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FILLING IN THE GAAP: WILL THE SARBANES-OXLEY ACT PROTECT INVESTORS FROM CORPORATE MALFEASANCE AND RESTORE CONFIDENCE IN THE SECURITIES MARKET?

*Andrew F. Kirkendall**

I. INTRODUCTION

FEDERAL regulation of transactions in securities emerged in response to the stock market crash of 1929.¹ The two significant pieces of legislation are the Securities Act of 1933² (the “Securities Act”) and the Securities Exchange Act of 1934³ (the “Exchange Act”). The focus of the Securities Act is “to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing.”⁴ The Exchange Act declares “securities prices are susceptible to manipulation and that manipulation precipitates, intensifies and prolongs national emergencies like the depression that followed the stock market crash of 1929.”⁵ The Exchange Act attacked the problems pervasive in the securities market that led to the 1929 market crash by making manipulative trading practices illegal and by regulating other trading practices.⁶ Congress intended the Exchange Act to provide protection to

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1. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194-95 (1976) (discussing Securities Act of 1933, 48 Stat. 74, codified as amended at 15 U.S.C. § 77a to 77z-3.). See generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* (Houghton Mifflin Co. 1982) (recounting the history of the relationship between the Commission and corporate finance from 1929 to 1987).

2. Securities Act of 1933, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a to 77z-3).

3. Securities Exchange Act of 1934, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm).

4. *Ernst & Ernst*, 425 U.S. at 195 (citing H.R. Rep. No. 85, 73d Cong., 1st Sess., 1-5 (1933)).

5. Steve Thel, *\$850,000 in Six Minutes—The Mechanics of Securities Manipulation*, 79 CORNELL L. REV. 219, 219 (1994) (citing 15 U.S.C. § 78b(3)-(4) (1988)).

6. *Id.*

investors against “manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national security exchanges.”⁷ The desired effect of the two acts was to restore investor confidence in the American capital markets by establishing a fraud-free securities market, or at least the perception of one.

The recent events in corporate America raise questions regarding the success of the Securities and Exchange Commission (the “Commission”) in protecting investors and assuring the integrity of the U.S. capital markets. In order to reestablish confidence in the stability of corporate America, users of financial information need assurance that the information on which they base their investment decisions is reliable, accurate, and free of manipulation. Congress, in response to pervasive insider trading, corporate fraud, and the resulting market crash of 1929, enacted legislation that changed the dynamic of securities regulation in America. More than a laundry list of procedures and revolution in substance, the resulting legislation signaled the aggressive stance and pivotal role of the federal government in the regulation of securities.

Once again Americans are in need of reassurance from the federal government. Once again Congress has responded: over the summer of 2002, Congress enacted the Sarbanes-Oxley Act of 2002 (SOA).⁸ The SOA addresses a broad range of issues raised by the recent events in corporate America. In general, the SOA focuses on two recurring themes characterizing the corporate scandals: regulation of the auditing industry and conflicts of interests within corporate America. But is the SOA anything more than an attempt to quell investors’ fear of continued misbehavior by executives? Will the SOA have the teeth necessary to accomplish the intended purpose? While the SOA adequately addresses the issues raised by recent corporate scandals, the reactionary nature of the regulations and the current status of accounting standards in the United States will fail to prevent future malfeasance, in part because the enacted legislation fails to limit the underlying influence: greed.

The remainder of the introduction discusses a few of the noteworthy corporate scandals; provides a brief historical overview of regulation of the accounting profession and auditing industry; and describes the contribution of various corporate actors in the downfall of many large and once reputable companies. Part II summarizes provisions of the SOA and compares those provisions to a few of the corporate scandals and the major issues raised by the scandals, such as conflicts of interests among the parties responsible for the production of a corporation’s financial statements. Part III argues that even though the SOA provides a comprehen-

7. *Ernst & Ernst*, 425 U.S. at 195 (citing S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934)).

8. Sarbanes-Oxley Act of 2002, Pub L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

sive response to the issues raised by the corporate scandals, the current accounting standards and the existence of greed—for both money and power—created by a capitalist economy will limit the effectiveness of the SOA in preventing future malfeasance on the part of corporate executives and in the business community in general.

A. CORPORATE AMERICA SETS NEW RECORDS

The close of the twentieth century marked the end of the dot-com era and a decade of economic and financial success. America's economy experienced ten years of unprecedented growth. Personal fortunes blossomed while the "American Dream" attained a new meaning. Economic records were broken, companies beat the Street's estimates, revenue was up, and shareholders were pleased.

