” (U.S. SEC, 2014, “The Investor’s Advocate: Creation of the SEC” section, para. 5). The SEC believes that all investors have a right to basic information about a public company before investing in that company; therefore, the SEC seeks to protect investors as they make important investment decisions. All public companies must register and file annual and quarterly financial reports with the SEC (U.S. SEC, “The Investor’s Advocate”, 2014). A 10-K is a company’s annual report and a 10-Q is a company’s quarterly report (U.S. SEC, “Index to Forms”, 2014). Per SEC Regulation D, Rule 505, a company must have a CPA audit their financial statements included in Form 10-K. In addition to audits of financial statements, SEC filings ensure that public companies are accurately representing their financial information rather than misleading investors or fraudulently reporting their financial activities (U.S. SEC, “The Investor’s Advocate”, 2014). The necessity for assurance on a company’s financial activities is due to the involvement of the public in the company’s investing activities. For instance, individuals may hold stock or debt securities in a public company (U.S. SEC, “The Investor’s Advocate”, 2014).

Despite the creation of the SEC and government regulation of public companies in 1934, the accounting profession remained self-regulated throughout the 20th century.

According to Flesher, Miranti, and Previts (1996), the AICPA established accounting standards until the Financial Accounting Standards Board (FASB) was created in 1973.

According to FASB (2014), its mission is “to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports” (FASB, 2014, Facts About FASB: Mission section, para. 1). FASB is an independent organization separate from other professional organizations, like the AICPA.

Additionally, FASB establishes accounting standards, referred to as Generally Accepted Accounting Principles (GAAP). The Securities Exchange Act of 1934 gave the SEC authority to establish accounting standards; however, the SEC has largely delegated that responsibility to the profession. As a result, the SEC regards GAAP as authoritative.

Professionals reference GAAP as they prepare to file their financial information with the SEC and to share with investors (FASB, 2014). The creation of FASB and GAAP did not alter the self-regulation of the accounting profession. However, accounting scandals in the late 1990s and in the early 21st century, such as those at Waste Management, Enron, and WorldCom, led to an overhaul of regulation of the accounting profession. The following examples illustrate the environment surrounding the accounting profession at the turn of the century.

The Tipping Point: Fraud Examples

The Waste Management (WM) scandal of the 1990s was one of the first major scandals in a series that would occur over the next decade. According to an SEC press release (2002), Waste Management’s top officers misrepresented and falsified financial information from 1992 until 1997. WM’s founder, Dean Buntrock, was the officer in

charge of the misstatements. Like most public companies that file with the SEC, WM provided earnings estimates to analysts and the public at large. In order to meet earnings targets, WM officers falsified the company's financial information by capitalizing items that should have been expensed, failing to properly depreciate vehicles, and neglecting to impair the value of landfills (along with other fraudulent activities). WM's auditor, Arthur Andersen, attempted to provide WM with journal entries that would correct their falsifications; however, management ignored Andersen's suggestions. As a result, Arthur Andersen issued unqualified opinions on their auditors' reports for WM. Unqualified opinions suggest to investors that the auditors believe the financial statements to be free from material errors. In 1997, WM's new CEO uncovered the fraud. As a result, WM issued a \$1.7 billion restatement in 1998, but not before shareholders had lost approximately \$6 billion in the market value of their investments (U.S. SEC, "Waste Management", 2002).

Before the 1990s, other accounting scandals had occurred, but the WM scandal was much larger than previous scandals. Many people believed that the WM scandal was an anomaly, but within the next five years, two more massive scandals broke that significantly changed the accounting profession. Enron, a large energy company, was the next company tainted by an accounting scandal. Wall Street often pressures public companies to meet earnings targets. Enron's CEO and Chairman, Kenneth Lay, went to great lengths to satisfy Wall Street and portray Enron as a successful company. According to an SEC press release (2004), Lay sold a significant number of improperly valued shares. Furthermore, the company used a prepay system to generate operating cash flow that did not represent the company's true financial state. To make matters

worse, Enron overvalued different investments and assets on its books by about \$7 billion and financial officers neglected to report goodwill impairment of \$700 million. Lay repeatedly assured the public that Enron was going to meet earnings targets and be able to offer ample returns to its shareholders. Lay maintained this position up until a few months before Enron filed for bankruptcy protection in December 2001. Additionally, according to an article by Kim (2011), Enron's bankruptcy cost employees "\$1.2 billion in retirement funds and \$2 billion in pension funds" (Kim, 2011, "10 Things: Preferred stockholders get preferred treatment" section, para. 3). The total loss to shareholders was estimated to be over \$63 billion ("The Enron scandal by the numbers", 2002).

