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THE SARBANES-OXLEY ACT: IS THE INVESTING PUBLIC REALLY ANY BETTER OFF?

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I. INTRODUCTION

On July 30, 2002, President Bush signed legislation intended to address the corporate accounting issues that arose in the corporate scandals of late 2001 and 2002.¹ The Sarbanes-Oxley Act, designed to “protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities law,”² passed Congress in the wake of the Enron bankruptcy and other corporate accounting scandals.³ The Act attempts to address a number of the issues related to publicly traded corporations by creating a new federal oversight agency,⁴ establishing auditor independence rules,⁵ creating new laws to address corporate responsibility,⁶ enhancing financial disclosure requirements,⁷ addressing analyst conflicts of interest,⁸ creating new corporate and criminal fraud laws,⁹ and enhancing penalties for white collar crime.¹⁰

One of the key ways the Sarbanes-Oxley Act attempts to protect investors and restore confidence is by addressing corporate accounting issues.¹¹ The Act creates a new federal agency to oversee accounting firms that perform audits, the Public Company Accounting Oversight Board (PCAOB).¹² The Act also establishes new rules and procedures for auditors¹³ and issuers.¹⁴ This comment analyzes the provisions of the Sarbanes-Oxley Act that attempt to improve corporate accounting and examines how the Act fits into the already complicated statutory and regulatory scheme designed to protect and inform the investing public.

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

2. *Id.* The full title of the Sarbanes-Oxley Act is “An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”

3. Bill Carlino, *The Waiting Game: Profession Begins Weighing Impact of Fraud Legislation; Sarbanes-Oxley Act*, ACCT. TODAY, Aug. 19, 2002, at 1.

4. Sarbanes-Oxley Act §§ 101-109.

5. *Id.* §§ 201-209.

6. *Id.* §§ 301-308.

7. *Id.* §§ 401-409.

8. *Id.* § 501.

9. *Id.* §§ 801-807, 1101-1107.

10. *Id.* § 901-906.

11. Mike Allen, *Bush Signs Corporate Reforms into Law; President Says Era of “False Profits” Is Over*, WASH. POST, July 31, 2002, at A4; *President Signs Sweeping Corporate Reform Bill into Law*, DEL. CORP. LITIG. REP., Aug. 19, 2002, vol. 17, no. 1, at 10; Susan Cornwell, *Corporate America Having Tough Time in Capital This Year; Congress Passes Accounting Crackdown but Leaves Bankruptcy, Terrorism Bills in Limbo*, L.A. TIMES, Oct. 21, 2002, pt. 3, at 6.

12. Sarbanes-Oxley Act § 101(a). *See infra* part IV.A.

13. Sarbanes-Oxley Act §§ 201-209. *See infra* part IV.C.

14. Sarbanes-Oxley Act §§ 301-409. *See infra* part IV.E.

The term “issuer” means an issuer (as defined in section 3 of the Securities Exchange Act (15 U.S.C. 78(c))), the securities of which are registered under section 12 of that Act (15 U.S.C. 78(l)), or that is required to file reports under section 15(d) (15 U.S.C. 78(o)(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77(a), *et seq.*), and that it has not withdrawn.
Sarbanes-Oxley Act § 2(a)(7).

This comment argues that, although the Sarbanes-Oxley Act is a noteworthy attempt at accounting reform, it is largely a compilation of mild reforms, many of which previously existed as Securities Exchange Commission (SEC) rules. While the Act contains a few valuable provisions, the legislation's bark is much greater than its bite. Furthermore, the legislation leaves to the resource-strapped SEC and the newly formed PCAOB the duty to enforce and monitor the majority of the provisions.

II. BACKGROUND

A. *The Securities Act of 1933*

The Securities Act of 1933 (Securities Act)¹⁵ was Congress's first attempt to regulate securities.¹⁶ It was part of Franklin Roosevelt's New Deal legislation, passed in response to the stock market crash of 1929.¹⁷ A major goal of the legislation was to provide full, accurate disclosure to the investing public.¹⁸ The Securities Act required companies to register any securities with the Securities Division of the Federal Trade Commission prior to selling or offering the securities for sale.¹⁹ The Securities Act also created civil liabilities for misstatements or omissions of material facts by the corporation, the directors, the officers, the underwriters, and experts such as accountants.²⁰

B. *The Securities Exchange Act of 1934*

In 1934, Congress enacted the Securities Exchange Act of 1934 (Exchange Act).²¹ The Exchange Act created the Securities and Exchange Commission, an independent federal agency responsible for registering and regulating national security exchanges.²² The Exchange Act requires issuers of securities to register with a security exchange in order to trade on the exchange.²³ Furthermore, the Exchange Act authorizes the SEC to require issuers to provide financial information upon registration²⁴ and in annual and quarterly reports.²⁵ The SEC has broad authority to prescribe the content of these reports and the accounting methods to be used in completing them.²⁶

15. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994).

16. See LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATIONS § 1-F (3d ed. 2001).

17. *Id.*

18. *Id.* § 1-G-3.

19. 15 U.S.C. § 77(e) (1994) (original version amended by Amendments to the Securities Act of 1933, Pub. L. 100-181, § 201, 101 Stat. 1252 (1987) (substituting "Securities and Exchange Commission" for "Federal Trade Commission")).

20. 15 U.S.C. § 77(k).

21. Securities Exchange Act of 1934, 15 U.S.C. §§ 78(a)-(l) (1994).

22. *Id.* § 78(d).

23. *Id.* § 78(l).

24. *Id.*

25. *Id.* § 78(m).

26. See *id.*

Historically, the SEC has delegated its authority to establish accounting methods to private regulatory boards.²⁷ The SEC has largely adopted the accounting methods established by the Financial Accounting Standards Board (FASB),²⁸ the primary standard setter for the accounting profession.²⁹ The standards established by FASB are referred to as Generally Accepted Accounting Principles (GAAP).³⁰

C. The Role of Accounting and the Independent Public Auditor

Both the Securities Act and the Exchange Act aim to provide the investing public with accurate information about securities.³¹ Financial accounting is the way that this information is transmitted to the public.³² As explained by the SEC, "accurate and reliable reporting lies at the heart of our disclosure-based system, and is critical to the integrity of the U.S. securities market."³³ Members of the accounting profession have been described as "the referees and scorekeepers for American business."³⁴

Thus, pursuant to the securities laws, the SEC requires issuers of securities to regularly provide financial statements, many of which must be certified by an independent auditor.³⁵ The auditor plays a critical role in insuring financial information is accurate.³⁶ Auditors have been characterized as "the 'gatekeepers' to

27. See MATTHEW BENDER, ATTORNEY'S HANDBOOK OF ACCOUNTING, AUDITING & FINANCIAL PLANNING § 1.02 (2002).

28. *Id.* § 1.02[6].

29. *Id.* § 1.02[3].

30. See *id.* §§ 1.02[1], 1.02[3].

31. Revision of Commission's Auditor Independence Rules, 65 Fed. Reg. 76,008, 76,008 (Dec. 5, 2000) (codified at 17 C.F.R. pts. 210, 240).

32. BENDER, *supra* note 27 § 1.01.

33. SEC, *Standards Related to Listed Company Audit Committees*, 2003 SEC LEXIS 38 (Jan. 8, 2003).

34. Albert B. Crenshaw & Brett D. Fromsom, *A Conflict for CPAs' Firms' Independence Questioned as Ties to Clients Grow*, WASH. POST, Mar. 29, 1998, at H1.