Unfortunately the economic success of the early-to-mid 90s did not last and with the end of the millennium around the corner companies began setting new records. On the corporate side, Xerox claimed title to the largest ever civil penalty levied by the Commission against a public corporation for financial fraud.⁹ Waste Management grasped the title for largest restatement of a company's financial statements,¹⁰ but possession was momentary: subsequently, "Rite Aid was forced to restate its pre-tax income by \$2.3 billion and net income by \$1.6 billion."¹¹ Enron laid claim to the largest bankruptcy petition in American history,¹² but similar to Waste Management, the dishonor was brief: in July of 2002, WorldCom surpassed Enron when it petitioned for bankruptcy, listing \$41 billion in debt.¹³ Accountants and auditors set records of their own. For the first time the Commission ordered a foreign audit firm to pay a civil penalty for a violation of auditor independence.¹⁴ The Commission also issued, for the first time in twenty years, an anti-fraud injunction against one of the Big Five¹⁵ accounting firms, which also happened to be the largest-ever civil enforcement penalty against such a firm.¹⁶ The former accounting firm of Arthur Andersen can be tied to a significant number of the

9. Stephen M. Cutler et al., Practising Law Inst., *Recent SEC Enforcement Cases* (Sept. to Oct. 2002), WL 1332 PLI/Corp 585, 591 (discussing SEC v. Xerox Corp., Lit. Rel. No. 17,465 (April 11, 2002), www.sec.gov/litigation/litreleases/lr17465.htm).

10. *Id.* at 593 (discussing SEC v. Dean L. Buntrock et al. (Waste Management), Lit. Rel. No. 17,435 (Mar. 26, 2002), www.sec.gov/litigation/litreleases/lr17326.htm).

11. *Id.* at 588 (discussing SEC v. Frank M. Bergonzi et al. (Rite Aid), Lit. Rel. No. 17,577, AAE Rel. No. 1581 (June 21, 2002), www.sec.gov/litigation/litreleases/lr17577.htm).

12. HAROLD S. BLOOMENTHAL, *SARBANES-OXLEY ACT IN PERSPECTIVE* § 1:6 (Sept. 2003), WL SEC-SOAP § 1:6.

13. *Id.* In June 2002, WorldCom confessed to "overstat[ing] its income during 2001 and the first quarter of 2002 by \$3.8 billion." *Id.*

14. Cutler et al., *supra* note 9, at 594 (discussing *In re* Moret Ernst & Young Accountants, Exchange Act Release No. 46,130, AAE Rel. No. 1584, (June 27, 2002), <http://www.sec.gov/litigation/admin/34-46130.htm>).

15. The "Big Five" is a term referring to the largest five accounting firms. With the demise of Arthur Andersen LLP, the "Final Four" remain.

16. Cutler et al., *supra* note 9, at 596 (discussing SEC v. Arthur Andersen LLP, et al., Lit. Rel. No. 17039, (June 19, 2001), Exchange Act Release Nos. 44,444, 4445, 4446, 4447, and 4448, (June 19, 2001), www.sec.gov/litigation/litreleases/lr17039.htm).

corporate scandals.¹⁷ On a more personal level, Dennis Koslowski plundered Tyco International for over \$500 million.¹⁸ These cited incidents of corporate malfeasance are but few of the many.¹⁹

B. ACCOUNTING AND AUDITING STANDARDS

From inception a corporation is required under the securities laws to submit independently audited financial statements to the Commission.²⁰ The financial statements of a corporation submitted to the Commission are one of the "primary sources of information available to guide the decisions of the investing public."²¹ These documents, used by investors, are the responsibility of management; but their objectivity, accuracy, and conformity with generally accepted accounting principles ("GAAP") are checked by an outside auditor.²² The competitive advantage and success of the capital markets in the United States is buttressed by these "[h]igh-quality financial accounting and reporting standards."²³ Further contributing to this success is the confidence that investors place in the U.S. capital markets,²⁴ which stems from the "confirming role of audited financial

