2003

Exploring the Sarbanes-Oxley Act: Will Government Intervention in the Public Accounting Profession Prevent Another Enron?

Sally S. Spielvogel
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj

Part of the Banking and Finance Law Commons

Click here to let us know how access to this document benefits you.

Recommended Citation
Available at: https://uknowledge.uky.edu/klj/vol92/iss1/10

This Note is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledge@lsv.uky.edu.
Exploring the Sarbanes-Oxley Act: 
Will Government Intervention in the 
Public Accounting Profession 
Prevent Another Enron?

BY SALLY S. SPIELVOGEL

I. INTRODUCTION

Each Day Every Day In big cities and small towns. Away from the headlines. We are here. Auditing financial statements. Providing tax services. And delivering Business Insight. Counted on for our integrity. Passionate about getting it right. And intolerant of those who break the rules. We depend on your trust and work to earn it each day, every day.¹

Certified Public Accountants ("CPAs") historically have enjoyed an excellent public reputation. CPAs’ involvement in Enron’s downfall, however, has taken a toll on the profession. The opening quote, taken from the American Institute of Certified Public Accountants’ ("AICPA") first annual report since the Enron debacle, provides evidence that the profession is serious about restoring the public’s confidence in its members.

Before Enron’s downfall, companies relied on CPAs for their expertise in providing a variety of services, including traditional audit and tax functions and consultation, internal audit, and information system design. CPAs were well suited for these responsibilities. Those who worked in

public accounting understood their clients' accounting systems and recognized that the products of those systems were necessary for making sound financial decisions. An in-depth understanding of clients' financial anatomy allowed CPAs to tailor their services based on the clients' needs.

In 2001, events at Enron substantially affected the public accounting profession. The public depended on Enron's audited financial statements to make investment decisions and had confidence in the integrity of those statements. By the time Enron filed for bankruptcy, the public felt deceived because the investment decisions it had made were based on illusory financial statements. In placing blame, the public accounting profession was an obvious choice. In the wake of the Enron scandal, Congress saw the need to restore the public's investing confidence. Within nine months of Enron's collapse, the government responded by enacting the Sarbanes-Oxley Act of 2002 ("the Act").

This Note will explore the Act and its effect on the public accounting profession. Part II of this Note will provide a brief description of the events at Enron with a focus on Arthur Andersen's role. This part will also identify two factors contributing to the misbehavior of Arthur Andersen employees. Part III of this Note will describe the regulatory framework of the public accounting profession before the Act. Part IV of this Note will describe the Act and its purpose. Part V will contain the majority of the analysis of the Act. This section of the Note will isolate specific requirements under the Act and compare them with pre-Act requirements. This part of the Note will also address whether the Act's requirements are designed to deter future misbehavior similar to Arthur Andersen's employees in the Enron debacle. Part VI of this Note will address ancillary issues in the Act including the role that attorneys played in Enron.

2 For the purposes of this Note, the public accounting profession refers to CPAs who work as a part of CPA firms.

3 Products of a company's accounting system are the balance sheet, income statement, cash flows statement, and statement of retained earnings among others.


5 See infra notes 14-43 and accompanying text.

6 See infra notes 37-43 and accompanying text.

7 See infra notes 44-52 and accompanying text.

8 See infra notes 53-62 and accompanying text.

9 See infra notes 63-180 and accompanying text.

10 See infra notes 63-180 and accompanying text.

11 See infra notes 63-179 and accompanying text.
studies mandated by the Act, and the potential cascade effect of the Act. Part VII will conclude this Note.

II. ARTHUR ANDERSEN’S ROLE IN ENRON

Arthur Andersen (“Andersen”) audited the financial statements of Enron from 1997 to 2000, and in each of those years, Andersen issued an opinion that Enron’s financial statements fairly presented the corporation’s financial condition. The financial statements, however, omitted important

12 See infra notes 181-204 and accompanying text.
13 See infra notes 205-09 and accompanying text.
14 After a financial statement audit is complete, the auditor issues an “Independent Accountant’s Report” that gives an opinion on the financial statement. The following, for illustrative purposes, is one of the reports issued by Andersen along with Enron’s financial statements (from 1997 to 2000 the opinion was the same as the following illustration):

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS
To the shareholders and Board of Directors of Enron Corp.:
We have audited the accompanying consolidated balance sheet of Enron Corp. (an Oregon corporation) and subsidiaries as of December 31, 2000 and 1999, and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders’ equity for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of Enron Corp.’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Enron Corp. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations, cash flows and changes in shareholders’ equity for each of the three years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP
information about some high risk, losing investments that Enron owned and
thus did not fairly represent Enron's financial condition.

Enron, formed during a 1985 merger, was originally involved in the
natural gas pipeline industry. Because that industry was highly regulated,
there was a ceiling on the rate of return that Enron could achieve. To
avoid this ceiling in order to increase Enron's overall rate of return, Enron
made high risk investments in unregulated industries. The company
formed special entities (known as Special Purpose Entities or SPEs) to own
those investments, and Enron was a substantial owner of those entities.
In addition, Enron executives personally invested in the SPEs and received
extremely high returns. One Enron in-house attorney invested $5800 and
received a $1 million windfall from her investment in the special entities.

Despite initial substantial returns, the risky investments eventually lost
money and thus the entities owning the investments lost money. As a
substantial owner of these entities, Enron lost money, too, but this poor
financial picture was not painted for the investing public.

Typically, when two entities are substantially intertwined due to
common ownership, their financial statements are consolidated before they
are presented to the public. If the SPEs' financial statements had been
consolidated with Enron's, Enron's financial well-being (or not-so-well-
being) would have been more fairly presented to the investing public;

1024401/000102440101500010/0001024401-01-500010.txt (last visited No. 17,
2003).

Deborah L. Rhode & Paul D. Paton, Lawyers, Ethics, and Enron, 8 STAN.
J.L. BUS. & FIN. 9, 13 (2002).

Over time, Enron's business focus shifted from regulated transportation
of natural gas to energy trading in an unregulated environment. During this
evolution, top management ventured away from traditional approaches to
the core business in order to generate higher financial returns. According
to a Congressional Research Service Report, 'the guiding principle seems
to have been that there was more money to be made in buying and selling
financial contracts linked to the value of energy assets (and to other
economic variables) than in the actual ownership of physical assets.'

Id.

CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Finan-
cial Accounting Standards No. 94 ¶ 61 (Financial Accounting Standards Bd. 2002).
however, the financial statements of Enron and the special entities were not consolidated. Enron avoided combining the financial statements of the SPEs with its own because the accounting standards pertaining to such combinations were vague. Enron’s decision not to combine the financial statements was based on a technical reading of the accounting regulations instead of an attempt to comply with the spirit of accounting, which is to provide an accurate portrayal of a company’s financial position.