According to Nicholls and Willits (2014), as a result of Enron's collapse and its effects on stakeholders, Congress drafted SOX. Initially, no legislative action was taken on the act. When the WorldCom scandal broke in 2002, however, Congress believed that something must be done to prevent further accounting scandals from occurring and restore investor confidence in financial reporting (Nicholls and Willits, 2014).

At the same time that Enron was spiraling out of control, officers at WorldCom, a large telecommunications company, were engaging in fraudulent acts. According to an SEC litigation release (2002), WorldCom misstated its financial results during 2001 and into the first quarter of 2002. By capitalizing about \$3.8 billion in costs, WorldCom overstated its assets and reported non-existent earnings. According to Romero and Atlas (2002), at the time that WorldCom filed for bankruptcy on July 21, 2002, bondholders held a total of \$28 billion. After filing for bankruptcy, WorldCom became MCI and owed \$750 million in fines. When MCI emerged from bankruptcy protection in April 2004, former bondholders were scheduled to receive 36 cents per dollar of their former

WorldCom bonds and stocks. (Scharff, 2005). Therefore, the total loss to bondholders at WorldCom was nearly \$18 billion.

Many would say that WorldCom was the tipping point for the federal government to oversee the accounting profession. Fraudulent acts committed by a few people had ramifications for investors and accounting professionals alike. In particular, Arthur Andersen, the auditor of WM, WorldCom, and Enron, collapsed after the WorldCom scandal (Krishnan and Visvanathan, 2007). Understandably, shareholders had reasons to distrust officers of public companies and their reported financial results after three major fraud cases. Congress believed that shareholders and investors needed protection from dishonest financial reports. Therefore, SOX went into effect on July 30, 2002. According to a study conducted by the U.S. Government Accountability Office (GAO) in 2002, “[T]he act addresses many of these [corporate governance and financial reporting] concerns, including strengthening corporate governance and improving transparency and accountability to help ensure the accuracy and integrity of the financial reporting system” (p. 7). According to Willits and Nicholls (2014), Congress passed SOX to accomplish three goals: to improve auditor independence, to create the Public Company Accounting Oversight Board, and to “improve corporate governance” (p. 38).

SOX and Auditing

SOX primarily provides regulation for professionals providing audit services. The American Accounting Association (AAA) Committee on Basic Auditing Concepts (1973) defines auditing as “a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the

results to intended users” (AAA Committee on Basic Auditing Concepts, 1973).

According to this definition, the end result of an audit is to render an opinion as to whether a company fairly stated, in all material respects, its financial statements in accordance with GAAP.

Investors and other stakeholders consider audit opinions as they decide how to invest their money. Scandals decrease investor confidence, though, which is why Congress passed SOX in 2002. However, the intent to increase investor confidence came at the expense of public companies. According to Coates and Srinivasan (2014), “in general terms, SOX required companies to pay audit firms for what were initially costly, time-consuming, detailed, and what many viewed as unjustified testing of companies’ policies, procedures and technologies for preventing theft and fraud” (p. 8). Adhering to SOX costs audit firms significant time and costs clients time and money. In fact, Willits and Nichols (2014) found that auditor fees increased by about 74 percent after SOX passed. Not only did audit costs increase, but the audit process itself changed – specifically for large public companies with a market capitalization of over \$75 million.

Perhaps one of the largest changes came under Section 404 of SOX. As Coates and Srinivasan (2014) describe, Section 404 did not require companies to change their internal control systems, but instead, asked that companies report on any weaknesses in their internal controls. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2013) explains that a company’s internal controls are “designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance” (p. 3). Therefore, Section 404 of SOX mandates that investors have a right to know if companies are unable or unwilling to operate

effectively, accurately report their financial information, or comply with GAAP and other regulations. Louwers, Ramsay, Sinason, Strawser, and Thibodau (2013) describe how Section 404 affects auditors. Not only do auditors have to report on whether financial statements are free from material errors, but they must also report on a company's internal controls.