35. Revision of Commission's Auditor Independence Rules, 65 Fed. Reg. at 76,012 n.34:

For example, Items 25 and 26 of Schedule A to the Securities Act, 15 U.S.C. 77aa(25) and (26), and Section 17(e) of the Exchange Act, 15 U.S.C. 78q, expressly require that financial statements be audited by independent public or certified accountants. Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. 78l and 78m, Sections 5(b)(H) and (I), 10(a)(1)(G), and 14 of the Public Utility Holding Company Act of 1935 ("PUHCA"), 15 U.S.C. 79e(b), 79j, and 79n, Sections 8(b)(5) and 30(e) and (g) of the Investment Company Act of 1940 ("ICA"), 15 U.S.C. 80a-8 and 80a-29, and Section 203(c)(1)(D) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. 80b-3(c)(1), authorize the Commission to require the filing of financial statements that have been audited by independent accountants. Under this authority, the Commission has required that certain financial statements be audited by independent accountants. See, e.g., Article 3 of Regulation S-X, 17 C.F.R. 210.3-01, *et seq.* In addition, public companies must have their quarterly reports reviewed by independent accountants. Article 10 of Regulation S-X, 17 C.F.R. 210.10-01(d) and Item 310(b) of Regulation S-B, 17 C.F.R. 228.310(b). The federal securities laws also grant the Commission the authority to define the term "independent." Section 19(a) of the Securities Act, 15 U.S.C. 77s(a), Section 3(b) of the Exchange Act, 15 U.S.C. 78c(b), Section 20(a) of PUHCA, 15 U.S.C. 79t(a), and Section 38(a) of the ICA, 15 U.S.C. § 80a-37(a), grant the Commission the authority to define accounting, technical, and trade terms used in each Act. Section 17 of the Exchange Act, 15 U.S.C. 78q, and Section 31 of the Investment Company Act, 15 U.S.C. 80a-30, grant the Commission authority to prescribe accounting principles to be used in the preparation of financial statements required.

Id.

36. *Id.* at 76,008.

the public securities markets.”³⁷ Audits are to be performed in accordance with Generally Accepted Auditing Standards (GAAS).³⁸ Although authorized to modify and supplement auditing principles, the SEC has largely adopted the principles and standards established by the American Institute of Certified Public Accountants (AICPA), an organization consisting mostly of certified public accountants (CPAs).³⁹

D. Changes in the Accounting Profession

Recently, the accounting industry has undergone significant change.⁴⁰ The accounting profession has expanded into a global business.⁴¹ Moreover, many accounting firms merged, and consequently the majority of independent audits are now performed by the five largest accounting firms, the “Big Five.”⁴²

One result of the consolidation of accounting firms and global expansion is the performance of non-traditional accounting services by accounting firms.⁴³ Most major accounting firms now offer a wide variety of non-audit services.⁴⁴ These include not only traditional accounting services such as tax services, but also internal audits, financial consulting, actuarial services, marketing services, and certain legal services.⁴⁵

For the Big Five, revenue from non-audit services now makes up half of their total revenue.⁴⁶ Thus, non-audit service revenues are important, if not crucial, to the financial success of accounting firms. This reliance on non-audit services draws into question the true independence of the auditor.⁴⁷ A common fear is that audit clients use their control over non-audit services to influence the auditing firm’s opinion on their financial statements.⁴⁸

37. *Id.* at 76,011.

38. See BENDER, *supra* note 27 § 12.01.

39. *Id.* See generally AICPA, at <http://www.aicpa.org> (last visited July 21, 2003) (providing text of the GAAS and Auditors Code of Professional Conduct).

40. Revision of Commission’s Auditor Independence Rules, 65 Fed. Reg. at 76,013.

41. *Id.*

42. *Id.* See generally Reed Abelson, *Two of the Big Six in Accounting Plan to Form New No. 1*, N.Y. TIMES, Sept. 19, 1997, at A1 (noting that the “Big Five” referred to Arthur Anderson, L.L.P.; PricewaterhouseCoopers, L.L.P.; Ernst & Young, L.L.P.; KPMG, Peat Marwick, L.L.P.; and Deloitte & Touche, L.L.P.).

43. Revision of Commission’s Auditor Independence Rules, 65 Fed. Reg. at 76,013.

44. *Id.*

45. The remaining “Big Four” offer a wide variety of accounting services on their websites. See generally KPMG, Peat Marwick, at <http://www.kpmg.com/services/> (last visited July 21, 2003); Deloitte & Touche, at <http://www.deloitte.com/dt/home/0%2C2334%2Csid%25253D1000%2C00.html> (last visited July 21, 2003); PricewaterhouseCoopers, at <http://www.pwcglobal.com/us/eng/about/svcs/index.html> (last visited July 21, 2003); Ernst & Young, at <http://www.ey.com/global/content.nsf/International/services> (last visited July 21, 2003).

46. Revision of Commission’s Auditor Independence Rules, 65 Fed. Reg. at 76,012.

47. *Id.* at 76,010.

48. *Id.*

E. Changes in the Financial Market Landscape

Changes in the operation of financial markets have also affected accounting practices.⁴⁹ In the current market, the price of a company's stock is heavily influenced by the company's ability to meet the growth and earnings projections of financial analysts.⁵⁰ Thus, public companies are under extreme pressure to maintain or improve stock prices by meeting earnings estimates.⁵¹ This pressure leads companies to make accounting decisions based on the results the decision will have on earnings—in effect, to manage their earnings.⁵² The net result can be “creative” accounting practices that inaccurately represent a company's financial situation.⁵³

There are a handful of accounting methods that are often used to manipulate statements of a company's earnings. The most common area of abuse involves the recognition of revenue.⁵⁴ In general, revenue should be recognized in the period in which it is realized and earned.⁵⁵ Improper revenue recognition occurs when a company recognizes revenue in a period before it is truly earned or realized, or when a company falsely recognizes revenue.⁵⁶ For example, Enron apparently manipulated its earnings by inaccurately recognizing revenue on energy trades.⁵⁷ When the company traded electricity or gas, it recorded the entire amount of the transaction as revenue.⁵⁸ A more accurate accounting would have recorded the profit or loss on the transaction as revenue, treating it like a brokerage fee or commission.⁵⁹

Another common area of manipulation involves losses.⁶⁰ Companies use loss contingencies, allowances, and reserves to smooth income from year to year.⁶¹ These so-called “cookie jar reserves” allow a company to overestimate or prematurely record a loss or expense in order to reduce income in an earlier period.⁶² WorldCom used this type of reserve by overestimating expected expenses and then later reversing them to improve reported earnings.⁶³

The capitalization of expenses provides another opportunity to manipulate earnings.⁶⁴ Generally, when a cost incurred is related to a benefit that is expected to be limited to the current accounting period, the entire cost should be expensed in

49. *See id.* at 76,013.

50. *Id.*

51. *Id.*

52. Manuel A. Rodriguez, Comment, *The Numbers Game: Manipulation of Financial Reporting by Corporations and Their Executives*, 10 U. MIAMI BUS. L. REV. 451, 459 (2002).

53. *Id.*

54. David B. Harms et al., *Behind the Numbers: A Review of Six Accounting Problem Areas*, in WHAT EVERY LAWYER NEEDS TO KNOW ABOUT ACCOUNTING—OR ELSE 579, 584 (John White, chair, 2002).