Andersen was heavily involved in Enron’s financial decisions, as evidenced by the fees received by Andersen for its services to Enron. In 2001, Andersen received $27 million for non-audit financial services to Enron and another $25 million for audit services. There were two separate times when Andersen could have advised Enron in its decision to combine or not to combine the financial statements. First, Enron looked to Andersen for advice when it made the initial decision not to combine its financial statements. Second, when Andersen audited Enron’s financial statements, Andersen should have revisited the decision not to combine the financial statements in order to issue its opinion that the financial statements were presented fairly. It was Andersen’s responsibility as an auditor to be objective in determining if the financial statements should or should not be combined.

In hindsight, the financial statements should have been combined. The special entities were eventually terminated due to substantial losses from their investments. The September 2001 announcement that the special entities would be terminated “was the first public disclosure even hinting at the severity of the problems.” In November 2001, Enron announced that it was restating $1.5 billion of losses by charging the losses against its income. The restatements resulted from Enron’s failure to combine the SPEs’ financial statements with its own. In December 2001, Enron filed for Chapter 11 bankruptcy.

---

26 See Worden, supra note 24, at 513.
27 See id.
29 Id.
30 Id.
31 See id.
32 Id.
Andersen erred when it did not advise Enron to combine the SPEs' financial statements. Andersen made a greater error when it issued a clean opinion for Enron's financial statements. However, Andersen's biggest mistake came after Enron filed for bankruptcy, when employees of the accounting firm destroyed documents related to Enron.\textsuperscript{33} Andersen officials admitted that a significant number of documents was shredded between October and November 2001.\textsuperscript{34} As a result, Andersen was later charged with obstruction of justice.\textsuperscript{35}

Andersen did not fare much better than Enron in the aftermath of the scandal. One commentator noted that Andersen "derived less than one percent of its business from Enron-related matters. Yet the accounting firm imploded in less than a year when its other clients fled after public exposure of the firm's alleged role in the creation of misleading public reports of Enron investment structures."\textsuperscript{36} Indeed, the Enron debacle and Andersen's misdeeds created suspicion of the public accounting industry.

Why did Andersen perform as it did with Enron? Andersen lacked objectivity. William T. Allen and Arthur Siegel of the Independence Standards Board\textsuperscript{37} listed these five threats to objectivity:

a. Self-interest threats—threats that arise from auditors acting in their own interest. . . .

b. Self-review threats—threats that arise from auditors reviewing their own work or the work done by others in their firm. . . .

c. Advocacy threats—threats that arise from auditors or others in their firm promoting or advocating for or against an auditee. . . .

\textsuperscript{33} See id. at 22.

\textsuperscript{34} Id. ("Media reports chronicled the accumulation of more than eighteen trunks and thirty boxes of documentary debris on only one of the days at one of the offices.").

\textsuperscript{35} See id. at 23.

\textsuperscript{36} Id. at 10.

\textsuperscript{37} William T. Allen & Arthur Siegel, Conflicts of Interest in Corporate and Securities Law: Threats and Safeguards in the Determination of Auditor Independence, 80 WASH. U.L.Q. 519 (2002). The ISB was formed to develop "a conceptual framework for independence applicable to audits of public entities which will serve as the foundation for the development of principles-based independence standards."

Id. at 525 (quoting Independence Standards Board Operation Policies, art. 1, para. 1.B, at http://www.cpaindependence.org. "Events in the form of changing political climate . . . led the SEC to abandon its commitment to the ISB as an agency for formulating independence concepts (subject to SEC acceptance). The ISB, at the suggestion of the SEC, dissolved in July of 2001." Id. at 525.
d. Familiarity (or trust) threats—threats that arise from auditors being influenced by a close relationship with an auditee.

e. Intimidation threats—threats that arise from auditors being, or believing that they are being, overtly or covertly coerced by auditees or by other interested parties. 38

Of the five threats listed, self-interest and familiarity threats were the primary reasons for Andersen’s lack of objectivity. As noted previously, in 2001, Andersen received $25 million for Enron’s audit, and another $27 million for non-audit services. 39 This amounted to $1 million a week in fees from Enron. 40 While these fees represented only a small portion of Andersen’s total fees received, 41 it is likely that the Andersen staff and partners associated with Enron’s account received personal gains for their work. At a minimum, retaining a satisfied client could have advanced an accountant’s potential career opportunities at Andersen and at Enron. Familiarity threats also impaired the objectivity of the Andersen staff. Andersen employees had offices at Enron headquarters where they worked throughout the year. 42 Accounting staff assigned to a particular client for multiple years often create relationships with the client’s employees similar to the relationships between co-workers.

The Sarbanes-Oxley Act was the government’s response to the problems that arose from the public accounting profession’s lack of objectivity, necessary to perform the “public watchdog” function that auditors are expected to perform. 43 If the Act’s requirements had been imposed years ago, would it have prevented Andersen’s role in Enron’s demise? Since self-interest and familiarity threats were the underlying issues that prompted Andersen’s actions, the question can be restated: If the Act had been imposed years ago, would the self-interest and familiarity threats to Andersen’s objectivity in dealing with Enron have been substantially reduced or eliminated?

To answer this question, the regulatory system that existed when Enron collapsed must be examined. Also, the Act’s provision must be examined to determine what changes it makes to current practices. Finally, one must

38 Id. at 528-29.
39 Worden, supra note 24, at 521.
40 Id.
41 See Rhode & Paton, supra note 15, at 10.
43 See Worden, supra note 24, at 516-17.
address whether those changes will reduce or eliminate the threats identified previously.

III. REGULATORY FRAMEWORK OF THE PUBLIC ACCOUNTING PROFESSION BEFORE THE SARBANES-OXLEY ACT

State boards of accountancy regulate the threshold standards required to become a CPA and to practice in the public accounting profession. Many standards are uniform among states; however, there are variations. Examples of these standards include requiring higher education credit hours in accounting courses, passing the uniform CPA examination, and mandatory apprenticeships with an experienced CPA. Once CPA candidates meet the necessary requirements, they receive a license to practice from the appropriate state board of accountancy. The board is then responsible for the renewal of CPA licenses and the monitoring of continuing education requirements. The licensing scheme is analogous to that of the legal profession and the regulations of the American Bar Association.

Once licensed, a CPA is eligible for membership in the AICPA,\(^4\) which offers both individual and firm memberships. Because membership in the AICPA lends credibility to a public accounting firm’s reputation, rarely would a public accounting firm choose not to be a member. In addition, AICPA membership provides the firm with a professional association advantageous for sharing information, technical advice, journal subscriptions, group health or life insurance programs, and other services.