The most important implication of SOX for this research was the creation of the PCAOB, which the SEC oversees. According to the PCAOB (2014), within three months of the passage of SOX, the first five-member board of the PCAOB was appointed. According to the PCAOB website, the board exists "to protect investors and the public interest by promoting informative, accurate, and independent audit reports" (PCAOB, 2014, "About the PCAOB" section, para. 1). Additionally, the PCAOB maintains registrations of public accounting firms; inspects public accounting firms; establishes consequences for noncompliance with auditing standards when necessary; and establishes and adopts audit quality standards. Initially, the PCAOB used guidance established by the AICPA, but began to create its own auditing standards by June of 2003 (PCAOB, 2014). However, as SOX 101(c) indicates, the PCAOB ultimately exists to ensure compliance with SOX. In fact, SOX Section 302 requires a company's CEO and CFO to sign the financial statements before the company files its 10-K with the SEC each year. Both of these sections emphasize that SOX holds companies, and especially top officers, accountable for their actions. The PCAOB is the main source of accountability for auditors of public companies today.

AUDIT QUALITY

Many scholars and professionals attempt to define audit quality, but a universal definition does not exist. Perhaps one of the most comprehensive studies conducted on audit quality was Jere R Francis' study. Francis (2011) discusses the definition of audit quality, "audit quality as a continuum," and audit inputs and outputs. According to Francis (2011), "Audit standards imply that audit quality is achieved by the issuance of the 'appropriate' audit report on the client's compliance with generally accepted accounting principles. Bonner (2008) stated that "audit quality is a complex concept and cannot be reduce[d] to a simple definition" (as cited in Francis, 2011, p. 127). Even though audit quality does not have an explicit definition, Francis (2011) implies that an audit is a function of not only audit outputs, but also inputs. While an audit report is an output, the auditors and the tests they perform are inputs. Based on Francis' input/output theory, "an audit will only be as good as the quality of the evidence generated by audit-testing procedures." Another interesting idea that Francis proposes in his study of audit quality is the idea of "audit quality as a continuum." Rather than consider an audit a failure or a success, one must look for the middle ground. Francis indicates the importance of viewing audit quality as a continuum because "it is quite possible there are many low-quality audits that are of no better quality than those that are known to be audit failures" (Francis, 2011, p. 128). Based on Francis' study, audit quality is not a quantifiable point that a company reaches. Instead, audit quality is a process of using the best inputs to generate the best outputs possible.

Geiger and Raghunandan (2002) provide a contrast to audit quality by defining audit failure. "[N]ot signaling significant concerns regarding the ability of an audit client

to continue as a going concern, prior to filing for bankruptcy, would likely be construed as an audit failure by those outside the accounting profession” (p. 69). This statement implies that audit quality includes giving stakeholders early warning of potential financial issues and problems. Francis (2011) addressed the auditors’ report as an output of an audit. Geiger and Raghunandan (2002) state further that “the audit report is the final outcome of the audit process, and is the only external communication of what the auditor has done and concluded during the audit” (Geiger and Raghunandan, 2002, p. 70). Therefore, audit quality, while largely unobservable, is of greatest importance to company stakeholders.

In 2013, the PCAOB stated that the development of audit quality indicators would be a priority for the board. Martin (2013) indicates that audit quality is based on stakeholder perspective. Firms, audit committees, investors, regulators, and management all have different ideas about what audit quality entails. Firms view audit quality as a “continuous process.” Audit committees consider personnel and risks as it relates to audit quality. According to Louwers et al. (2013), “audit committees are composed of independent, outside members of the board of directors (those not involved in the company’s day-to-day operations) who can provide a buffer between the audit firm and management” (p. 145). The interests described by Louwers et al. correlate to their interest in the roles of personnel and risk in the audit process. Furthermore, investors have a limited understanding of the audit process and therefore rely on audit outputs to gauge audit quality. Because the auditors’ report is the only observable audit output, stakeholders also rely heavily on auditors.