55. *Id.*

56. *Id.*

57. Gretchen Morgenson, *Enron's Collapse: News Analysis; A Bubble No One Wanted to Pop*, N.Y. TIMES, Jan. 14, 2002, at A1.

58. *Id.*

59. *Id.*

60. Harms, *supra* note 54, at 610.

61. *Id.*

62. Rodriguez, *supra* note 52, at 461.

63. David Ward, *Reserves Being Misused to Boost Earnings; Accounting: WorldCom Employed the “Cookie Jar” Practice to Help It Hide \$3.9 Billion in Expenses*, Experts Say, L.A. TIMES, Aug. 12, 2002, pt. 3, at 3.

64. Harms, *supra* note 54, at 624.

that period.⁶⁵ In contrast, a cost that is expected to provide a benefit in future periods should be capitalized.⁶⁶ The underlying principle is that the cost should be spread out over the periods when the benefit occurs.⁶⁷ Whether a benefit occurs in the current period, however, is not always clear.⁶⁸ This ambiguity may be used to understate expenses, and likewise overstate earnings, by improperly capitalizing expenses.⁶⁹ WorldCom was charged with overstating its income in 2001 by \$3.8 billion using this technique.⁷⁰

These and many other accounting methods are used by companies to manipulate earnings. Caught in the middle of these accounting manipulations are the auditors who are pressured to go along with the companies' estimates and decisions.⁷¹ As former SEC chairman Arthur Levitt explains, "Companies can't afford to disappoint Wall Street earnings expectations, so they are tempted to push their earnings, even to the point of deception. And aggressive or sometimes creative accounting is often overlooked by auditors preoccupied with the desire to preserve lucrative auditing and consulting contracts."⁷²

F. Accounting Issues under Scrutiny

The many roles played by accounting firms and the increased pressure on auditors to rubber stamp creative accounting practices raised serious questions about the integrity of the financial disclosure and auditing system in the United States.⁷³ In 1996, Representative John Dingell requested a review of the accounting profession by the General Accounting Office (GAO).⁷⁴ The GAO produced a comprehensive report that addressed five areas related to auditing: (1) auditor independence, (2) auditor's responsibilities for fraud and internal controls, (3) audit quality, (4) the accounting and auditing standard-setting process and the effectiveness of financial reporting, and (5) the role of the auditor in the further enhancement of financial reporting.⁷⁵ The report brought to the forefront questions about the reliability of audits and the financial reporting system.⁷⁶

In 1997, in response to pressure from Congress, investors, and many others, the SEC announced that the AICPA was creating an Independence Standards Board

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* at 648.

70. James S. Granelli et al., *The WorldCom Scandal; What Went Wrong? SEC Targets Top Execs; Errors Shock Analysts*, L.A. TIMES, June 27, 2002, pt. 3, at 1 (explaining that ordinary costs for connecting customers to WorldCom's network were recorded as capitalized expenses on the company's balance sheet rather than expenses on the profit and loss statement).

71. *Id.* See also Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008, 76,013 (Dec. 5, 2000) (codified at 17 C.F.R. pts. 210, 240).

72. Arthur Levitt, *Who Audits the Auditors?*, WASH. POST, Jan. 17, 2002, at A29.

73. See *supra* note 71.

74. ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, THE ACCOUNTING PROFESSION, MAJOR ISSUES: PROGRESS AND CONCERNS 2 (1996).

75. *Id.* at 4, 22.

76. *Id.*

(ISB) to establish independence standards for auditors.⁷⁷ However, in 2000, in an unusual move, the SEC bypassed the AICPA and the ISB and proposed a number of its own rules regarding the independence of auditors.⁷⁸ The proposed rules detailed financial, employment, and business relationships that impair auditor independence.⁷⁹ The proposed rules also banned ten types of non-audit services.⁸⁰ In December 2000, the SEC enacted a watered-down version of these rules.⁸¹

III. RECENT DEVELOPMENTS

A. *Enron, WorldCom, and Other Corporate Scandals*

In the midst of discussions about auditor independence came the Enron scandal. On December 2, 2001, Enron filed the largest bankruptcy petition in U.S. history.⁸² Enron allegedly overstated reported profits by almost \$600 million⁸³ and managed to hide more than \$1 billion in debt in partnerships.⁸⁴ Implicated in the Enron scandal was the Big Five firm Arthur Anderson, which had conducted Enron's audits.⁸⁵ Enron, however, was just the beginning, as other accounting scandals were exposed in the months after Enron's bankruptcy announcement.

Late in June 2002, WorldCom announced that it had misstated \$3.8 billion in its financial statements.⁸⁶ The SEC quickly filed civil fraud charges against the company.⁸⁷ Shortly thereafter, the company filed for bankruptcy protection.⁸⁸ The company went on to make additional restatements totaling more than \$9 billion.⁸⁹

These and other accounting scandals left many doubting the integrity of the auditing system.⁹⁰ In response, Congress drafted legislation to address the apparent problems in the corporate accounting arena.⁹¹

77. News Release, SEC and AICPA Announce the Creation of a New Independence Standards Board (May 21, 1997), available at <http://www.sec.gov/news/press/pressarchive/1997/97-41.txt>.

78. Revision of Commission's Auditor Independence Rules, 65 Fed. Reg. 43,148 (July 12, 2000).

79. *Id.* at 43,148 & 43,190-92.

80. *Id.* at 43,148 & 41,192. The proposed rules prohibited ten non-audit services: bookkeeping services, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing, management functions, human resources, broker-dealer, investment advisor or investment banking services, legal services, and expert services. *Id.*

81. Revision of Commission's Auditor Independence Rules, 65 Fed. Reg. 76,008, 76,043 (Dec. 5, 2000) (codified at 17 C.F.R. pts. 210, 240) (revising final rules to prohibit nine non-audit services and adding several exceptions to the prohibitions).

82. Peter Behr, *Ailing Enron Files for Chapter 11 Bankruptcy Protection*, WASH. POST, Dec. 3, 2001, at A7.

83. *Id.*

84. Bloomberg News, *Enron Shareholders' Move Against Banks Is Rebuffed by Judge*, N.Y. TIMES, Feb. 28, 2003, at C5.

85. Floyd Norris, *Enron's Many Strands: The Auditors; Memo Says Auditors Sought, but Didn't Get, Crucial Data*, N.Y. TIMES, Feb. 7, 2002, at C7.

86. WorldCom announced the financial misstatements on June 21, 2002. Seth Schiesel & Simon Romero, *WorldCom Strikes a Deal with SEC*, N.Y. TIMES, Nov. 27, 2002, at C1.

