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Effects of SOX 404(b) implementation on audit fees by SEC filer size category

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ABSTRACT

This study provides novel information about the consequences of the Sarbanes-Oxley Act (SOX) by documenting differential audit fee shocks accompanying implementation of SOX 404(b) internal control tests and reports for clients in three size categories: large accelerated filers (LAFs), small accelerated filers (SAFs), and non-accelerated filers (NAFs). First, we find that although both LAFs and SAFs experience audit fee shocks attributable to 404(b), SAFs on average experience relatively greater fee shocks than LAFs (107.8% versus 84.6%; Table 6). Second, even though NAFs are not subject to 404(b) procedures, we document a 42.7% fee shock for NAFs. Our interpretation is that 404(b) generated an immediate increase in demand for audit services with no corresponding sudden increase in supply of experienced audit personnel, enabling audit firms to charge higher prices for all filers including NAFs. We find that audit fee shocks attributable to 404(b) are positively associated with audit offices' bargaining power relative to clients, and that the effect of offices' bargaining power is strongest for SAFs and weakest for NAFs. Although higher audit fees (with client characteristics held constant) are often considered an indicator of better audit quality, we find virtually no evidence that the massive fee increases in 2004 are accompanied by improvements in same-year or next-year audit quality, measured as decreases in discretionary accruals and a lower likelihood of subsequent restatements of audited financial reports.

1. Introduction

The Institute of Internal Auditors (2008, 3) describes the intended benefits and expected costs of Section 404 of the Sarbanes-Oxley Act (SOX, U.S. Congress 2002) as follows:

> … the intent was to drive improvements in companies' internal controls. The benefits were seen as greater assurance to shareholders and other stakeholders in published financial reports, while compliance costs were of lesser significance and were dramatically underestimated.

Section 404(a) mandated that managers of all public companies assess the effectiveness of their companies' internal controls over financial reporting. Section 404(b) required external auditors to implement tests of internal controls in order to provide an opinion on managers' Section 404(a) assessments. This study provides evidence regarding a cost that Congress (in the words of the Institute of Internal Auditors) "dramatically underestimated": the effects of initial implementation of 404(b) tests and reports of internal control

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over financial reporting (i.e., 404(b) "audits") on audit fees for clients of various sizes.[1]

The SEC's current three-tier report filing system classifies public clients into three size categories: (1) large accelerated filers (LAFs), i.e. companies having public float of $700 million or more, (2) small accelerated filers (SAFs), i.e. companies having public float of $75 million to $700 million, and (3) non-accelerated filers (NAFs), i.e. companies having public float less than $75 million. LAFs and SAFs together represent accelerated filers (AFs), i.e. companies having public float of $75 million or more. The SEC initially required audit firms to implement 404(b) audits for *all* public clients for fiscal years ending after November 15, 2004. However, beginning in 2004, the SEC deferred implementation of SOX 404(b) audits for NAFs several times, and the Dodd-Frank Act (U.S. Congress 2010) permanently exempted NAFs from SOX 404(b) audits.

Congress arguably intended that 404(b) audits would motivate improvement in public companies' internal controls (ICs) with no increases in audit fees (SEC, 2006, 28).[2] Contrary to congressional expectations, prior literature documents significant audit fee increases for AFs resulting from auditors' initiation of 404(b) in 2004 (Raghunandan and Rama, 2006; Ettredge et al., 2007; Krishnan et al., 2008). However, we are not aware of prior published research studying the predictable effect of 404(b) implementation on audit fees of NAFs. This is not surprising given that NAFs were not initially or subsequently mandated to purchase Section 404(b) audits. Nor are we aware of prior research investigating possible differences in the effects of 404(b) implementation for AFs of differing sizes, i.e., LAFs versus SAFs. Again this is unsurprising because the SEC mandated 404(b) audits for AFs of all sizes, and because the auditing standard initially guiding such engagements (Auditing Standard No. 2) applied to clients of all sizes.

Based on an analytical model of the audit fee effects of 404(b) implementation by client size category, this study predicts, documents, and attempts to explain initial audit fee changes (shocks) for clients across the three SEC-designated filer size categories: LAFs, SAFs, and NAFs. Further, we investigate whether estimated audit fee shocks attributable to 404(b) audits, which we capture in variable *404 FEE SHOCK*, were affected by the relative bargaining power of audit offices versus their clients in 2004, and whether the strength of such effects differed with client size. Further, we provide evidence whether *404 FEE SHOCK* is positively associated with increases in audit quality in 2004 or 2005. The results provide novel information about the consequences of SOX 404, which is "arguably the most costly and controversial SOX provision" (DeFond and Zhang, 2014, 307).