According to Niemi (2004), a common claim is that “the largest auditing firms with international reputations are above-average quality suppliers of audits” (Niemi, 2004, p. 542). Therefore, stakeholders may believe that the results they receive from an audit conducted by an internationally-known audit firm are more reliable. For example, preparers’ management has two main interests in audit quality: “assuring high-quality financial reporting” and ensuring that “audits are conducted as efficiently and unobtrusively as possible” (Martin, 2013, A21). As mentioned earlier, audit quality cannot be explicitly defined, which is partially due to the fact that stakeholders desire different information from audits. Audit quality and audit quality indicators can only be defined in the context of stakeholders’ interests.

According to research done by Kleinman, et al. (2014), disclosure transparency, restatements, and earnings quality are all current audit quality indicators used by large audit firms. Kleinman, et al. (2014) examine international auditing procedures as they relate to American auditing procedures. Based on their research, Americans cannot judge whether or not auditing has improved by examining PCAOB reports alone because the sample of reports is small. However, audit quality does indicate that a company’s operations are free from deficiencies, and in 2012, PCAOB Chairman Doty stated that “‘inspections continue to reveal an unacceptable level of deficiencies.’” In his research, Francis (2011) notes that an audit’s inputs impact audit quality. According to Kleinman, et al. (2014), audits are only as strong as the regulation behind them. Based on this statement, regulatory regimes are another input in the auditing process.

As noted in Louwers et al. (2013), the AICPA says that audits are conducted “to enhance the degree of confidence that intended users can place in the financial

statements” (p.497). Therefore, a quality audit should ensure that confidence is granted to the various groups of a company’s stakeholders. According to Riley et al. (2008), audit quality is more than adhering to generally accepted accounting principles (GAAP). Rather, “[Q]uality audits are a function of consistent application of proper auditing tools and techniques” (A23).

RESTATEMENTS

This research measures audit quality by the number of financial restatements among public companies in the United States. According to the United States Government Accountability Office (2006), a public company files a restatement when errors or fraud are detected in the financial statements. A 2002 study conducted by the GAO states that three entities may prompt restatements: the restating company, an external auditor, or the SEC. Furthermore, restatements occur for eight main reasons: acquisitions and mergers; cost or expense-related issues; in-process research and development; reclassification; related-party transactions; restructuring, assets, or inventory; revenue recognition; and securities related issues. While the study cited these main issues, other situations, such as delinquent loans or write-offs, may lead to restatements as well.

Many scholars advocate the use of restatements to measure audit quality. According to DeFond and Francis (2005), “the biggest advantage of using restatements is that they provide more direct evidence that the auditor failed to either detect or report an accounting treatment that is inconsistent with GAAP” (p. 24). Wang (2013) argues that restatements affect all stakeholders of a public company -- managers, investors,

regulators, auditors, academics, issuers, and the board of directors. If audit quality affects all stakeholders, an audit quality indicator such as restatements is more reliable than something like earnings quality, which would be most relevant to investors. Furthermore, Lobo & Zhao (2013) state that “[T]he Securities & Exchange Commission (SEC) regards restatements as ‘the most visible indicator of improper accounting’” (p. 1386).

The main responsibility of auditors is to report an opinion on a company’s financial statements based on the evidence they have gathered about the company’s reporting and internal control procedures. According to Blankley et al. (2013) restatements indicate that auditors did not do their job -- they did not find material errors during their audit and were therefore unable to work with clients to prevent those errors from occurring. Material errors are linked to material weaknesses in internal control, and according to Wang (2013), “material weakness is often disclosed following restatement” (p. 20).

Measuring audit quality based on restatements is not a new concept. Perhaps one of the most relevant studies to this writer’s research is a study conducted by Vito (2013). In her research, Vito analyzes only restatements of the cash flow statement because the cash flow statement links the four financial statements together. Because the cash flow statement is created based on balance sheet and income statement information, it provides an adequate view of the company’s operations and financial position. Users must analyze financial statements jointly to truly gain an understanding of the company’s overall performance. Vito’s research emphasized restatements after SOX Section 404 implementation. Vito found that the number of restatements between 2004 and 2005 increased from 440 to 1,295. Section 404 implementation in 2004 required public

companies with a market capitalization of \$75 million or greater to provide an internal controls assessment. Auditors were required to report on both financial information and internal control design beginning in 2004 – causing a steep increase of restatements from 2004 to 2005. According to Vito, more companies probably would have restated their financial statements in 2005 if companies with market capitalizations of less than \$75 million had been included in the new regulations of 2004.