17. See, e.g., David Milstead et al., *Quest's Tangled Web; Highly Questionable Deals Involving Fiber-Optic Lines Helped Bring the Telco to the Verge of Bankruptcy. Quest and Auditor Arthur Andersen Blame Each Other. Who Should We Believe?*, ROCKY MOUNTAIN NEWS, Oct. 2, 2002, at 16, 2002 WL 9115431 (Baptist Foundation of Arizona (promised to pay \$217 million to settle suits claiming the auditor ignored fraudulent activity resulting in significant losses); Enron (convicted for obstructing investigation regarding \$1 billion of losses hidden in off balance sheet transactions); Global Crossing (fiber-optic company under investigation for "allegedly entering into capacity swaps with Qwest and others to inflate revenue and prop up stock"); Sunbeam (agreed to pay \$110 million to shareholders to settle a lawsuit alleging the audit firm helped inflate profits); Waste Management (agreed to pay \$7 million civil fine to settle Commission charges that Andersen "knowingly or recklessly" approved false and misleading reports that inflated" earnings by more than \$1 billion); WorldCom (audit failed to detect \$7 billion in accounting discrepancies)).

18. Anthony Bianco et al., *The Rise and Fall of Dennis Kozlowski*, BUS. WK., Dec. 23, 2002, at 64. Interestingly, Mr. Kozlowski was trained as an accountant and used his knowledge to facilitate his fraudulent activities. *Id.*

19. See Cutler et al., *supra* note 9, at 587 ("In Fiscal Year 2001, the Division brought 484 enforcement actions.").

20. E.g. Securities Act of 1933, Schedule A (25)-(27), 48 Stat. 88, 15 U.S.C. § 77aa (filing of audited financial statement prior to registration of new stock); Securities Exchange Act of 1934, § 13(a)(2), (b), 48 Stat. 894, 15 U.S.C. § 78m(a)(2) (2002) (filing of annual reports); Securities Exchange Act of 1934, § 14, 48 Stat. 895, 15 U.S.C. § 78n (2002) (filing of an audited financial statement in connection with proxy and information statements).

21. *United States v. Arthur Young & Co.*, 465 U.S. 805, 810 (1984); see also FINANCIAL ACCOUNTING FOUNDATION, 2001 ANNUAL REPORT, HIGH-QUALITY FINANCIAL REPORTING 2 (2002) [hereinafter 2001 ANNUAL REPORT] (statement of Warren E. Buffet) ("Financial reporting . . . is the beginning of every decision that we make . . . We look at the numbers, try to evaluate the quality of the financial reporting and then figure out what that means for the bonds and stocks that we're looking at, and thinking of either buying or selling.").

22. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AUDIT ISSUES IN REVENUE RECOGNITION 3, 31 (1999) [hereinafter ISSUES IN REVENUE RECOGNITION].

23. 2001 ANNUAL REPORT, *supra* note 21, at 1.

24. ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 1.

statements.”²⁵

Investors, creditors, and other users of financial statements rely on the availability of transparent, credible, and comparable financial information. “Investors use financial information to assess operating results, make judgments about probable future performance, and evaluate non-accounting factors . . . of [an] enterprise Thus one of the greatest risks to investors is the risk that the financial information upon which they rely is materially misstated.”²⁶ The reasons for material misstatements in financial statements are numerous, ranging from outright fraud on the part of management to a misunderstanding of how to apply GAAP.²⁷

To ensure comparability, reliability, and materiality of the financial statements of a company, the statements must be prepared in accordance with GAAP, and auditors must adhere to the generally accepted auditing standards (GAAS).²⁸ GAAS provides the procedures, and GAAP provides the substance.

1. *History of the Development and Enforcement of Accounting and Auditing Standards*

While the Commission may have the authority to do so,²⁹ it does not create GAAP.³⁰ Rather, this responsibility has been delegated to various private organizations since the inception of federal regulation of the securities markets.³¹ Between 1936 and 1959, the Committee on Accounting Procedure of the American Institute of Certified Public Accounts established the first financial reporting and accounting standards.³² Beginning in 1959 the Accounting Principles Board, which is also a part of the AICPA, assumed the role of standard-setter.³³ The Financial Accounting Standards Board (FASB), since 1973, has been designated as the “private sector [organization responsible] for establishing standards of fi-

25. *Id.*

26. Daniel V. Dooley, *Financial Fraud: Accounting Theory and Practice*, 8 FORDHAM J. CORP. & FIN. L. 53 (2002). “Financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with [GAAP].” ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 32.

27. ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 3.

28. *Id.* at 31.

29. *See, e.g.*, § 19(a) of the Securities Act of 1933, 15 U.S.C. 77s(a); § 13(b)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78m(b)(1).