Based upon a sample of 2014 firm-year observations in 2004, and after controlling for audit office bargaining power, plus industry and metro fixed effects, we find that the scaled change in audit fee attributable to 404(b) for LAFs, SAFs, and NAFs is 84.6%, 107.8%, and 42.7% respectively. In other words, although both LAF and SAF clients experience fee increases due to 404(b) compliance, SAFs experience an increase that is 23.2% greater on average compared to LAFs. Our assumptions summarized in Fig. 1, and our analytical model, presented in Appendix A, provide explanations for these results. Since auditors' efforts devoted to internal control (IC) tests in pre-404(b) audits already were greater for their largest clients (LAFs), the necessary (size adjusted) increases in audit efforts to reach the desired extent of post-404(b) IC testing are smaller for LAFs compared to SAFs. Although NAFs are exempt from 404(b) audits, these clients still experience fee increases, possibly because 404(b) audits generated an immediate increase in demand for audit services with no corresponding sudden increase in supply of experienced audit personnel, enabling audit firms to charge higher prices per unit of audit effort for all filers including NAFs.

We further examine the effect of the relative bargaining power of an audit office versus each of its clients in the context of 404(b) audit implementation. These analyses are facilitated by the availability of the client-specific audit fee shock variable, *404 FEE SHOCK*. Our audit office bargaining power proxy, *BP_FACTOR*, is derived from seven individual proxies using principal component analysis. We find that the audit office bargaining power factor is positively associated with *404 FEE SHOCK*. We further find that audit office bargaining power moderates (strengthens) the *404 FEE SHOCK* for LAFs and SAFs but not for NAFs. This strengthening effect is larger for SAFs than for LAFs, and larger for LAFs than for NAFs, because the size-adjusted incremental audit effort under SOX 404 is greater for SAFs versus LAFs, and for LAFs versus NAFs. Although higher audit fees (with client characteristics held constant) are often considered an indicator of better audit quality, we find virtually no evidence that the massive fee increases in 2004 are accompanied by improvements in same-year or next-year audit quality, measured as decreases in discretionary accruals and a reduced likelihood of subsequent restatements of audited reports.

Our study contributes to the literature on the consequences of SOX 404(b) audit implementation. First, whereas prior literature has documented increases in audit fees for AFs (Raghunandan and Rama, 2006; Ettredge et al., 2007), our finding suggests that scaled fee increases due to 404(b) differ by client size among AFs. In particular, smaller AFs (i.e., SAFs) experience greater 404(b) fee shocks than larger AFs (i.e., LAFs). Second, we document a clearly unintended consequence of SOX 404(b), i.e., NAF clients experience audit fee shocks in 2004.[3] We provide economically plausible explanations for these results.

Our study also contributes to the literature on audit office bargaining power relative to clients by examining fee effects in the novel setting of SOX 404(b) audit implementation. Bargaining power arguably played an enhanced role in that setting as offices and clients negotiated over massive fee increases. Our approach of measuring bargaining power using a summary factor that extracts

[1] For brevity, and consistent with common academic practice (DeFond and Zhang, 2014 Section 5.1.3.2) we refer to 404(b) tests and reports of internal control over financial reporting as comprising 404(b) "audits".

[2] A possible explanation for this expectation could have been a belief that the prospect of increased IC testing by auditors would motivate clients to improve their internal controls in advance of 404(b) implementation. Improvement in the IC environment might reduce the auditor's assessed level of control risk and, by definition, result in a lower assessment of risk of material misstatement. The reduction in assessed risk of material misstatement would mean that the amount of audit work would not necessarily increase following 404(b) implementation. In essence, increased auditor testing of IC might have been expected to substitute for substantive testing.

[3] A Senate Committee Report quoted by the SEC's Advisory Committee on Smaller Public Companies (SEC, 2006, 28) stated that the Committee did not intend that the auditor's SOX 404 report "be the basis for increased charges or fees". If legislators did not intend SOX 404(b) to increase audit fees for filers receiving 404(b) reports, it is even more unlikely that they expected companies not receiving 404(b) reports to pay higher fees.