87. *Id.*

88. *Id.*

89. *Id.*

90. See, e.g., *The Watchdog Doesn't Bark*, WASH. POST, Jan. 30, 2002, at C16.

91. See Carlino, *supra* note 3.

B. Legislation in Response to Enron and Other Scandals

On February 14, 2002, shortly after Enron announced bankruptcy, Representative Michael Oxley introduced House Bill 3763, titled the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002.⁹² The bill addressed auditor independence and financial disclosures.⁹³ House Bill 3763 passed the House, with a few minor amendments, on April 24, 2002, by a vote of 334 to 90.⁹⁴

On June 25, 2002, Senator Paul Sarbanes introduced Senate Bill 2673.⁹⁵ The bill contained three separately titled proposals: The Public Company Accounting Reform and Investor Protection Act of 2002, the White-Collar Crime Penalty Enhancement Act of 2002, and the Corporate and Criminal Fraud Accountability Act of 2002.⁹⁶ On July 15, 2002, the Senate passed House Bill 3763 with amendments from Senate Bill 2673.⁹⁷ The Senate included the provisions regarding criminal fraud⁹⁸ and white-collar crime penalty enhancements.⁹⁹ A conference committee worked out the details of the bill and on July 25, 2002, both chambers overwhelmingly passed the Sarbanes-Oxley Act of 2002.¹⁰⁰ On July 30, 2002, President Bush signed the legislation, announcing it to be “the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt.”¹⁰¹

IV. THE SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act addresses the failings of corporate accounting from three starting points. First, the Act establishes federal regulation of the accounting industry by creating the PCAOB.¹⁰² Second, the Act prescribes specific rules and procedures for accounting firms and auditors.¹⁰³ And finally, the Act prescribes new rules and procedures for issuers.¹⁰⁴

A. The Public Company Accounting Oversight Board

Title I of the Sarbanes-Oxley Act establishes the PCAOB.¹⁰⁵ The PCAOB is responsible for registering public accounting firms that audit publicly traded

92. See Union Calendar No. 247, H.R. 3763, 107th Congress (2d sess.), available at http://www.house.gov/rules/h3763_rh.pdf (last visited July 21, 2003).

93. Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, H.R. 3763, 107th Cong. (2002).

94. Union Calendar No. 247, H.R. 3763, *supra* note 92.

95. Calendar No. 442, S. 2673, 107th Congress (2d sess.), available at <http://www.energy marketers.com/documents/S2673.pdf> (last visited July 21, 2003).

96. Public Company Accounting Reform and Investor Protection Act of 2002, S. 2763, 107th Cong. (2002).

97. Calendar No. 442, S. 2673, *supra* note 95.

98. H.R. 3763 §§ 801-807.

99. H.R. 3763 §§ 901-911.

100. Union Calendar No. 247, H.R. 3763, *supra* note 92.

101. President George W. Bush, Remarks at the Signing of the Corporate Accountability Bill (July 30, 2002), in FED. NEWS SERV., July 30, 2002.

102. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(a), 116 Stat. 745, 750 (codified at 15 U.S.C. § 7211).

103. *Id.* §§ 201-209.

104. *Id.* §§ 301-409.

105. *Id.* § 101(a).

companies.¹⁰⁶ The Act requires the registration of any public accounting firm involved in the preparation or issue of an audit report for an issuer.¹⁰⁷

The PCAOB is directed to set auditing, quality control, and independence standards that will govern registered public accounting firms.¹⁰⁸ The Act provides that the PCAOB shall adopt accounting standards requiring each registered public firm to prepare and maintain audit work papers for seven years, require that a “concurring or second partner review and approv[e]” audit reports, and describe the auditor’s testing of the issuer’s internal control structure in the audit report.¹⁰⁹

The PCAOB is also given authority to conduct inspections of registered accounting firms¹¹⁰ to identify any “act, practice or omission” that may be in violation of the Sarbanes-Oxley Act, the rules of the PCAOB, the rules of the SEC, the firm’s own quality control procedures, or professional standards.¹¹¹ Accounting firms that regularly audit more than 100 issuers are to be inspected every year.¹¹² Firms auditing less than 100 issuers are to be inspected no less frequently than every three years.¹¹³

Furthermore, the PCAOB is authorized to conduct investigations and disciplinary proceedings and impose sanctions on registered public accounting firms.¹¹⁴ The Sarbanes-Oxley Act authorizes the PCAOB to impose sanctions that include suspension or revocation of registration, limitations on a firm’s activities, civil penalties, additional professional education or training, and any other sanction included in the PCAOB’s rules.¹¹⁵

The Sarbanes-Oxley Act gives the SEC “oversight and enforcement authority over the [PCAOB].”¹¹⁶ The PCAOB is to be funded through registration fees collected from accounting firms and “accounting support fees” collected from issuers.¹¹⁷

B. Analysis of the PCAOB

1. The Accounting Industry Is No Longer Self-Regulated

Undoubtedly the accounting industry is forever changed by the creation of the PCAOB. Prior to the passage of the Sarbanes-Oxley Act, accountants and accounting firms were essentially self-regulated. The AICPA and FASB, organizations largely made up of accountants, established the majority of the rules governing the accounting industry. The Act fundamentally altered the regulatory

106. *Id.* § 101(c)(1).

107. *Id.* § 102(a).

108. *Id.* § 101(c)(2).

109. *Id.* § 103(a)(2)(A).

110. *Id.* § 101(c)(3).

111. *Id.* § 104(c).

112. *Id.* § 104(b).

113. *Id.*

114. *Id.* § 101(c)(4).

115. *Id.* § 105(b)(3).

116. *Id.* § 107(a).

117. *Id.* § 109.

scheme for auditing by requiring every public accounting firm to register with the PCAOB and comply with the PCAOB's auditing standards.

Furthermore, the creation of the PCAOB establishes the SEC's authority to discipline the accounting profession. The SEC previously proposed to administratively create a similar board, but questions existed regarding the SEC's authority to do so.¹¹⁸ The Sarbanes-Oxley Act clearly establishes that the SEC, through the PCAOB, may regulate the accounting industry. Thus, with the passage of the Act, the accounting industry becomes a federally regulated industry.

2. The Accounting Industry's Influence Continues

a. The PCAOB May Adopt Rules Established by Accounting Organizations

Despite this new regulatory scheme, accountants may continue to exert significant influence over the regulation of the accounting industry. The Sarbanes-Oxley Act authorizes the PCAOB to adopt auditing standards proposed by professional groups of accountants such as the AICPA or FASB.¹¹⁹ Thus, although the PCAOB is required to satisfy the specific auditing provisions set out in the Sarbanes-Oxley Act, it may do so by adopting rules established by the AICPA or other professional groups. Drafting completely new auditing rules is a difficult and daunting task, and the PCAOB may opt to rely on the accounting industry to write these rules. In this way, the accounting industry may retain a substantial amount of influence over its own regulators.

b. The SEC and PCAOB Operate Under Intense Political Pressure

Similarly, the members of the PCAOB are exposed to political pressure from the accounting industry.¹²⁰ Section 101(e) of the Sarbanes-Oxley Act details the membership requirements for the PCAOB. The PCAOB is to consist of five members with "an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures."¹²¹ However, the Act allows no more than two members to be or have been CPAs.¹²² Although this limitation on CPAs undoubtedly reduces the PCAOB members' personal ties to the accounting industry, the accounting industry remains a powerful lobbying force and can be expected to pressure the PCAOB.

118. *Senate, House Conferees Agree on Reform Measure*, FED. SEC. L. REP. Issue No. 2038, at 2035 (July 26, 2002).

119. Sarbanes-Oxley Act § 103(a)(3).

120. The accounting industry has considerable political power. The industry has avoided regulation thus far by aggressively lobbying legislators and making political contributions. The accounting industry launched a multi-million dollar lobbying campaign to prevent Congress from passing the accounting reforms in the Act. *See* Jackie Spinner, *Audit Firms Rev Up Lobbying Push*, WASH. POST, Mar. 13, 2002, at E1; Jim VanderHei & David S. Hilzenrath, *Hill Leaders Agree on Corporate Curbs; Attack on Fraud Includes Auditing Control and Jail Terms; Markets Soar*, WASH. POST, July 25, 2002, at A1.