30. GAAP are “the conventions, rules, and procedures that define accepted accounting practices.” *Arthur Young*, 465 U.S. 805, 811 n.7 (1984) (citing WALTER B. MEIGS ET AL., PRINCIPLES OF AUDITING 25-26 (5th ed. 1973)).

31. For a thorough recount of the development of the institutions responsible for creating GAAP and their interaction with other organizations, see PELHAM GORE, THE FASB CONCEPTUAL FRAMEWORK PROJECT 1973-1985, at 9-12 (Manchester University Press 1995) (1992).

32. FINANCIAL ACCOUNTING STANDARDS BOARD, FASB FACTS [hereinafter FASB FACTS], at <http://www.fasb.org/facts/index.shtml> (last visited Nov. 14, 2002).

33. *Id.*

nancial accounting and reporting.”³⁴

FASB issues Statements of Financial Accounting Standards (SFAS) and Statements of Concepts.³⁵ “Pronouncements of those predecessor bodies remain in force unless amended or superseded by the FASB.”³⁶ The standards promulgated by FASB govern the preparation of financial statement reports and are considered authoritative by both the Commission and the American Institute of Certified Public Accountants.³⁷ Auditors may also use non-authoritative sources in circumstances where no authority clearly addresses a situation.³⁸

The mission of the FASB is to “establish and improve standards of financial accounting and reporting for both public and private enterprises.”³⁹ Overseeing the FASB is the Financial Accounting Foundation (FAF), which was organized in 1972.⁴⁰

The Financial Accounting Standards Advisory Council (FASAC), with more than 30 members, consults with the “FASB on the Board’s technical agenda, project priorities, issues likely to require the attention of the FASB, selection and organization of task forces and other matters as may be requested by the FASB or its Chairman.”⁴¹ The recently created Emerging Issues Task Force (EITF) is responsible for identifying issues that are ripe for FASB consideration.⁴²

The FASB focuses on “consumers—users of financial information, such as investors, creditors and others.”⁴³ The FASB attempts to “ensure that corporate financial reports give consumers an informative picture of an enterprise’s financial condition and activities and do not color the image to influence behavior in any particular direction.”⁴⁴

2. Abuse of Accounting Standards

The means and ends vary, but the goal is the same: to produce financial statements that encourage investment. To do so, as history repeatedly illustrates, managers have been willing to manipulate financial statements. The two financial statements subject to the most manipulation are

34. *Id.*

35. FINANCIAL ACCOUNTING STANDARDS BOARD, FACTS ABOUT FASB 6, 7 (2002) [hereinafter FACTS ABOUT FASB] (printable version), <http://www.fasb.org/facts/index.shtml> (last visited Nov. 14, 2002).

36. FASB FACTS, *supra* note 32.

37. *Id.*

38. ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 22.

39. 2001 ANNUAL REPORT, *supra* note 21, at 10. “Those standards are essential to the efficient functioning of the economy because investors, creditors and other consumers of financial reports rely heavily on transparent, credible and comparable financial information.” *Id.*

40. *Id.* at 4. The FAF “comprises 16 Trustees representing a broad range of professional backgrounds. Trustees share a common understanding of the importance of independent, private-sector accounting standard setting to the efficiency of the U.S. capital markets.” *Id.*

41. *Id.* at 10.

42. *See id.* at 13.

43. *Id.* at 11 (statement of Edmund L. Jenkins, FASB Chairman).

44. *Id.* (statement of Edmund L. Jenkins, FASB Chairman).

the balance sheet and the income statement. The balance sheet is a picture of a company's financial status on a given day. The income statement provides financial information about a company for a specified period. The preparation of financial statements must be prepared in accordance with GAAP. Illustrations of deviations from GAAP are numerous, some simple, and others complex.⁴⁵

The web of financial transactions spun by Enron illustrates one of the more complex methods of earnings management. In October 2001, Enron announced it would be taking a charge during the third quarter in 2001 of \$1.01 billion in connection with write downs of failed investments, resulting in a \$618 million loss and reducing shareholder's equity by \$1.2 billion.⁴⁶ The next month, a press release issued by Enron and related Form 8-K "disclosed that as a result of 'further review of certain related-party transactions' the company and its auditors had determined that based on generally accepted accounting principles its prior financial statements since 1997 would have to be restated to take into account three unconsolidated entities that should have been consolidated."⁴⁷ The assessment in November 2001 was that the restatement would reduce net income reported in years 1997-2001 by hundreds of millions of dollars.⁴⁸ Myriad simpler tactics and schemes have been used to manipulate earnings and the recognition of revenue over the years.⁴⁹

