The Effect of the Sarbanes-Oxley Act on Auditors' Audit Performance

Tae G. Ryu
Metropolitan State College of Denver

Barbara Uliss
Metropolitan State College of Denver

Chul-Young Roh
East Tennessee State University

ABSTRACT

The issue of audit reporting for financially distressed firms continues to be of interest to the public and to legislators. Previous studies have consistently shown that auditors fail to issue going-concern opinions to more than half of bankrupt firms one year prior to bankruptcy.

The Enron and Arthur Andersen failures in late 2001 and early 2002, respectively, led to the enactment of the Sarbanes-Oxley Act (SOX) in July 2002. Audit firms now claim that they have become much more conservative with respect to client retention and acceptance decisions because the risks associated with auditing increased significantly after the enactment of the SOX. The primary purpose of this study is to provide a basis for a proper evaluation of auditors' performance. We conducted performance comparisons between the pre- and post-SOX periods. Although auditors are now expected to use a more vigorous audit process in deciding whether to issue going-concern or other qualified opinions to financially distressed firms, our preliminary results show that there is no significant difference between the two periods.

Key words: Audit Decision, Going-Concern, Opinion, Z-score, Industry Failure Rate

INTRODUCTION

The Enron and Arthur Andersen failures in late 2001 and early 2002, respectively, led to the enactment of the Sarbanes-Oxley Act (SOX) in July 2002. Audit firms now claim that they have become much more conservative with respect to client retention and acceptance decisions because the risks associated with auditing increased significantly as a result of the SOX (Rama & Read, 2006). For example, the act greatly altered the regulatory regime of auditing by shifting the oversight of audit firms from the private-sector American Institute of Certified Public Accountants to the quasi-governmental Public Company Accounting Oversight Board. Also, insurance- and other liability-related costs increased significantly in the post-SOX period. For these reasons, it is expected that auditors have changed their views on issuing audit opinions since the enactment of the SOX.

In 1988, the AICPA issued Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue in Existence*. The main purpose of this statement was to bridge an expectation gap between what financial statement users believe auditors are responsible for and what auditors believe their responsibilities are. The auditor's responsibility to assess and report on the ability of an entity to continue as a going concern was significantly increased by the issuance of SAS No. 59. As part of every engagement, the auditor must consider whether there is substantial doubt about the entity's ability to continue operations for a reasonable period of time not to exceed one year from the date of the financial statements. Under SAS No. 59, the auditor first evaluates various types of evidence to determine the nature and significance of any of the client's financial problems. For all significant problems, auditors must seek evidence about any mitigating factors, such as management plan to overcome the problems. If, after considering the mitigating factors, the auditor still has substantial doubt about the entity's ability to continue as a going concern, the auditor must include an explanatory paragraph in the standard audit report.

Under SAS No. 34, *The Auditor's Consideration When a Question Arises About an Entity's Ability to Continue in Existence*, issued in 1981, in which an entity's continuation was usually assumed, substantial doubt alone did not require going-concern qualification. Instead, substantial doubt about continued existence led auditors to evaluate the recoverability of assets and the amount and classification of liabilities. The audit report was to be qualified if uncertainty about assets and liabilities existed. Under SAS No. 59, however, substantial doubt is now sufficient to require an explanatory paragraph in the audit report—even when asset recoverability and liability amounts and classification are not in question. Thus, SAS No. 59 expands the auditor's traditional role in reporting on the entity's ability to continue in existence beyond the effect on assets and liabilities (Ellingsen, Pany, & Fagan, 1989).

Auditors are responsible for assessing the effects of going-concern uncertainties for a period of approximately one year. Hence, auditors may not avoid lawsuits if their clients go bankrupt with allegedly little or no warning from audit reports issued within a year of bankruptcy. In contrast, the auditor's relationship with the client may deteriorate, and the likelihood that the auditor will lose the client may increase, if a going-concern opinion is issued and the client remains healthy. Auditors may be reluctant to issue a going-concern opinion because of the possible loss of clients even when they identify those clients as being in financial distress. Therefore, it is plausible that in spite of the increased responsibility necessitated by SAS No. 59, auditors still may take into account factors other than the strict probability of failure.