The United States Government Accountability Office (GAO) also conducted research on financial restatements pre- and post-SOX. In fact, Section 701 of SOX commissioned the GAO to research financial restatements issued between 1997 and 2002. According to the initial study conducted by the GAO in 2002, even before Congress passed SOX, restatements were on the rise. Between January, 1997, and June, 2002, the number of restatements increased by about 145 percent.

In 2006, the GAO conducted a follow-up study to determine how SOX and the creation of the PCAOB affected the number of restatements. The GAO's follow-up study analyzed restatements between 2002 and September, 2005. In this study, the GAO indicated an initial hypothesis:

Industry observers expected that the number of public companies restating their financial statements would increase for some period of time because of increased scrutiny of internal controls over financial reporting, and then eventually level off as companies improved their controls (p. 2).

In fact, the proportion of companies that restated their financial statements during the studied time period increased from 3.7 to 6.8 percent. To further emphasize the increase in financial restatements after SOX's implementation, the GAO reported the following in

its 2006 study: “The cumulative totals were 919 restatements over a 66-month period that ended June 30, 2002, and 1,390 restatements over the 39-month period that ended September 30, 2005” (p. 4).

However, according to a Compliance Week press release in 2008, “Restatements of financial results, which soared shortly after SOX was passed, dropped in 2007 for the first time in five years” (Compliance Week, 2008). In 2010, CFO.com published an article reporting that 2009 was the third consecutive year in which the number of financial restatements fell. In 2009, only 630 companies filed 674 restatements – down significantly from an all-time high of 1,795 restatements filed by 1,564 companies in 2006. Based on the reports by Compliance Week and CFO.com, the hypothesis addressed in the GAO’s 2006 study has merit. Industry observers expected that restatements would eventually level off, and between 2007 and 2009, it appears that restatements decreased after years of increasing restatements. The research presented in this study will further analyze restatements between 2006 and 2013 to determine if the number of restatements has continued to fall – indicating that auditors better understand how to comply with regulations while accurately opining on companies’ financial statements.

AN UPDATED STUDY ON PUBLIC COMPANY FINANCIAL RESTATEMENTS

Question and Hypothesis

This research explores the following question: How has audit quality improved since the implementation of the PCAOB? This research hypothesizes that since the creation of the PCAOB, audit quality will have improved. Based on the reliance placed

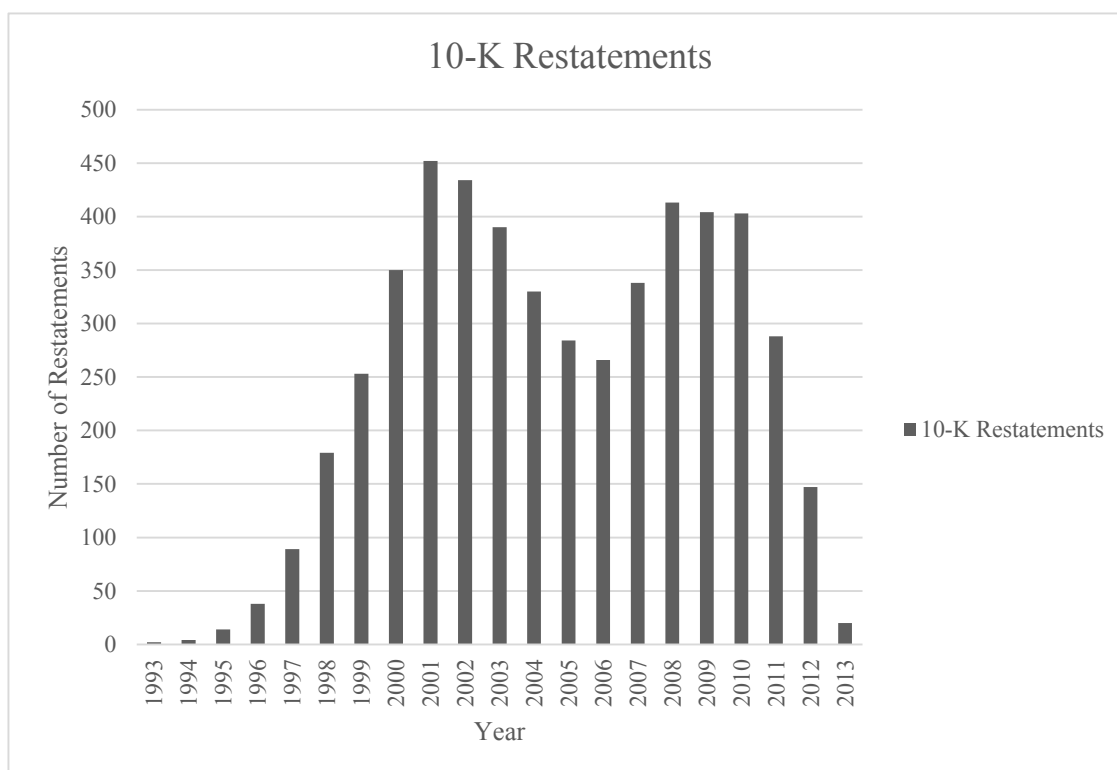
on restatements as an indicator of audit quality, this research should find an overall decrease in financial restatements from 2002-2013.