Once a member of the AICPA, public accountants are subject to the standards and rules promulgated by the organization, such as the Code of Professional Conduct.\(^5\) This Code contains certain guiding principles and rules concerning ethical issues facing the public accounting profession. Additionally, the AICPA has also established the Statements on Auditing Standards, which serve as auditing guidelines, giving precise instructions

---

\(^4\) In addition to seeking membership to the AICPA, a CPA also seeks a membership in their parallel state institute of Certified Public Accountants. For example, a CPA in Kentucky is licensed by the Kentucky State Board of Accountancy, and then may choose to seek membership in the American Institute of Certified Public Accountants and the Kentucky Society of Certified Public Accountants.

on every aspect of the audit process. Additionally, the AICPA has also enacted peer review standards for its members, which provide a process through which the AICPA can monitor its members’ compliance with the organization’s governing standards. Members of the AICPA who audit public companies must also join the AICPA senior committee known as the Securities Exchange Commission Practice Section (“SECPS”). To obtain the mandatory membership to the SECPS, a public accounting firm must meet stringent membership requirements.

Recently, the Securities and Exchange Commission (“SEC”) issued additional regulations for companies that audit financial statements filed with the SEC. These requirements were intended to heighten the standards concerning auditor independence. Due to implementation dates in the regulations, however, many regulatory requirements have not yet been integrated into the public accounting profession.

For purposes of the Part V analysis, it will be assumed that public accountants are all properly licensed by their state boards of accountancy and that they are members of the AICPA. In summary, subject to the above assumption, the public accounting profession must comply with the following regulations when auditing financial statements: (1) AICPA Code of Professional Conduct; (2) AICPA Statements on Auditing Standards; (3) AICPA Peer Review Standards; (4) SECPS Membership Requirements (if

---


47 2 AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, Peer Review, in AICPA PROFESSIONAL STANDARDS 17,651, 17,651 - 17,921 (2001) [hereinafter Peer Review].


51 Id. ("Section 210.2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client.")

52 Id. § 210.2-01(e).
the public accounting firm is an auditor of public companies); and, (5) 17 C.F.R. § 210.2-01 (if the public accounting firm audits financial statements that are filed with the SEC).

IV. REGULATORY FRAMEWORK OF THE PUBLIC ACCOUNTING PROFESSION AFTER THE SARBANES-OXLEY ACT

The Act was passed in July 2002, and it is divided into eleven sections called "Titles." This analysis of the Act will focus on Title I, Public Company Accounting Oversight Board; Title II, Auditor Independence; and Title VIII, Corporate and Criminal Fraud Accountability. The Act is a federal law that adds to existing regulations described in Part III. The Act created the Public Company Accounting Oversight Board ("PCAOB") to promulgate regulations that apply to public accounting firms registered with the PCAOB. The application of these regulations will be discussed in more detail in Part V. Generally, the PCAOB regulations will apply to public accounting firms that audit public companies.

The Act mandates that the PCAOB impose minimum requirements on the accounting firms registered with it. The PCAOB will pass detailed regulations in addition to the minimum requirements to achieve the purported purpose of the Act, which is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." In promulgating the regulations, the PCAOB is encouraged to adopt standards proposed by other public accounting regulatory agencies, such as the AICPA. The minimum requirements stated in the Act will be the focus of this Note.

V. ANALYSIS OF THE SARBANES-OXLEY ACT

As discussed in Part IV, the Act establishes minimum requirements that the PCAOB must promulgate. Since the Act was passed in response to

---

54 Id.
55 See supra notes 44-52 and accompanying text.
57 Id. § 7213(a)(1).
58 See infra notes 63-179 and accompanying text.
60 Id. § 7213(a)(3).
63 See supra notes 53-62 and accompanying text.
Enron, it is logical to assume that legislators intended for the Act’s requirements to prevent a future Enron debacle. In Part II, self-interest and familiarity were recognized as threats to Andersen’s objectivity in dealing with Enron. This section of the Note will analyze the new requirements of the Act as they relate to the public accounting profession. These requirements will be compared to the pre-Act regulations that were discussed in Part III. Then the following question will be addressed with each new requirement analyzed: Will the difference between the new requirements and the pre-Act regulations substantially reduce or eliminate the self-interest and familiarity threats in order to prevent the public accounting profession from contributing to a future Enron?

A. Title I—Public Company Accounting Oversight Board

1. Development and Composition of the Public Company Accounting Oversight Board

The most notable requirement of the Act is the establishment of the PCAOB. The PCAOB is a non-profit organization that will exist until Congress dissolves it. The Act mandates that PCAOB consist of five members, two CPAs and three non-CPAs. The Chairperson of the PCAOB cannot be a CPA unless he or she has not practiced in the public accounting field within a five-year period before his or her appointment as a PCAOB member. Members of the PCAOB must be knowledgeable in financial disclosures required of public companies that file with the SEC. In addition, members are to be “prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public . . . .” The members will serve on a “full-time basis” for up to two five-year terms, and they “may not, concurrent with service on the Board, be employed by any other person or engage in any other professional or business activity.” Registration fees collected by the

64 See supra notes 14-43 and accompanying text.
65 See supra notes 44-52 and accompanying text.
67 Id. § 7211(e).
68 Id. § 7211(e)(2).
69 Id. § 7211(e)(2).
70 Id.
71 Id. § 7211(e)(3).
72 Id. § 7211(e)(5)(A), (B).
73 Id. § 7211(e)(3).
The purpose of the PCAOB is to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.75

The AICPA Board of Directors and the SECPS committee are the pre-Act governing bodies designed to oversee the audits of public companies.76 The AICPA is a non-profit organization;77 its Board of Directors is composed of a chairman, vice chairman, immediate past chairman, president, sixteen present or former members of the AICPA council, and three representatives who are not members of the AICPA.78 The SECPS is a senior committee of the AICPA that is composed of fourteen representatives from public accounting firms that audit public companies.79 The AICPA recognizes its responsibility to the investing public in its Code of Professional Conduct as follows:

A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.80

---

74 Id. § 7219(c)(1).
75 Id. § 7211(a).
79 SECPS REFERENCE MANUAL, supra note 76, § 1000.09 to 1000.10.
80 Code of Professional Conduct, supra note 45, at 4301.
The purposes of the PCAOB and the AICPA are consistent, yet a composition of the two governing bodies evinces significant differences. A majority of the PCAOB are non-CPAs,\textsuperscript{81} while the AICPA’s twenty-three member Board only has three non-CPA members.\textsuperscript{82} The PCAOB makeup may reduce the self-interest threat in the public accounting industry because non-CPA members are likely to have the objective distance necessary to place investor needs before client or firm needs when promulgating new standards. While the composition of the PCAOB and AICPA might result in more objective standards, it is not clear that unethical CPAs will be deterred. One commentator questioned whether Enron was the result of individual deceit, and noted that “[t]here will always exist businesspeople willing to take shortcuts.”\textsuperscript{83} Furthermore, except to the extent that non-CPAs are more willing to promulgate rules to limit familiarity between auditors and auditees, the composition of the PCAOB will not reduce the familiarity threat.