121. Sarbanes-Oxley Act § 101(e)(1).

122. *Id.* § 101(e)(2).

The SEC's difficulty in appointing members to the PCAOB demonstrates how difficult and politically complicated the PCAOB's job will be. According to the Sarbanes-Oxley Act, PCAOB members serve for a term of five years.¹²³ Furthermore, members must serve on a full-time basis and may not have any other employment or business activity during their term.¹²⁴ The exclusivity and time requirements alone limit the number of individuals that are able, let alone willing, to serve on the PCAOB.

From this pool of individuals the SEC must then find members that are politically acceptable. This has proven to be difficult.¹²⁵ For example, SEC Chairman Harvey Pitt initially attempted to appoint John Biggs to head the PCAOB.¹²⁶ Biggs had been critical of the accounting profession and publicly supported increasing accounting oversight.¹²⁷ However, Pitt was pressured by Republican lawmakers and the accounting industry to forgo this candidate, who was seen as being too tough on the accounting industry.¹²⁸

The SEC then appointed William Webster to head the PCAOB, over the bitter objections of the Democratic commissioners.¹²⁹ Pitt and the other Republican commissioners faced accusations that they "had succumbed to the pressures from the accounting industry"¹³⁰ because Webster lacked the experience and knowledge needed to oversee the accounting industry.¹³¹ Webster's appointment exploded in controversy when it was revealed that Webster headed the audit committee of a Washington company with significant accounting problems.¹³² After less than a month as head of the PCAOB, Webster resigned.¹³³

Also implicated in the controversy was Chairman Pitt.¹³⁴ He tendered his own resignation after it was revealed that Webster had informed him of the audit committee issues, but Pitt had failed to deliver this information to the other commissioners.¹³⁵ On February 14, 2003, the Senate confirmed the nomination of William H. Donaldson as the new chairman of the SEC.¹³⁶ Donaldson indicated that

123. *Id.* § 101(e)(5).

124. *Id.* § 101(e)(3).

125. Stephen Labaton, *SEC Chief Hedges on Accounting Regulator*, N.Y. TIMES, Oct. 4, 2002, at C1; Paul Krugman, Editorial, *Revenge of the Accountants*, N.Y. TIMES, Oct. 10, 2002, at A38; Paul Krugman, Editorial, *Fool Me Once*, N.Y. TIMES, Oct. 8, 2002, at A31; David S. Hilzenrath, *Webster to Lead Auditing Oversight; SEC Votes 3-2 over Democratic Objections*, WASH. POST, Oct. 26, 2002, at E1; David S. Hilzenrath & Kathleen Day, *Webster Leaving Audit Job; Resignation May Hinder Cleanup*, WASH. POST, Nov. 13, 2002, at A1.

126. Labaton, *supra* note 125; Krugman, *Revenge of the Accountants*, *supra* note 125; Krugman, *Fool Me Once*, *supra* note 125.

127. Labaton, *supra* note 125; Krugman, *Revenge of the Accountants*, *supra* note 125; Krugman, *Fool Me Once*, *supra* note 125.

128. Labaton, *supra* note 125; Krugman, *Revenge of the Accountants*, *supra* note 125; Krugman, *Fool Me Once*, *supra* note 125.

129. Hilzenrath, *supra* note 125.

130. *Id.*

131. *Id.*

132. While Webster was head of the audit committee, the company repeatedly failed to file financial reports on time and fired an outside auditor after the auditor warned the company that it "lacked the accounting controls necessary to produce reliable financial reports." *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. *Donaldson Confirmed for SEC*, WASH. POST, Feb. 14, 2003, at E2.

his first priority would be finding a chair for the PCAOB.¹³⁷ As of this writing, however, the board remains leaderless.

c. The SEC and PCAOB Have Insufficient Resources

Once the PCAOB is complete, it has a number of pressing tasks to complete. It must establish the auditing rules that will govern the industry, register public accounting firms, and then begin inspecting these firms. All this must be accomplished using the fees collected from issuers and accounting firms.¹³⁸

Although overseen by the SEC, the PCAOB will be hard pressed to obtain much assistance from the resource-strapped SEC. Suffering from budget constraints, the SEC has indicated it will not be able to handle the record number of enforcement actions arising out of the corporate scandals of 2002.¹³⁹ According to a GAO report, the SEC has insufficient financial resources and “has been faced with an ever increasing workload and ongoing human capital challenges.”¹⁴⁰ Although Congress has drafted spending legislation that significantly increases the SEC’s funding, the SEC has not, as of this writing, received additional funding.¹⁴¹ Clearly, the SEC does not have sufficient resources to do its own job. This makes it unlikely that the SEC will be able to help jumpstart the PCAOB.

3. Accounting Reform Depends on the Success of the PCAOB

Clearly the success of the Sarbanes-Oxley Act depends largely on the success of the PCAOB. The PCAOB is responsible for implementing key provisions of the Act. The PCAOB is responsible for inspecting accounting firms to ensure the Act is being properly followed. The PCAOB is also responsible for investigating and disciplining accounting firms that are not in compliance. With the PCAOB off to a rocky start, it faces numerous obstacles.

C. New Rules and Procedures for Auditors

The Sarbanes-Oxley Act also attempts to improve corporate accounting by addressing issues regarding auditors. The Act establishes rules regarding the independence of auditors.¹⁴² It also dictates procedures that auditors must follow in the performance of audits.¹⁴³

137. Kathleen Day, *Senate Committee Backs SEC Nominee, Donaldson Could Be at Work Next Week*, WASH. POST, Feb. 12, 2003, at E1.

138. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 109, 116 Stat. 745, 769 (codified at 15 U.S.C. § 7219).

139. *SEC Seeks Greater Resources for Enforcement Cases: Regulation Backed by a Study, the Agency Will Ask Congress for a Bigger 2003 Budget to Handle Post-Enron Demand*, L.A. TIMES, Mar. 6, 2002, pt. 3, at 6.

140. U.S. GENERAL ACCOUNTING OFFICE, SEC OPERATIONS; INCREASED WORKLOAD CREATES CHALLENGES, GAO-02-302, at 33 (Mar. 2002), available at <http://www.gao.gov/new.items/d02302.pdf>.

141. Dan Morgan, *GOP Wraps Up Spending Package; Despite Snags in \$397.4 Billion Plan, Republicans Signal Readiness to Vote*, WASH. POST, Feb. 13, 2003, at A1.

142. Sarbanes-Oxley Act §§ 201-209.

143. *Id.*

1. Auditor Independence

The Sarbanes-Oxley Act addresses auditor independence in a number of ways.¹⁴⁴ Section 201 addresses the potential conflict of interest that arises when an accounting firm audits a company and also performs non-audit services for the company. Section 201 prohibits the auditing firm from performing a number of non-audit services.¹⁴⁵ The Act specifically prohibits an auditing firm from performing bookkeeping services, financial information systems design or implementation, appraisal or valuation services, actuarial services, internal audit outsourcing services, management functions, investment banking services, legal services, and any other services the PCAOB decides to prohibit.¹⁴⁶ The Act does, however, allow the issuer's audit committee to approve non-audit services that are not specifically prohibited.¹⁴⁷

The Sarbanes-Oxley Act also addresses several other potential conflicts of interest between auditors and issuers. Section 203 requires the rotation of auditors by making it

unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.¹⁴⁸

In other words, if the lead audit partner has audited a client for five consecutive years, a new audit partner must perform the audit services on the sixth year.