An unqualified opinion is not a guarantee that a firm will continue as a going concern;

neither is the issuance of a going-concern opinion is not a prediction of bankruptcy. In reality, however, auditors may be blamed if a “clean: opinion is issued under circumstances that clearly warrant a qualified opinion. Creditors and investors may seek to recover losses from auditors through litigation because auditors are often expected to provide an early warning of approaching financial failure. Empirically, Hopwood, McKeown, and Mutchler (1989) have shown that financial statement users find qualified opinions (subject-to and going-concern opinions) useful as a warning signal for bankruptcy. Thus, it is reasonable to believe that there is a significant association between these types of qualified opinions and bankruptcy, and that these opinions can serve as “red flags” for financial statement users.

In light of the enactment of the SOX and changes in professional standards, the primary purpose of this study is to provide a basis for a proper evaluation of auditors’ performance. We conducted the performance comparisons among all audit firms for three different audit periods. SAS No. 34 and SAS No. 59 required auditors to consider the prospect that a firms would continue in existence as part of every audit engagement. But in the post-SOX period, because of the increased risks associated with auditing and the sustained negative publicity about auditors in the media, auditors are now expected to use even more vigorous processes and more conservative steps in deciding whether to issue going-concern or other qualified opinions than they used previously.

Our preliminary results indicate that there is no significant difference in auditors’ audit accuracy between the SAS No. 59 and SOX period, although there is difference between the SAS No. 34 and No. 59 periods. In the post-SOX period, auditors marked a 44.4% accuracy rate by issuing a going-concern opinion to 8 out of 18 bankrupt clients. During the SAS No. 34 and No. 59 periods, the accuracy rates were 40.7% and 51.9%, respectively. However, given the small sample size—18 bankrupt firms—it may be premature to argue that the SOX had no effect on auditors’ issuance of their audit opinions.

RESEARCH METHOD

The *Wall Street Journal Index* was searched for firms that went bankrupt in the years 1985–1997 and 2004–2006 under the heading “Bankruptcies.” Then, to find audit opinions, we examined 10-K or annual reports issued within 15 months prior to bankruptcy filing, as in Carcello, Hermanson, and Huss (1997). More than 300 firms were initially culled from the *Index,* but the deletion of firms because of unavailability of auditors’ opinions in the 10-K or annual report resulted in 207 sample firms.

RESULTS

Table 1 compares auditors’ performance in the three audit periods: SAS No. 34 (1984–1988), SAS No. 59 (1989–1996), and SOX (2003–2005).
The auditors’ accuracy rate during the SAS No. 34 period was only 40.7%; 11 out of 27 bankrupt firms received a qualified opinion (subject-to or going-concern). After SAS No. 59 became effective, auditors significantly improved their performance by marking an accuracy rate of 51.9%; they issued qualified opinions, that is, unqualified opinions with an explanatory

Table 1. Comparison of Auditors' Performance

Periods	UNQ	QUL	Total	Accuracy Rate (percent)
1984–1988 (SAS No. 34)	16	11	27	40.7
1989–1996 (SAS No. 59)	78	84	162	51.9
2003–2005 (SOX)	10	8	18	44.4
Total	104	103	207	49.8

UNQ: Unqualified, clean opinions
QUL: Qualified opinions
Accuracy rate = QUL / (UNQ + QUL)

paragraph for the reasons other than accounting changes or adoption of new accounting standard or disclaimer, to 84 out of 162 bankrupt firms. This result is consistent with Raghunandan and Rama (1995).

Our result is also comparable to the results reported by previous research, shown as follows.

Sample Period Accuracy Rate		
Altman and McGough (1974)	1970–1973	44.1%
Altman (1982)	1970–1982	48.1%
Menon and Schwartz (1986)	1974–1983	43.0%
Chen and Church (1992)	1983–1986	41.5%
Ryu et al. (2006)	1984–1988	40.7%
Ryu et al. (2006)	1989–1996	51.9%
Ryu et al. (2006)	2003–2005	44.4%

The accuracy rate (51.9%) from our study during the post–SAS No. 59 periods is higher than the rates reported by any previous research conducted before SAS No. 59 became effective.