Methods and Results

To answer the above research question and confirm or refute the above hypothesis, this research uses the Audit Analytics database to analyze public company restatements. The Audit Analytics database used in this study contains information on nearly 14,000 restatements between 1993 and 2013. Information about individual restatements includes the name of the public company filing the restatement, the auditor(s) involved in the restatement process, dates involved with the restatement, and the reason for the restatement. Furthermore, the database allows researchers to filter for the type of SEC filing along with the reason for the restatement (i.e. revenue recognition). This research only analyzed 10-K restatements filed with the SEC since the 10-K reports contain a company's audited financial statements.

To determine whether the number of restatements has decreased since the PCAOB was created, this researcher first sorted the data based on all years involved in the restatement. This included the beginning restatement date, the ending restatement date, and the restatement filing date. In this scenario, restatements are counted on an annual basis from the time they begin to the time they are filed with the SEC. By sorting data in this manner, a restatement situation is described. This results in the following graph:

Exhibit 1: Restatements from 1993-2013



To further analyze restatements based on dates, this researcher sorted the data based on filing date. Sorting the data in this manner sorts the data into restatement situations. The data in exhibit one may “double count” restatement situations since it spans the entire restatement and some restatements affect multiple years. The data in exhibit two, alternatively, illustrates the number of restatement situations resolved on a yearly basis. For example, if a company had to restate five years of financial statements due to improper lease accounting, the restatement is only counted in the filing year, according to exhibit two.

Exhibit 2: Yearly Restatements from 2000-2013



As mentioned earlier, SOX created new regulations for auditors and public companies. Of the 1,533 restatements identified since SOX was implemented on July 30, 2002, 614 of those restatements have related to material weaknesses relating to SOX Section 404 and/or Section 302. Therefore, 30% of restatements between July 30, 2002, and 2014 occurred due to failure to comply with SOX regulations.

However, when restatements classified with a SOX compliance issue are isolated from the rest of the data, the following graph results:

Exhibit 3: Restatements with a SOX Compliance Issue



Analysis of Results

According to the above results, audit quality has slightly improved since the creation of the PCAOB. This is shown in the fact that there are fewer restatements in 2013 than there were in 2003, the year after SOX passed. However, exhibit two shows that the decrease in restatements filed in 2003 and the restatements filed in 2013 is minimal. While the above exhibits indicate that audit quality began to improve, restatements increased again in 2006 and 2007.

One valid concern from those interested in this research is whether increases in restatements from year-to-year resulted because of an increase in public company listings. However, according to Gao, Ritter, and Zhu (2013), “[t]he number of initial

public offerings (IPOs) in the United States dropped from an average of 310 IPOs per year during 1980-2000 to only 99 IPOs per year during 2001-2012.” They proceed to suggest that IPOs decreased during 2001-2012 as a result of the increased compliance costs of SOX (Gao, Ritter, and Zhu, 2013). Furthermore, according to Strumpf (2014), the number of public companies listed on the stock exchange decreased every year from 1997 until 2012. In 1997, 8,884 public company listings existed. By 2012, only 4,916 existed (Strumpf, 2014). Therefore, this research concludes that an increase in the number of restatements is not due to an increase in the number of public company listings.