Similarly, Section 206 prohibits accounting firms from auditing companies whose officers are former employees.¹⁴⁹ Specifically, Section 206 forbids the audit of an issuer if the

chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.¹⁵⁰

As the SEC explains, when former employees of accounting firms assume positions with the firm's audit clients, they may be able to "influence the content of the audit client's accounting records and financial statements on one hand, and the conduct of the audit on the other."¹⁵¹ Section 206 addresses this potential conflict of interest.

144. *Id.*

145. *Id.* § 201(a).

146. *Id.*

147. *Id.* § 201(h).

148. *Id.* § 203.

149. *Id.* § 206.

150. *Id.*

151. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008, 76,041 (Dec. 5, 2000) (codified at 17 C.F.R. pts. 210, 240).

2. Audit Procedure

The Sarbanes-Oxley Act also dictates the contents of an auditor's report to the audit committee.¹⁵² Under Section 204, the auditor must report

(1) all critical accounting policies and practices to be used; (2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramification of the use of such alternative disclosures and treatments, and the treatment preferred by the registered accounting firm; and (3) other material written communication between the registered public accounting firm and the management of the issuer.¹⁵³

Furthermore, pursuant to Section 401, financial reports must disclose "all material correcting adjustments that have been identified by a registered public accounting firm in accordance with [GAAP] and the rules and regulations of the Commission."¹⁵⁴

Finally, Section 802 of the Sarbanes-Oxley Act requires "any accountant who conducts an audit of an issuer" to "maintain all audit or review workpapers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded."¹⁵⁵ An accountant that "knowingly and willfully" violates this provision faces fines and up to ten years imprisonment, or both.¹⁵⁶

D. Analysis of New Rules and Procedures For Auditors

1. Auditor Independence

When the Sarbanes-Oxley Act is compared to existing auditor independence rules, it is unclear whether the Act will really improve information or protect investors as it claims. At first blush, the prohibitions on non-audit services in Section 201 would appear to improve auditor independence by removing the possibility that the objectivity of an auditor will be influenced by potential fees from non-audit services. However, Section 201 does not accomplish as much as one might believe. The section does prohibit audit firms from performing many non-audit services,¹⁵⁷ but the nine prohibited services were already prohibited by the SEC.¹⁵⁸ Thus, the Act's provisions do not improve existing independence rules in this regard. Furthermore, the audit committee of the issuer is authorized to allow an accounting firm to perform any non-audit services that are not specifically prohibited.¹⁵⁹ There remains a significant opportunity for the objectivity of auditors to be tainted.

152. Sarbanes-Oxley Act § 204.

153. *Id.*

154. *Id.* § 401(a).

155. *Id.* § 802(a).

156. *Id.*

157. *Id.* § 201.

158. See 17 C.F.R. § 210.2-01(c)(4). See *supra* part II.F.

159. Sarbanes-Oxley Act § 201.

Moreover, Section 201 allows an accounting firm to provide tax services for an audit client with the approval of the audit committee.¹⁶⁰ Historically, accounting firms have been allowed to provide tax services to their audit clients.¹⁶¹ There has been considerable debate over whether an auditor's independence is impaired by performing tax services for an audit client.¹⁶² In the final rules, issued pursuant to the Sarbanes-Oxley Act, the SEC reiterated "its long-standing position that an accounting firm can provide tax services without impairing the firm's independence."¹⁶³

The accounting industry strongly opposed a prohibition on tax services because these services are a profitable business.¹⁶⁴ Because they are so valuable to accounting firms, there remains a logical and compelling argument that accounting firms are not independent when they perform both audit and tax services.¹⁶⁵ In an attempt to deal with this obvious conflict, the SEC imposed an additional requirement that the issuer disclose "the amount of fees paid to the accounting firm for tax services."¹⁶⁶

The partner rotation requirements of Section 203 are a valuable addition to auditor independence rules. Section 203 makes mandatory a practice that many accounting firms have used as part of their quality control programs.¹⁶⁷ Rotation of partners allows an issuer's financial statements to be viewed with fresh eyes.¹⁶⁸

The SEC's rules, pursuant to Section 203, go still further to improve auditor independence. Section 203 only prohibits a partner from performing audit services if the partner has performed the services "in each of the five previous fiscal years."¹⁶⁹ The SEC could have interpreted this to mean that after not performing the services for one year the partner could return. The SEC chose, however, to impose a five-year "time out" period for lead and concurring partners.¹⁷⁰ Thus, a partner may only perform audit services for an issuer for five years and must then wait a full five years before returning to that issuer.

Furthermore, the SEC extended the partner rotation requirements to "audit partners," members of the "audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management and the audit committee."¹⁷¹ This is a valuable extension of Section 203 because it

160. *Id.*

161. Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6017 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274).

162. *Id.* at 6016.

163. *Id.* at 6017.

164. Editorial, *Downsized Corporate Reform*, N.Y. TIMES, Jan. 23, 2003, at A24.

165. Jonathon D. Glater, *Enron's Many Strands: Consulting; Keen Rivalry by Consultants Expected after Auditor's Shift*, N.Y. TIMES, Feb. 22, 2002, at C1 ("[C]oncerns about conflicts of interest for accountants are likely to persist because there are some kinds of services that they will continue to sell, like tax advice. That means there is still the possibility that an auditor's judgment will be swayed by the prospect of nonaudit-related fees.").

166. Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6017.

167. *Id.*

168. *Id.*

169. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 203, 116 Stat. 745, 773 (codified at 15 U.S.C. § 78j-1).

170. Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6018.

171. *Id.* at 6019.

requires accounting firms to rotate all the auditors that are closely involved, not just those that hold lead or controlling partner positions.

2. Audit Procedures

Section 206 prohibits an accounting firm from auditing an issuer with a Chief Executive Officer (CEO), Chief Financial Officer (CFO), controller, or accounting officer who is a former employee of the accounting firm and participated in the issuer's audit during the previous year,¹⁷² which undoubtedly improves existing auditor independence rules.¹⁷³ Unlike the 2000 auditor independence rule, Section 206 "requires a 'cooling off' period of one year before a member of the audit engagement team can begin working for the registrant in certain key provisions."¹⁷⁴ The SEC had previously considered a "cooling off" period but determined it to "unnecessarily restrict the employment opportunities of former professionals."¹⁷⁵ Section 206 is an important provision, reflecting "the view that the passage of time is an additional safeguard to reduce the perceived loss of independence for the audit firm caused by the acceptance of employment by a member of the engagement team with an audit client."¹⁷⁶

Unfortunately, Section 206 and the SEC rules create as much ambiguity as they resolve. The rules expand the scope of Section 206 beyond the four named positions to individuals in a "financial reporting oversight role,"¹⁷⁷ a phrase whose interpretation is not immediately clear. The rules also provide a number of exceptions for "unique situations,"¹⁷⁸ another unclear phrase. Furthermore, the idea that an auditor becomes independent after a year and a day is a fiction. In all likelihood, the one-year cooling off period really improves only the appearance of independence.

