

SARBANES-OXLEY AND THE CROSS SECTIONAL COMPOSITION OF AUDIT SERVICES

*Richard Jenson, Jon M. Huntsman School of Business, Utah State University, 3540 Old Main Hill,
Logan, UT 84322-3540, (435) 797-2335, richard.jenson@usu.edu*

*Drew Dahl, Jon M. Huntsman School of Business, Utah State University, 3565 Old Main Hill, Logan,
UT 84322-3565, (435) 797-1911, richard.jenson@usu.edu*

ABSTRACT

Passage of the Sarbanes-Oxley Act of 2002 (SOX) resulted in a dramatic shift in the makeup of audit and non-audit accounting services provided by the independent auditor. Longitudinal changes—increases in audit services, decreases in non-audit services—have obvious implications for the relative proportions of each in the portfolios of accounting services acquired by companies in aggregate. But they also raise an interesting question concerning how these proportions may have changed, cross sectionally, for different kinds of companies. Did implementation of SOX foster uniformity in the composition of their portfolios of audit and non-audit services?

We hypothesize that SOX, along with other concomitant changes in accounting regulation, caused convergence in the portfolios of audit and non-audit services for different categories of companies. Convergence is defined in terms of a common target proportion of audit fees expressed as a percentage of total fees paid by companies to auditors. Our analysis considers companies categorized by industry (eight classifications under the Standard Industry Classification (SIC)) and by auditor (five classifications representing each of the Big 4 auditors and a residual representing all other auditors). This creates a total of 40 separate categorical groupings (eight industries by five auditors). We hypothesize that, after SOX, companies using different auditors, and operating in different industries, would be less subject to idiosyncratic influences in how they apportion audit and non-audit services.

Our sample consists of 20,434 annual observations of individual companies subject to SOX. We divide the sample into one group comprising observations from 2001 to 2003, prior to implementation of SOX, and another group comprising observations from 2007 to 2009, after implementation of SOX. Results of our tests indicate that target proportions of auditing service portfolios for companies with different auditors, and operating in different industries, were more uniform after passage of SOX. Greater uniformity in auditing practice may enhance the reliability of accounting information and thereby improve the allocation of capital across companies in different industries using different auditors. It may also, on the other hand, increase compliance cost.

Key Words: Audit Fees, Sarbanes-Oxley, Accounting Standards, Capital Allocation.

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