2. Registration with the Public Company Accounting Oversight Board

Under the Act, a public accounting firm must be registered with the PCAOB in order to audit a public company.\textsuperscript{84} The public accounting firm is then required to file annual reports with the PCAOB.\textsuperscript{85} The annual report must include the names of all the public companies that the accounting firm audits and must disclose the fees received by the accounting firm from the public companies for audit and non-audit services.\textsuperscript{86} Also, all professional staff within a registered public accounting firm involved with public company audits must be disclosed in the annual report.\textsuperscript{87}

Nevertheless, all public accounting firms auditing one or more companies registered with the SEC have been required to join the SECPS since 1990.\textsuperscript{88} Once a member, the public accounting firm is required to file annual reports with the SECPS;\textsuperscript{89} the reports include the number of public

\begin{itemize}
\item \textsuperscript{81} 15 U.S.C. § 7211(e) (2003).
\item \textsuperscript{82} Bylaws, supra note 48, at 5441.
\item \textsuperscript{84} 15 U.S.C. § 7212(a).
\item \textsuperscript{85} Id. § 7212(d).
\item \textsuperscript{86} Id. § 7212(b)(2).
\item \textsuperscript{87} Id. § 7212(b)(2)(E).
\item \textsuperscript{88} See Bylaws, supra note 48, at 5361.
\item \textsuperscript{89} SEC PRACTICE SECTION—REQUIREMENTS, supra note 49, para. g.
\end{itemize}
companies audited and the gross fees received by the accounting firm from those clients.\footnote{Id.}

The most notable difference between the pre- and post-Act requirements is that the PCAOB registration and filing system requires more detailed information.\footnote{See infra notes 92-93 and accompanying text.} Specificity provides for more efficient monitoring of familiarity threats and self-interest. The PCAOB annual reports monitor familiarity by naming the individual CPAs associated with the auditee,\footnote{See 15 U.S.C. § 7212(b)(2)(E).} and the reports monitor self-interest by requiring disclosure of all financial benefits that flow from auditee to auditor.\footnote{Id. § 7212(b)(2)(B).} The AICPA and SECPS annual filing system also monitors the threats, albeit less effectively. The Act creates a new registration process that overlaps with the pre-Act registration process. The incremental specificity of the PCAOB process over the AICPA process will reduce self-interest and familiarity threats.

3. Audit Workpaper Retention

The Act imposes a new audit workpaper retention requirement.\footnote{Id. § 7213(a)(2)(A)(i).} Audit workpapers include detailed evidence of the work that a public accounting firm performed during an audit.\footnote{For a definition of workpapers, see U.S. Auditing Standards, supra note 46, at 606.} These workpapers contain significant information concerning findings during an audit and decisions made by auditors concerning disclosure of those findings.\footnote{See id.} The Act now requires a public accounting firm registered with the PCAOB to retain their audit workpapers for seven years.\footnote{See 15 U.S.C. § 7213(a)(2)(A)(i).}

In comparison, the AICPA regulatory framework does not impose a specific period for workpaper retention.\footnote{See U.S. Auditing Standards, supra note 46, at 607.} It does, however, address this issue. Statements on Auditing Standards state that the "auditor should adopt reasonable procedures for safe custody of his working papers and should retain them for a period sufficient to meet the needs of his practice and to satisfy any pertinent legal requirements of records retention."\footnote{Id.}
It is unclear which of the two audit workpaper retention standards is most likely to reduce self-interest and familiarity threats to auditor independence. The bright-line Act requirement has the attractive feature of giving notice, while the AICPA requirement is more flexible. The Act's requirement overlaps with the AICPA requirement providing, at best, a small reduction of self-interest and familiarity threats.

4. Second Partner Review

The Act requires a second partner review.\(^\text{100}\) To understand this requirement, it is necessary to briefly describe the audit process.\(^\text{101}\) An audit begins with planning, and once the planning phase is complete, fieldwork begins.\(^\text{102}\) During fieldwork, the audit team studies detailed accounting records in order to determine if elements of the auditee's financial statements are reported correctly.\(^\text{103}\) After fieldwork is finished, the audit team prepares its opinion.\(^\text{104}\) The partner-in-charge of the audit then carefully reviews the work of the audit team and signs off on the audit.\(^\text{105}\) The second partner review requirement of the Act mandates that another partner in the firm who is not associated with the auditee sign off on the audit work as well.\(^\text{106}\)

The pre-Act requirement for second partner review was identical. The AICPA addressed this issue in its quality control standards,\(^\text{107}\) and the SECPS addressed it in its membership requirements.\(^\text{108}\) AICPA quality control standard, QC Section 20.18, in instructing members on how to design their firm's quality control system, states:


\(^{101}\) This description of the audit process is oversimplified, but it is sufficient to illustrate the meaning of a second partner review.

\(^{102}\) 2 AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, International Standards on Auditing, in AICPA PROFESSIONAL STANDARDS 12,001, 12,311 - 12,312 (2001).

\(^{103}\) See generally id. at 12,311 - 12,385 (detailing general procedures for auditing).

\(^{104}\) See generally id. at 12,421 - 12,430 (describing the auditor's report on financial statements).

\(^{105}\) See id. at 12,425.


\(^{107}\) See 2 AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, Quality Control, in AICPA PROFESSIONAL STANDARDS 17,001, 17,034 (2001) [hereinafter Quality Control].

\(^{108}\) See SEC PRACTICE SECTION—REQUIREMENTS, supra note 49, para. f.
To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover . . . supervising [and] reviewing . . . the results of each engagement. Where applicable, these policies and procedures should also address the concurring partner review requirements applicable to SEC engagements as set forth in membership requirements of the SEC Practice Section of the AICPA.  

Furthermore, the SECPS mandates a second partner review in its membership requirements as follows:

Member firms shall be obligated to . . . [e]stablish policies and procedures that meet the requirements set forth in the SECPS Reference Manual, for a concurring review of the audit report and the financial statements by a partner other than the audit partner-in-charge of an SEC engagement before issuance of an audit report on the financial statements of an SEC engagement . . . .

The Act adds nothing new by mandating a second partner review, and there is no concurrent reduction of the self-interest or familiarity threats to the objectivity of a public accountant or a public accounting firm.