The requirements of Section 204 create a mechanism by which auditors are required to discuss with the audit committee the accounting practices being employed and alternative practices that could be employed.¹⁷⁹ This is a valuable mechanism because auditors must consider the accounting practices being used and determine if, in their opinion, another practice is preferable. The auditor must then communicate this information to the audit committee. This requirement should force the auditor to decide what is the best accounting practice, rather than simply deciding whether a practice is acceptable.

Section 204 is also valuable because it improves the quality of information available to the audit committee. As Warren Buffett explained, it is the audit

172. Sarbanes-Oxley Act § 206.

173. See Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6007. Compare 17 C.F.R. § 210.2-01(c)(2) (2000) with Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6044.

174. Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6007.

175. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008, 76,041 (Dec. 5, 2000) (codified at 17 C.F.R. pts. 210, 240).

176. Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6007.

177. *Id.* at 6008.

178. *Id.* (The rules contain exceptions for conflicts resulting from mergers and acquisitions, conflicts in certain foreign jurisdictions, and conflicts from emergency or unusual circumstances.)

179. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 204, 116 Stat. 745, 773 (codified at 15 U.S.C. § 78j-1).

committee's job "to hold the auditor's feet to the fire."¹⁸⁰ The audit committee should consider whether the financial statements should have been prepared differently than the manner selected by management.¹⁸¹ The requirements of Section 204 require auditors to provide the audit committee with the information needed to properly consider accounting issues.

Section 802 is one of the few provisions of the Sarbanes-Oxley Act that clearly dictates an accountant's behavior and imposes a real penalty for noncompliance.¹⁸² The possibility of a significant fine and up to ten years in jail¹⁸³ should certainly motivate auditors to carefully maintain their audit and review papers. This provision seems likely to significantly reduce the willingness of accountants to destroy, alter, or fail to appropriately create documents.

E. New Rules and Procedures for Issuers

In addition to new rules and procedures for auditors, the Sarbanes-Oxley Act also contains a number of accounting and auditing provisions that apply to issuers. The Act addresses many accounting and auditing issues by prescribing the issuer's actions. The Act attempts to protect the integrity of financial statements by protecting the auditor from the influence of management, requiring management to take personal responsibility for financial reports, and requiring new accounting disclosures.

1. Separation Between Management and Auditors

Section 301 requires the audit committee of each issuer to be comprised of independent members of the board of directors.¹⁸⁴ A member is not considered independent if (1) the member accepts any consulting, advisory, or other compensation from the issuer, other than that received in his or her capacity as a member of the committee, the board of directors, or any other committee; or (2) is an affiliated person of the issuer or any subsidiary thereof.¹⁸⁵ This independent audit committee is to be "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer" performing the company's audit.¹⁸⁶ Section 202 requires the audit committee to pre-approve all auditing and non-auditing accounting services.¹⁸⁷ Similarly, Section 301 requires the accounting firms performing the audit to "report directly to the audit committee"¹⁸⁸ rather than to management or the board of directors in general.

180. Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6027.

181. *Id.*

182. Sarbanes-Oxley Act § 802.

183. *Id.*

184. *Id.* § 301 (The definitions indicate that if the company does not have an audit committee the requirements apply to the entire board of directors.). *Id.* § 2(a)(3)(B).

185. *Id.* § 301.

186. *Id.*

187. *Id.* § 202.

188. *Id.* § 301.

Along similar lines, Section 303 makes it unlawful for officers or directors of an issuer to improperly influence the conduct of audits.¹⁸⁹ Officers and directors may not “take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.”¹⁹⁰

2. Management’s Responsibility for Accounting

Section 302 of the Sarbanes-Oxley Act requires CEOs and CFOs to personally certify the financial statements that are filed by the issuer.¹⁹¹ These officers must certify that (1) the officer has reviewed the financial report; (2) to the officer’s knowledge the report does not contain or omit any material fact that renders the report misleading; (3) the financial report “fairly present[s] in all material respects the financial condition and results of operations”;¹⁹² (4) the signing officers are responsible for internal controls, have designed and evaluated such controls to ensure that the material information is made known to the signing officers, and have included in the report their conclusions regarding the effectiveness of their internal controls; (5) the signing officers have disclosed to the auditor any significant deficiencies in the internal controls and any fraud involving management or other employees who have a significant role in internal controls; and (6) the signing officers have indicated any changes that could “significantly affect internal controls subsequent to their evaluation.”¹⁹³ On June 27, 2002, the SEC ordered the CEOs and CFOs of companies reporting more than \$1.2 billion in revenue to certify their financial reports by August 14, 2002.¹⁹⁴

In a further attempt to hold chief officers accountable for financial reports, Section 304 provides for CEOs and CFOs to forfeit certain bonuses and profits in the event an issuer is required to prepare accounting restatements due to “material noncompliance of the issuer, as a result of misconduct.”¹⁹⁵ These officers must forfeit “any bonus or other incentive-based or equity-based compensation”¹⁹⁶ or “any profits realized from the sale of securities”¹⁹⁷ during the twelve-month period prior to filing the noncompliant financial report.

3. Additional Financial Disclosures

The Sarbanes-Oxley Act requires a number of new financial disclosures. Section 401 requires the disclosure of “all material correcting adjustments that have been

189. *Id.* § 303.

190. *Id.*

191. *Id.* § 302.

192. *Id.*

193. *Id.* § 302.

194. *SEC Staff Completes Processing of CEO, CFO Certification*, FED. SEC. L. REP. (CCH) No. 2040, at 2043 (Aug. 28, 2002).

195. Sarbanes-Oxley Act § 304(a).

196. *Id.* § 304(a)(1).

197. *Id.* § 304(a)(2).

identified by a registered public accounting firm.”¹⁹⁸ Section 401 also requires the issuer to disclose

all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses.¹⁹⁹

Section 401 further requires pro forma financial information to be presented in a manner that is not misleading and adheres to GAAP.²⁰⁰

Section 403 of the Sarbanes-Oxley Act requires directors, officers, and those owning more than ten percent of a company’s equity security to file a statement with the SEC disclosing ownership of the securities.²⁰¹ Section 404 requires annual reports filed with the SEC to state that management is responsible for establishing and maintaining an “adequate internal control structure and procedures for financial reporting” along with an assessment of those structures and procedures.²⁰² Section 406 requires each issuer to disclose whether the company has adopted a code of ethics for senior financial officers or, if not, to explain why no code has been adopted.²⁰³ Section 407 requires each issuer to disclose whether or not its audit committee contains at least one member who is a financial expert.²⁰⁴ Likewise, if the audit committee does not include a financial expert, the issuer must disclose why.²⁰⁵ The Act also requires issuers to disclose the approval by the audit committee of a non-audit service that is to be performed by the auditing accounting firm.²⁰⁶

198. *Id.* § 401.

199. *Id.*

200. *Id.*

201. *Id.* § 403.

202. *Id.* § 404.

203. *Id.* § 406.

204. *Id.* § 407.

[A]n audit committee financial expert means a person who has the following attributes: (i) An understanding of generally accepted accounting principles and financial statements; (ii) The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (iii) Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities; (iv) An understanding of internal controls and procedures for financial reporting; and (v) An understanding of audit committee functions.

Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110, 5127 (Jan. 31, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 249).

205. Sarbanes-Oxley Act § 407.

206. *Id.* § 202.