Ultimately, there should be a negative correlation between audit quality and financial restatements. If audit quality continually improves, the number of restatements should continually decline. However, the above results do not indicate this to be the case. Instead, one sees upward and downward trends. This indicates that audit quality is a difficult concept to quantitatively measure, and it probably should be. The accounting profession changes constantly. Companies’ financial statements should provide accurate representations of financial standing for investors to make informed decisions about their investments. If auditors determine that a company has been reporting its financial information in a way that misrepresents its true financial condition for several years, a company will restate its financial statements for all years involved, in accordance with FASB Accounting Standards Codification.

WHY IT MATTERS

Public Companies

The accounting profession was self-regulated for a significant amount of time. SOX changed that. Public accounting firms became significantly more responsible for auditing their clients' financial statements and internal controls. With increased responsibility came increased costs. Complying with SOX added additional expenses to companies' general ledgers. According to Coates and Srinivasan (2014), additional costs related to SOX compliance included those related to internal control testing along with increased audit fees.

Not only did public company management have to adapt to the financial impact of SOX, but they also had to adapt to increased accountability standards. SOX Section 302 placed increased responsibility on top public company officers for their companies' financial statements. For the increased time and costs associated with SOX and the PCAOB, public company management teams had a right to expect positive qualitative and quantitative results as a result of improved audit quality.

Auditors

Initially, it appeared that auditors benefited from SOX the most due to increased audit fees that audit firms now charge their clients. SOX placed new requirements and limitations not only on public companies, but also on audit firms. According to Anandarajan, Kleinman, and Palmon (2008), SOX placed several limitations on auditors: Audit firms cannot perform non-audit services for their audit clients; audit partners must rotate engagements every five to seven years; and a cooling off period of one year is required for auditors before they become a member of a client's management.

While audit firm revenues did increase, the amount of time auditors spent in compliance with SOX regulation significantly increased. For instance, according to Riley, Jenkins, Roush, and Thibodeau (2008), “in preparation for a PCAOB inspection, the large firms may devote as many as 400 hours preparing for and participating in the inspection of each audit engagement” (p. A22).

It is not unreasonable for public company stakeholders to have expected to see an increase in audit quality after SOX. However, as mentioned above, audit firms came under strict regulation from the PCAOB when SOX was implemented. Increased audit fees were needed due to the extra time and money spent to comply with PCAOB requirements. Perhaps substantive evidence of increased audit quality does not exist due to more stringent requirements placed on audit firms. Audit firms must contribute the same amount of effort to their clients, and also ensure that they comply with relatively new PCAOB requirements. When Arthur Andersen was convicted of a felony for obstructing justice and later filed for bankruptcy, audit firms realized the consequences of failing to comply with the standards set forth for them. Perhaps as regulators, public company management, and auditors begin to advance further on the learning curve, there will be substantial evidence of improved audit quality.

Investors

After highly-publicized frauds in the early 2000s, legislators saw a need for the accounting profession to change. Investors needed to believe that their investments would be safe, and after the frauds described earlier in this paper, legislators acknowledged that something had to be done to increase investor confidence.

The definition of auditing introduced earlier in this paper concludes with a phrase about “communicating results to intended users.” For public companies, investors are

intended users of financial statements. Audits are conducted to improve decision-making (Louwers et al., 2013). Therefore, this researcher argues that audit quality should be most important to public company investors. Unreliable information prevents investors from making accurate decisions about their investments. Ultimately, investors fund public companies and encourage growth and innovation within public companies. While public companies and auditors conduct the work associated with SOX compliance, investors should be significantly concerned with the results of those efforts.

CONCLUSION

In 2014, more than 10 years after the creation of the PCAOB, quantitative results of audit quality improvement are difficult to measure. SOX created the PCAOB to oversee public accounting firms, which ultimately means that the PCAOB should provide enough guidance for auditors to conduct quality audits in a manner which minimizes the number of restatements. Regulatory committees exist not only to detect problems, but also to prevent them.

One would expect ten years to be sufficient time for public accounting firms to learn and implement new rules in conducting audits. A learning curve was certainly expected, and it was expected that restatements would increase right after the creation of SOX while public companies and auditors sought to comply with new regulations. Ultimately, this study concludes that it will take more time for the PCAOB to have the effect that it was designed to have when it was created in 2002.

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