However, in the post-SOX period, the accuracy rate went back down to below 50%. it may be premature to make any decisive conclusion from this study because of the relatively small sample size. More comprehensive research on this issue using more sample firms is needed in the future.Table 2 presents the frequency distribution of the observations classified by audit firms, Big 6 (4) versus Non–Big 6 (4).

Table 2. Comparisons of Auditors' Performance

		Big Six (Four)	Non–Big Six (Four)	Total
1984–1988 (SAS No. 34)	UNQ	13	3	16
	QUL	10	1	11
	AR	**43.5**	**25.0**	**40.7**
1989–1996 (SAS No. 59)	UNQ	67	11	78
	QUL	73	11	84
	AR	**52.1**	**50.0**	**51.9**
2003–2005 (SOX)	UNQ	9	1	10
	QUL	6	2	8
	AR	**40.4**	**66.7**	**44.4**
Total	UNQ	89	15	104
	QUL	89	14	103
	AR	**50.0**	**48.3**	**49.8**

UNQ: Unqualified, clean opinions
QUL: Qualified opinions (going concern opinions)
Accuracy rate = QUL / (UNQ + QUL)

There is a significant difference in the accuracy rate between the SAS No. 34 and No. 59 periods for both Big 6 (4) and Non–Bid 6 (4) firms. The auditors' accuracy rates greatly improved after the issuance of SAS No. 59, from 43.5% to 52% for Big 6 (4) firms and from 25.0% to 50.0% for Non-Big 6 (4) firms.

In the post-SOX period, Big 4 audit firms issued going-concern opinions to 6 out of 15 firms, marking a 40.4% accuracy rate, but because of the small sample size, we cannot conclude anything about the SOX effect.

Table3. Audit Opinions in the SOX Period (2003–2005)

Bankruptcy Year	Company	Auditor	Audit Opinion
2004	Footstar	Amper, Politziner & Mattia	QUL
	WCI	KPMG	QUL
	Applied Extrusion	Deloitte & Touche	UNQ
	US Airways	KPMG	QUL
	Hollywood Casino	BDO Seidman	QUL
	Interstate Bakeries	Deloitte & Touche	UNQ
	ATA Holdings	Ernst & Young	UNQ
	W. R. Grace	Price Waterhouse	QUL
	Trico Marine Service	Price Waterhouse	QUL
	Federal-Mogul	Ernst Young	QUL
2005	Tower Automotive	Deloitte & Touche	UNQ
	Refco	Grant Thornton	UNQ
	Allied Holdings	KPMG	UNQ
	Owens Corning	Price Waterhouse	QUL
	Calpine	Deloitte & Touche	UNQ
	Delphi	Deloitte & Touche	UNQ
	Huffy	KPMG	UNQ
2006	Dana	Price Waterhouse	UNQ

Table 3 reports audit opinions issued by Big 4 and Non–Big 4 auditors to 18 bankrupt firms in the post-SOX period: 10 firms in 2004, 7 firms in 2005, and 1 firm in 2006.

SUMMARY AND CONCLUSIONS

As an intermediary between preparers and users of financial statements, an auditor's most fundamental judgment is to evaluate a client's ability to continue to operate as a going concern. It has long been questioned by financial statement users whether auditors have taken on enough responsibility for evaluating going concern. There is an expectation gap—a difference between what users believe auditors are responsible for and what auditors believe their responsibilities are. SAS No. 59 was issued to bridge this gap by increasing the auditor's responsibility to assess and report on the client's ability as a going concern.

The Enron and Arthur Andersen failures led to the enactment of the Sarbanes-Oxley Act in July 2002. After the enactment, auditors were expected to use even more vigorous audit processes and to take more conservative steps in deciding whether to issue going-concern or other qualified opinions to financially distressed firms because the risks associated with auditing, as well as insurance- and other liability-related costs, increased significantly.

The primary purpose of this study was to provide a basis for a proper evaluation of auditors' performance. We accomplished this objective by examining auditors' audit accuracy rates for pre- and post-SOX period issuance of qualified opinions to bankrupt firms within 15 months prior to bankruptcy. Our preliminary results show that there is no significant difference between the two periods.

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