F. Analysis of New Rules and Procedures for Issuers

1. Analysis of Separation Between Management and Auditors

The requirement that each issuer have an independent audit committee is a valuable step toward removing potential conflicts of interest between the auditor and the company being audited. Historically, it has been management that contracted with accounting firms to perform audits and other accounting services.²⁰⁷ This brought into question the objectivity of the auditors, who could find it difficult to contradict the accounting practices of the management officials responsible for employing them. Section 301, in conjunction with Section 202, helps create a “forum apart from management where the accountants may discuss their concerns.”²⁰⁸

However, the effectiveness of these new rules critically depends on the audit committee’s understanding of accounting issues. Regrettably, the Sarbanes-Oxley Act does not require that any members of the audit committee be financial experts.²⁰⁹ Thus, there is a possibility that the audit committee will lack the financial sophistication to properly consider questionable accounting practices and to confront management regarding these practices.

The usefulness of these provisions also depends on the audit committee’s independence from both the accounting firm and management. These provisions do not address the conflicts of interest that arise because of political and social dependence among accounting firms and boards of directors. Despite this failing, the audit committee independence requirement gives the SEC some concrete criteria for evaluating the independence of directors and auditors.

Section 303, likewise, provides the SEC with a rule that can be used to punish officers or directors that inappropriately pressure auditors.²¹⁰ Although similar to existing rules,²¹¹ this is an added protection for the auditing process. The value of this provision, however, depends on the SEC’s willingness and ability to enforce it.

2. Analysis of Management’s Personal Responsibility for Financial Statements

The provisions of the Sarbanes-Oxley Act that bind senior officers to the accuracy of the issuer’s financial statements correctly identify management as a significant source of accounting problems. On June 27, 2002, the SEC ordered the CEOs and CFOs of companies reporting more than \$1.2 billion in revenue to certify

207. Strengthening the Commission’s Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6022 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274).

208. *Id.*

209. Section 407 requires issuers to disclose whether or not the audit committee contains at least one financial expert with an understanding of GAAP and experience in auditing. Sarbanes-Oxley Act § 407.

210. *See id.* § 303.

211. 17 C.F.R. 240.13b2-1 indicates that “[n]o person shall, directly or indirectly, falsify or cause to be falsified” accounting records. 17 C.F.R. 240.13b2-2 indicates that directors and officers shall not “[m]ake or cause to be made any materially false or misleading statements to an accountant” or “[o]mit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in the light of the circumstances under which statements were made, not misleading to an accountant....”

their financial reports by August 14, 2002.²¹² Section 302 extends the SEC's rule to all public companies.²¹³

According to the SEC, "the overwhelming majority of CEOs and CFOs filed statements certifying the material accuracy and completeness of their companies' prior disclosure reports."²¹⁴ The SEC struggled to wade through the initial 947 certifications and to determine what would happen to companies that did not comply.²¹⁵ The certifications required by Section 302 are expected to number about 14,000.²¹⁶ Undoubtedly, the sheer volume of the certifications calls into question the ability of the SEC to deal adequately with the certification process.

The provisions of Section 304 offer a more proactive approach to accounting accuracy. Incentive-based compensation and stock options are a popular form of executive compensation because they are believed to align management's interests with those of shareholders.²¹⁷ However, these forms of compensation also increase management's incentive to use creative accounting to meet earnings expectations.²¹⁸ Section 304 curbs some of that incentive by requiring CEOs and CFOs to forfeit bonuses and profits if the company is required to restate financial information.²¹⁹ Once again, however, the value of this provision will depend on the ability of the SEC to identify noncompliant reports and require restatements.

3. Implications of Additional Financial Disclosures

The financial disclosures required by the Sarbanes-Oxley Act will provide additional information to the investing public. The disclosures in Section 401 are the most beneficial. Requiring issuers to disclose corrections to financial statements made during the audit signals to investors that the auditor found a problem in the accounting and it was corrected. This both motivates the issuer to be careful that the accounting is done satisfactorily in the first place and provides investors with information that may help them consider the company's financial statements more carefully.

The requirement that off-balance sheet transactions be disclosed likewise provides valuable information for investors. Off-balance sheet transactions have been used to keep corporate debt off the balance sheet, misrepresenting a corporation's true liability and risk.²²⁰ This requirement forces issuers to more accurately represent their liabilities to investors.

212. *SEC Staff Completes Processing of CEO, CFO Certification*, FED. SEC. L. REP. (CCH) No. 2040, at 2043 (Aug. 28, 2002).

213. Sarbanes-Oxley Act § 302(a).

214. *SEC Staff Completes Processing of CEO, CFO Certification*, *supra* note 212.

215. Krissah Williams, *A Two-Way Race to Certify Financial Statements; Executives Scramble to Comply as Regulators Puzzle Over What to Do About Laggards*, WASH. POST, Aug. 13, 2002, at E1.

216. *Id.*

217. Eric L. Johnson, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 IOWA J. CORP. L. 145, 148 (2000).

218. *See supra* part II.E.

219. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (codified at 15 U.S.C. § 7243).

220. Enron used partnerships and other special purpose entities to keep billions of dollars of debt off its balance sheet. *See Enron Shareholders' Move Against Bank Is Rebuffed by Judge*, N.Y. TIMES, Feb. 28, 2003, at C5.

The other disclosures required by the Act are less valuable, in that they do not provide accounting information. They may, however, be useful for motivating issuers to adopt codes of ethics and place financial experts on the audit committee rather than explain why they have not done so.

V. CONCLUSION: THE VALUE OF THE SARBANES-OXLEY ACT DEPENDS ON THE ABILITY OF THE SEC AND PCAOB TO ENFORCE IT

The Sarbanes-Oxley Act approaches accounting reform holistically,²²¹ requiring the federal government, accountants, and issuers to take steps to improve the accuracy of financial statements. The creation of the PCAOB has the potential to improve corporate accounting and auditing. The PCAOB is authorized to use powerful tools, but investors will not benefit unless the board is willing and able to aggressively use those tools.

Unfortunately, the provisions of the Sarbanes-Oxley Act that address accounting firms and auditors do not offer the same potential for accounting reform. Many of the auditor independence rules are little more than a codification of previous SEC rules. Furthermore, the Act fails to prohibit auditing firms from performing tax services for audit clients. Thus, issuers continue to hold a powerful bargaining chip that may impair the accounting firm's objectivity.

The Sarbanes-Oxley Act makes a timely attempt to address corporate governance issues that impair the accuracy of financial information. The use of independent audit committees creates a needed firewall between management and auditors. Holding management accountable for financial information forces officers to take responsibility for the accuracy of financial statements. These provisions, combined with the increased disclosures, offer some helpful assurances that management is not simply creating the accounting figures they want the public to see.

On the whole, the Sarbanes-Oxley Act contains a number of provisions that have the potential to improve corporate accounting practices. However, the legislation leaves to the SEC and the PCAOB the responsibility to implement and enforce the legislation. Due to political forces and serious resource constraints, it is unclear if these agencies will be able to implement the Act. Whether these agencies will be able to effectively implement the Sarbanes-Oxley Act to improve corporate accounting and protect investors remains to be seen.

221. Many have called the Sarbanes-Oxley Act sloppy legislation, a hodgepodge of provisions. *See generally* David Futrelle, *What Is the Government Doing to Help?*, MONEY, Sept. 2002, at 81; Pamela Yip, *Oath Brings Angst for Execs; Corporate Leaders Scramble to Comply with Reform Bill; Lawyers Try to Help Sort Out Accounting Details as Deadline to Certify Statements Nears*, DALLAS MORNING NEWS, Aug. 11, 2002, at 1H.