5. Public Company Accounting
   Oversight Board Quality Control Standards

The Act requires that the PCAOB promulgate quality control standards that would apply to public accounting firms registered with the PCAOB. Those quality control standards relate to: (1) monitoring professional ethics and independence; (2) in-firm consultation on accounting and auditing questions; (3) hiring, professional development, and advancement of personnel; (4) acceptance and continuation of engagements; and (5) internal inspection and other requirements. The AICPA has promulgated, in its quality control standards, regulation on each of the five topics listed in the Act noted above as follows: (1) Quality Control Standards Sections 20.09 and 20.10 regulate “[i]ndependence, [i]ntegrity, and [o]bjectivity;” (2) Quality Control Standards Section 20.18 regulates “[e]ngagement [p]erfor-
mance," which includes supervision;\footnote{114} (3) Quality Control Standards Section 40.02 regulates "[p]ersonnel [m]anagement;"\footnote{115} (4) Quality Control Standards Sections 20.14 and 20.15 regulate "[a]cceptance and [c]ontinuance of [c]lients and [e]ngagements;"\footnote{116} and (5) Quality Control Standards Section 30.03 regulates "[m]onitoring [p]rocedures."\footnote{117}

Once again, the Act adds nothing new to quality control standards, given that the AICPA has been regulating these issues for years. The AICPA quality control standards are mandatory for public accountants wishing to maintain good standing with the AICPA.\footnote{118} Violations of the standards would result in sanctions.\footnote{119} Likewise, the PCAOB quality control standards are mandatory for public accountants wishing to maintain good standing with the PCAOB.\footnote{120} Violations of those standards would also result in sanctions.\footnote{121} It is likely that the PCAOB will rely on the regulations of the AICPA when promulgating its own regulations.

6. Public Company Accounting Oversight Board Inspection

The Act charges the PCAOB with the duty of inspecting public accounting firms that are registered with it.\footnote{122} The public accounting firms are to be inspected tri-annually if they audit less than one hundred public companies in a year, and annually if they audit more than one hundred public companies in a year.\footnote{123} The inspections are required to include an examination of selected audit workpaper files, evaluation of the quality control that a firm has in place, and other procedures that are appropriate and necessary.\footnote{124} In comparison, the SECP requires its members to undergo peer review every three years.\footnote{125} The AICPA peer review includes selected engagements and a review of a firm’s compliance with its system of quality control at all organizational and functional levels within the firm.\footnote{126}
The substance of the PCAOB inspection and AICPA peer review are almost the same. A notable difference in the two systems is that under the Act, public accounting firms auditing more than one hundred public companies must undergo inspection annually.\textsuperscript{127} This enhanced inspection requirement will be effective in reducing self-interest and familiarity threats because undergoing scrutiny by CPAs who are not members of the firm allows self-interest and familiarity threats to be detected and eliminated. The two systems overlap, but the Act does add additional protection.

7. Sanctions and Disciplinary Proceedings

In order to warrant punishment, violations under the Act must rise to the level of either intentional or knowing conduct, which includes reckless or repeated instances of negligent conduct.\textsuperscript{128} Punishments include temporary suspension or permanent revocation of registration, a prohibition against any association between a CPA and a registered public accounting firm, civil penalties, censures, or additional required professional education.\textsuperscript{129} Notice of sanctions is to be made by publication.\textsuperscript{130}

Under AICPA regulation, disciplinary options include expulsion or suspension from the AICPA.\textsuperscript{131} This punishment would include expulsion from the SECPS, which would end relationships between public accounting firms and public companies. Notice of the disciplinary action taken is made by publication.\textsuperscript{132}

The Act and the AICPA differ very little in their disciplinary procedures. Discipline for a professional under either of the schemes would be detrimental to his or her career, and the Act's disciplinary provisions add little to the pre-existing scheme. It is not likely that the Act's provisions will reduce the self-interest and familiarity threats.

8. Summary

Title I will dramatically change the structure of the public accounting profession. In analyzing the establishment of the PCAOB, this section of the Note has identified four ways that the new governing body will attempt

\textsuperscript{128} Id. § 7215(c)(5).
\textsuperscript{129} Id. § 7215(c)(4).
\textsuperscript{130} Id. § 7215(d).
\textsuperscript{131} See Bylaws, supra note 48, at 5931.
\textsuperscript{132} Id. at 5971.
to reduce self-interest and familiarity threats. They are as follows: (1) The PCAOB will be constituted by a majority of non-CPAs, which will reduce the conflict inherent in both regulating and benefiting from the accounting profession; (2) Enhanced specificity of annual reports filed by public accounting firms with the PCAOB will simplify monitoring of self-interest and familiarity between an auditor and an auditee; (3) A bright-line audit workpaper retention requirement will provide notice to CPAs who may be tempted to destroy workpapers to advance their self-interests; and (4) Annual inspections of public accounting firms that audit public companies will provide an objective assessment of whether or not self-interest and familiarity threats exist. While acknowledging the above four advantages of the Act, it must be noted that the advantages do not outweigh the dramatic change that the Act will have on the public accounting profession. These changes could have been implemented another way, such as through action taken by the AICPA, which was not afforded the time to adapt to Enron's failure and act on its own before the federal government took action. Alternatively, the federal government could have promulgated the regulations that create the previously mentioned advantages through the SEC. The government chose, however, to create an entirely new governing body with substantial overlap between these existing governing bodies.

B. Title II—Auditor Independence

The foundation of the public accounting profession is independence and objectivity. Traditionally, auditors have had little stake in their audit

133 The benefit of this Sarbanes-Oxley requirement is not entirely clear. As noted in subsection 3, the new Sarbanes-Oxley requirement does not have the flexibility that is found in the AICPA requirement. See supra notes 94-99 and accompanying text.

134 See, e.g., Code of Professional Conduct, supra note 45, at 4321 (“[A] member who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interest.”); id. at 4341 (“Integrity requires that service and the public trust not be subordinated to personal gain and advantage. Objectivity and independence require that members be free from conflicts in discharging professional responsibilities.”); U.S. Auditing Standards, supra note 46, at 161 (“In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.”); id. (independence implies a “judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may
clients, but as the complexity of business has developed, auditors have become financial advisors providing non-audit services. One commentator noted that non-audit services made up fifty percent of the top five public accounting firms' revenues in 1999 versus thirteen percent in 1981, and that many public accounting firms underprice their audit services in order to gain more profitable non-audit services from the auditee. It is well recognized by the public accounting profession that the combination of audit and non-audit services can decrease an auditor's objectivity toward its audit client, thus impairing independence. Auditors gain financially, however, by using their expertise to attract additional services and fees. In addition, auditees receive benefits from their auditor's expertise in the form of higher quality services. Consequently, there is a tension between impairing independence and exploiting the benefits that can arise from the auditor/auditee relationship. Until the Act was imposed, that tension had been remedied by impressing upon auditors the need to retain professional skepticism towards their clients and to take responsibility for dealing with individual independence impairments. As noted above, independence impairments that threaten objectivity arise from self-interest and familiarity. The components of the Act analyzed in this section attempt to address this problem by reducing self-interest and familiarity threats that arise from auditor independence impairments.

otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

See Worden, supra note 24, at 516.

Id. at 517. Furthermore, revenues from non-audit services grew twenty-six percent at public accounting firms from 1993 to 1999, compared to a nine percent increase in the growth from audit services. Id.

See id. at 517-18.

See id. at 516-17.

Id. at 523.

See, e.g., U.S. Auditing Standards, supra note 46, at 295 ("Due professional care requires the auditor to exercise professional skepticism.").

See Allen & Siegel, supra note 37, at 528-29.
1. Prohibition Against Audit and Non-Audit Services

The Act requires a registered public accounting firm that performs an audit to refrain from providing non-audit services. The prohibited non-audit services include bookkeeping, designing financial information systems, appraisal and valuations services, actuarial services, internal audit outsourcing services, management functions, investment advisor services, and legal services. The Act provides some flexibility by retaining the option to waive the prohibition in some circumstances.

The SEC has passed regulations minimizing non-audit services as well. 17 C.F.R. section 210.2-01 prohibits bookkeeping, designing financial information systems, appraisal and valuations, actuarial services, internal audit outsourcing services, managerial services, broker services, and legal services if the public accounting firm is also performing that company's audit. Several of the prohibitions are limited in application. For example, auditors may assist in designing information systems, appraisals and valuations, and actuarial services if management of the company does the work, expresses determinations, and maintains involvement in and control over the project. Internal audit services can be performed if the company is less complex or if the total hours the auditors spend on those services are less than a certain percentage of the total internal audit hours. It is important to note that the statutory prohibition against appraisal and valuations and internal audit services did not take effect until August 5, 2002, almost a year after Enron's trouble began.

It is questionable whether the Act's attempt to curtail non-audit services will reduce the self-interest and familiarity threats. At first glance, the Act appears to be more of a blanket prohibition with fewer exceptions than found in the SEC regulation. The Act did leave room for flexibility, however, and it will be interesting to see whether rules promulgated by the

---

144 Id.
145 Id. § 7231.
147 Id.
148 Id.
149 Auditors may perform internal audit services if the auditee has $200 million in assets or less. Id. § 210.2-01(c)(4)(v)(A).
150 An auditor can perform up to forty percent of the total hours spent on internal audit within a company. Id.
151 Id. § 210.2-01(e)(1)(i).
PCAOB will destroy that flexibility. Even if the Act is a blanket prohibi-
tion, the effect may not be a decrease of the self-interest and familiarity
threats. Under the Act, one public accounting firm registered with the
PCAOB will perform the client’s audit while another public accounting
firm provides the same client with non-audit services. This may create new
problems, such as alliances between accounting firms that increase self-
interest and familiarity. Further, it is possible that the public accounting
firm performing non-audit services will not fall under the governing
umbrella of the PCAOB. It is at best unclear that the Act’s attempt to
diminish non-audit services will positively affect auditor self-interest and
familiarity.

2. Rotation of Audit Partners

The Act requires that the partner-in-charge of an audit and the second
reviewing partner rotate off of a client’s audit after five consecutive
years. The audit could then be assigned to other partners within the
public accounting firm who have not been involved with the audit. Partner rotation, however, was already a membership requirement of the
SECPS. That provision obligates an audit firm to “[a]ssign a new audit
partner to be in charge of each SEC engagement that has had another audit
partner-in-charge for a period of seven consecutive years, and prohibit such
incumbent partner from returning to in-charge status on the engagement for
a minimum of two years . . . .”

The rotation requirement is designed to reduce familiarity threats to
objectivity. The requirements are effective for that purpose, but the Act
added nothing new. Instead, it reduced the number of years a partner
may serve before rotating from seven to five but failed to include the
SECPS’s prohibition against the partner returning to in-charge status for

153 Id.
154 SEC PRACTICE SECTION—REQUIREMENTS, supra note 49, para. e.
155 Id.
156 See, e.g., Press Release, SEC, Commission Approves Rules Strengthening
(noting that the new rules, including mandatory partner rotation, are designed to
increase auditor independence). The AICPA provides a link to this site from its
own site, which also discusses auditor independence. See AICPA, SEC Approves
two years. Moreover, reducing the potential years of service from seven
to five does not add an incremental element of familiarity threat reduction
according to an AICPA study. That study found to the contrary that
"allegations of audit failure occur much more frequently when a firm is in
its first couple of years as a company’s auditors." Since the threat of
failure exists during the beginning of an auditor’s relationship with an
auditee rather than at the end, reducing the number of years before rotation
will have little effect on audit integrity.

3. Auditee Recruitment of Auditors

The Act states that auditor independence is destroyed if an auditor in
a public accounting firm ends a career with that firm and within one year
begins a career as a C.E.O., C.F.O., C.A.O., or the equivalent with a
company that they audited. It is common for a CPA to work for a public
accounting firm, and later make a lateral career move to a company they
have been auditing. The auditor has inside knowledge and experience with
the auditee, and this expertise can be valuable to the auditee.

In 17 C.F.R. section 210.2-01, the SEC promulgated a similar mandate
destroying auditor independence in certain situations. If a former
employee of a public accounting firm holds a position with any of the
firm’s audit clients, then the firm is not independent. The regulation has

157 Compare 15 U.S.C. § 78j-1(j) (“It shall be 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.”), with SEC PRACTICE
SECTION—REQUIREMENTS, supra note 49, para. e (“Member firms shall be
obligated to . . . assign a new audit partner to be in charge of each SEC
engagement that has had another audit partner-in-charge for a period of seven
consecutive years, and prohibit such incumbent partner from returning to in-charge
status on the engagement for a minimum of two years . . . .”).
158 Statement of Position, AICPA, Regarding Mandatory Rotation of Audit
Firms of Publicly Held Companies (Mar. 24, 1992) [hereinafter Statement of
Position Regarding Mandatory Rotation], http://www.aicpa.org/members/div/
secps/lit/sops/1900.htm.
159 Id.
162 Id.
an exception.\textsuperscript{163} If the employee does not influence financial decisions within the company and has no financial arrangement with the former public accounting firm, then independence is not impaired.\textsuperscript{164}

The Act adds no new requirements with respect to impairment of independence by auditee recruitment of auditors. Only minor adjustments were made in the Act to pre-existing SEC requirements. Therefore, the SEC regulations already in place were sufficient to reduce the familiarity threats associated with auditee recruitment.

4. \textit{Summary}

Title II of the Act adds nothing new to the regulatory framework that was already in place. The Act's provisions, such as the prohibition of non-audit services and mandatory partner rotation, mirror SEC regulations and SECPS standards that were already in place. Because of the high degree of overlap between the old and new regulations, it is unlikely that the new regulations will result in a significant reduction of audit failure due to familiarity or lack of auditor objectivity.

C. \textit{Title VIII—Corporate and Criminal Fraud Accountability}

1. \textit{Destroying or Altering Records}

The Act creates a new federal criminal law regarding the destruction or alteration of records.\textsuperscript{165} The law is intended to deter the destruction of documents by auditors as Andersen destroyed documents from the Enron audit.\textsuperscript{166} The new law reads:

Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case file under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.\textsuperscript{167}

\textsuperscript{163} \textit{Id.} § 210.2-01(c)(2)(iii)(A)(1).
\textsuperscript{164} \textit{Id.}
\textsuperscript{166} \textit{See supra} notes 14-43 and accompanying text.
\textsuperscript{167} 18 U.S.C. § 1519.
Obstruction of justice is punished by imprisonment for not more than five years in 18 U.S.C. § 1505. The United States Sentencing Guidelines classify a first obstruction of justice offense as punishable by ten to twenty-four months of imprisonment. The obstruction of justice law contains the same culpability and conduct standards as the Act. The Act does extend the obstruction of justice statute to acts done in contemplation of a federal investigation; however, it has been noted that the obstruction of justice statute was already being read broadly to include "all steps and stages in [a proceeding] from its inception to its conclusion." The most notable addition of the Act is the increase in the imprisonment penalty from five years to twenty years. To contrast, the United States Sentencing Guidelines only impose a sentence of up to twenty-four months. The Act has mandated that a review of the United States Sentencing Guidelines be performed and that appropriate amendments be made to ensure deterrence and punishment under the new obstruction of justice laws created by the Act. A more substantial criminal penalty may deter an auditor from destroying potential evidence if she finds herself in Andersen's position. Until corresponding adjustments are made to the Federal Sentencing Guidelines, however, the Act will have no impact on actual sentencing for the crime of obstruction of justice.

2. Destruction of Corporate Audit Records

The Act creates a second criminal law that focuses on accountants that states:

(a)(1) Any accountant who conducts an audit of an issuer of securities . . . shall 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.

(b) Whoever knowingly and willfully violates subsection (a)(1) . . . shall be fined under this title, imprisoned not more than 10 years, or both.

169 See U.S. SENTENCING GUIDELINES MANUAL § 2J1.2 (2002); id. at ch. 5, pt. A.
171 Rice v. United States, 356 F.2d 709, 712 (8th Cir. 1966).
It is arguable that the federal obstruction of justice statute, 18 U.S.C. § 1505, would deter the behavior that § 1520 intends to punish as well. It has been noted that

[w]hile the new § 1520 looks like a novel offense targeting accountants, prosecutors will likely not waste precious resources pursuing negligent or sloppy recordkeeping. Rather, they will most likely use § 1520(b) when they have reason to believe that accountants are behaving improperly—that is, "knowingly and willfully" failing to maintain proper corporate audit records.

The commentator then goes on to note that 18 U.S.C. § 1520 does not technically create a new criminal law because auditor misconduct was already punishable under the pre-existing obstruction of justice statutes.

The Act did establish an imprisonment penalty of ten years for an auditor who obstructs justice. This is an increase of five years from the former general obstruction of justice penalty; however, there remains a discrepancy between the penalty imposed by the Act and the Federal Sentencing Guidelines. Despite the increased penalty, the Guidelines continue to recommend the same sentences for the new crime of auditor obstruction of justice as the pre-existing general obstruction of justice statute.

3. Summary

Neither of the two new criminal laws in title VIII of the Act appear to add significant value to the criminal obstruction of justice law that was already in place. The increased penalties may give a prosecutor more bargaining room when prosecuting obstruction of justice cases. Yet, if increased bargaining room was the desired effect, the Act was not necessary. In addition, the Federal Sentencing Guidelines do not currently add additional punishment for the new laws created under the Act.

176 Id.
177 See id.
178 See supra notes 165-77 and accompanying text.
179 Recent Legislation: Corporate Law, supra note 175, at 734.
180 See supra notes 165-77 and accompanying text.
VI. ANCILLARY ISSUES

A. Attorneys and Their Role in Enron

Attorneys were involved in Enron’s unfortunate decisions in three ways. First, Enron’s in-house attorneys took part in the decision not to combine the special entities’ financial statements with those of Enron.\(^{181}\) Second, Enron’s outside counsel prepared and reviewed proxy statements and footnotes in documents to meet the SEC disclosure reporting requirements.\(^{182}\) Finally, Andersen’s in-house counsel initiated the destruction of the Andersen workpapers when it appeared likely that there would be an investigation.\(^{183}\)

Attorney misconduct can be driven by the same factors as CPA misconduct. Both professions work under a billable hours system and strive to achieve optimal realization rates and both are essentially dependent on their clients’ fees for their livelihood. Due to the nature of the services that CPAs and attorneys perform, however, they should strive to maintain independence and objectivity. Both are governed by their own professional standards, and should put the integrity and respect of their profession before their own personal gain. One commentator sees the Enron debacle as a catalyst to encourage attorneys to scrutinize their profession much the same way that the public accounting profession has been scrutinized.\(^{184}\)

The Act addresses attorney conduct by increasing standards for attorneys who practice before the SEC.\(^{185}\) The standards require attorneys to report violations of securities laws or the breach of fiduciary duties within the company.\(^{186}\)

---

\(^{181}\) See Rhode & Paton, supra note 15, at 17.


\(^{183}\) See id. at 22.

\(^{184}\) Id. at 9. This section has briefly described the role attorneys played in Enron. For further information on this topic, see id.


\(^{186}\) Id. That section states:

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection
B. Studies Under the Sarbanes-Oxley Act

The Act directed governmental agencies to perform various studies concerning the public accounting profession. The General Accounting Office was to perform two studies: one on mandatory rotation of registered public accounting firms and one on the factor that led to the numerous consolidations of public accounting firms. Both studies were completed by their July 30 deadline. The following are descriptions of those studies.

1. Mandatory Rotation of Registered Public Accounting Firms

The Act commissions a study to determine the effect of requiring mandatory rotation of registered public accounting firms. Mandatoryrotation of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the Board of directors.

Id.

187 Id. § 7232.
190 15 U.S.C. § 7232. This study is described as follows:

(a) STUDY AND REVIEW REQUIRED.—The Comptroller General of the United States shall conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms.

(c) DEFINITION.—For purposes of this section, the term "mandatory rotation" refers to the imposition of a limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer.

Id.
rotation of public accounting firms would reduce self-interest and familiarity; in fact, it may be the most effective method of doing so. The need for auditors to form inappropriately close relationships with their client in hopes of keeping that client's long term business would be discouraged, or at least alleviated, but the ex ante knowledge that a particular accounting firm would be involved with a client only for a fixed number of years.

Despite its advantages, mandatory rotation of public accounting firms could create problems. First, mandatory rotation could change marketplace competition among public accounting firms. There are limited numbers of public accounting firms that are in positions to audit public companies. A public company might be forced to choose from a small number of accounting firms, thus driving up the price of audits. Second, because of the intricacies involved in audits, a new public accounting firm displacing an old firm would have to deal with the displaced firm to plan and perform its audit. This may create relationships between public accounting firms, which could potentially become alliances and create the self-interest and familiarity threats that public accounting firms formerly had with public company clients.

Despite the identified problems of potentially higher audit prices and closer relationships between accounting firms, mandatory rotation of public accounting firms might be an effective solution to reduce self-interest and familiarity. This proposed study should help enlighten the impact of rotation on audit integrity. Therefore, reviewing the results of the study will likely be an important step towards improvement of the public accounting profession.

2. *Factors that Have Led to Consolidation of Public Accounting Firms*

The Act also mandates a study to determine the factors that have caused a consolidation of public accounting firms.\(^{191}\) The federal government must theorize that the lack of competition among accounting firms has

---

\(^{191}\) Sarbanes-Oxley Act § 701. The study is described as follows:

(a) STUDY REQUIRED.—The Comptroller General of the United States shall conduct a study—

(1) to identify—

(A) the factors that have led to the consolidation of public accounting firms since 1989 and the consequent reduction in the number of firms capable of providing audit services to large national and multi-national business organizations that are subject to the securities laws...
created a monopoly in the audits of public companies. The Act recognizes the potential problems caused by the lack of competition as "(A) higher [auditing] costs; (B) lower quality of [accounting] services; (C) impairment of auditor independence; or (D) lack of choice." The additional regulation imposed on the public accounting profession should make it more difficult for public accounting firms that do not audit public companies to enter that market.

Increased competition among the public accounting profession is not consistent with reducing self-interest and familiarity threats. In fact, increased competition will force public accounting firms to align themselves with their clients in order to retain them. An auditor should not be aligned with his or her client, but instead, should be objective with no interest in the outcome of the audit. Increased competition will lower auditing costs, which can lead to shortcuts by auditors so that they can maintain their profits. The lower the quality of the audit, the fewer the mistakes and flaws that the auditor will catch. For these reasons, auditors and auditees should not be aligned.

C. The Cascade Effect

A substantial concern throughout the public accounting profession is that the Act’s requirements will apply to all audits and not just to audits of public companies. This is known as the "cascade effect." The reason for concern is that small and mid-sized firms may not be able to financially withstand the additional regulation imposed on their profession. Public accounting firms are already subject to immense regulations as noted in Part III. Additional regulations will mean that firms will have to revamp their audit, quality control, and peer review procedures. This will be quite costly to public accounting firms. Because of the prevalent competition among small and mid-sized public accounting firms, it will be difficult for public accounting firms to deal with these costs.

There are two ways that the Act could have the undesired cascade effect on the public accounting profession. First, state boards of accoun-

---

192 Id.
194 Id.
195 Id.
196 See supra notes 44-52 and accompanying text.
197 See supra notes 63-179 and accompanying text.
198 E.g., Statement of Position Regarding Mandatory Rotation, supra note 158.
tancy could adopt legislation requirements similar to the Act's requirements which would apply to all CPAs licensed in that state. The Act directly encourages this.\footnote{15 U.S.C. § 7234 (2003).} Section 209 of Title II reads as follows:

In supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise and the size and nature of the business of the clients of those firms. The standards applied by the Board under this Act should not be presumed to be applicable for purposes of this section for small and medium sized nonregistered public accounting firms.\footnote{Id.}

It would take very few Enron-like debacles before states would adopt the Act's requirements. Consider this example that could prompt a state to adopt the Act. A central Kentucky public accounting firm may not have any clients that are public companies, so they do not register with the PCAOB and are not subject to the Act's requirements. Assume that the public accounting firm audits a local bank and that the bank managers and the auditors are familiar with each other. They may be members of the same club, have children that go to school together, or have other connections that create familiarity threats to objectivity. In addition, the bank could be one of the public accounting firms largest clients, creating a self-interest threat to objectivity. Now, imagine that the bank fails. Jobs would be lost and depositors, debtors, and others would be hurt. This is an Enron-like situation on a smaller scale. It is likely that the state would look to the federal government's reaction to Enron in order to determine the appropriate remedy to the state problem. Thus, the state would adopt the Act's requirements, and other states would probably follow. This would be detrimental to small and mid-sized accounting firms.

The second way that the Act could have a cascade effect on small and mid-sized accounting firms is through audits of governmental agencies. Many governmental agencies require annual audits depending on the amount of government funds they receive.\footnote{See, e.g., 7 C.F.R. § 3052.200 (2003).} The General Accounting Office has issued special auditing requirements for governmental
agencies. The special requirements for governmental agencies are analogous to the special requirements for public company audits in that they are intended to protect a particular group. In the case of public company audits, the goal is to protect investors from manager deceptions. In the case of governmental audits, the goal is to protect taxpayers from government official mismanagement. The General Accounting Office may see the Act’s requirements as appropriate to protect taxpayers as well as investors. Many small and mid-sized public accounting firms have taken on governmental audits because they can be performed outside of the tax season. This provides an additional stream of revenue, but because of the bidding process, governmental audit fees are often low. If the Government Accounting Office adopted the Act’s requirements for governmental audits, small and mid-sized firms may be forced to discontinue those audits which would eliminate an entire stream of revenue for those firms.

VII. CONCLUSION

A detailed comparison of the regulatory framework before and after the Act and its requirements reveals that it does not achieve the goal of “improving the accuracy and reliability of corporate disclosures made pursuant to securities laws. . . .” In other words, the Act does not make the changes necessary to reduce self-interest and familiarity threats to auditor objectivity. The Act is not necessary to achieve that purpose because the AICPA and the SEC are adequate governing bodies to oversee the public accounting profession and to deal with problems such as those that led to the Enron debacle.

Further, the PCAOB will likely adopt the AICPA framework into the rules they promulgate. Following are two actions that the AICPA should take to reduce self-interest and familiarity threats. First, as discussed in Part VI, the mandatory rotation of registered public accounting firms would be an effective step in reducing self-interest and familiarity. The rotation

---

203 See supra note 75 and accompanying text.
204 See GOVERNMENT AUDITING STANDARDS, supra note 202, § 1.02.
207 See supra notes 181-204 and accompanying text.
cycle should be relatively lengthy, maybe seven to ten years, in order to allow auditors to reach their optimal auditing potential. The ex ante knowledge that the auditor/auditee relationship will end in a fixed number of years will create a more objective attitude towards the auditor/auditee relationship. This would be especially effective to reduce familiarity threats to auditor objectivity.

Second, the AICPA should form an independent audit fee review committee. The committee should consist of CPAs and non-CPAs who are familiar with the intricacies of performing and billing audits. The committee should review details of the billings and the fees received by public accounting firms from public companies. Every public accounting firm registered with the SECPS should have at least one public company audit client reviewed annually. Audit clients should be chosen for review based on random sampling. All fees, including non-audit fees, for the audit clients chosen should be included in the detailed review. The review should primarily focus on identifying self-interest threats to the objectivity of an auditor that arise because of the fees received by the public accounting firm from the auditee.

When the federal government implemented the Act, it intended to protect the investing public from the public accounting profession. The reality of the Act is that it did nothing substantial to achieve that purpose. Further, the public accounting profession did not need the federal government's intervention. The AICPA was and still is doing all that it can to maintain the integrity of the public accounting profession. A few people broke the rules. An entire profession should not be punished, and the overall image of that profession should not be tarnished because of the distasteful conduct of a few.

---