3. *Accountants, Auditors, and Corporate Governance: Ultimate Responsibility*

Management, the board of directors, executives, the audit committee, and the outside auditor are assigned certain responsibilities for the production of quality financial statements, free from fraud and material misstatements. There is little doubt regarding the significant role accountants and auditors played in the corporate calamity discussed above, primarily due to the lack of independence between auditors and their audit-clients.⁵⁰ Before assessing blame, critics must understand the function of accountants, auditors, and the rules governing accounting principles and auditing standards within the corporate governance structure.

45. For a description of various frauds committed in relation to financial statements, see Dooley, *supra* note 26, at 63-82.

46. BLOOMENTHAL, *supra* note 12, § 1:1, WL SEC-SOAP § 1:1.

47. *Id.*

48. *Id.*

49. See Dooley, *supra* note 26, at 57-60 (listing common forms of misstatements found in financial statements).

50. The most important rules governing accountants and auditors focus on auditor independence and guard against an unconscious bias on behalf of the independent auditor. DONALD C. COOK, THE CONCEPT OF INDEPENDENCE IN ACCOUNTING, ADDRESS BEFORE THE AMERICAN INSTITUTE OF ACCOUNTANTS (Oct. 3, 1950), *reprinted in* FEDERAL SECURITIES LAW AND ACCOUNTING 1933-1970: SELECTED ADDRESSES BY MEMBERS OF THE SECURITIES AND EXCHANGE COMMISSION AND MEMBERS OF THE STAFF 198, 202 (Gary John Previts & Alfred R. Roberts eds., 1986) [hereinafter FEDERAL SECURITIES LAW AND ACCOUNTING].

Ultimately, management is responsible “for the preparation and fair presentation of financial statements, including reported revenues.”⁵¹ The design, implementation, and effective operation of internal controls are also management’s responsibility.⁵² Simply stated, management should prevent problems before they begin,⁵³ which can be accomplished by establishing a corporate environment conducive to high-quality financial reporting.⁵⁴

The audit committee plays a critical role in the corporate governance structure as “informed, vigilant, and effective overseers of the financial reporting process.”⁵⁵ If effective, an audit committee can deter improper conduct on the part of management.⁵⁶ As part of the audit committee’s responsibilities, it should review the annual financial statements and confer with the independent auditor and management about them; gather the information an independent auditor is required to convey under auditing standards; “assess whether the financial statements are complete and consistent with everything else the committee knows; and assess whether the financial statements reflect appropriate accounting principles.”⁵⁷ But the members of audit committees might not possess the experience or necessary background in finance, accounting, or proper internal control structures.⁵⁸

The board of directors generally, and the audit committee particularly, set the tone of the internal control environment.⁵⁹ The remaining board members rely on the audit committee to “notice and question any unusual business practices, aggressive accounting methods or violations of the company’s code of business conduct.”⁶⁰

The independent audit has been described as a “public watchdog” function.⁶¹ “This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. If investors were to view the auditor as an advocate for the corporate client, the value of the audit might well

51. ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 3.

52. *Id.* at 6.

53. James W. Bean, Jr., *Corporate Governance: The Audit Committee’s Roadmap*, 1-99 AICPA J. ACCOUNT. 47 (Jan. 1999).

54. ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 3. Even if a set of written rules is in place, a lax attitude at the top increases the likelihood of fraudulent financial reporting.

55. *Id.* at 4.

56. *Id.*

57. Bean, *supra* note 53.

58. *Id.*

59. Internal control is defined as “a process, effected by an entity’s board of directors, management . . . designed to provide reasonable assurance regarding the achievement of objectives including reliable financial reporting.” ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 35.

60. Bean, *supra* note 53.

61. *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984) (noting that the independent public accountant “owes ultimate allegiance to the corporation’s creditors and stockholders, as well as the investing public”).

be lost.”⁶² An audit must be conducted in accordance with GAAS. These standards require an auditor to plan and perform an audit in such a manner as to obtain a reasonable assurance whether the financial statements contain material misstatements, whether the product of error or fraud.⁶³

4. *Analysts Fuel the Fire*

Contributing to the meltdown of the U.S. securities market that resulted in an \$8 trillion loss of market wealth⁶⁴ were the conflicts of interests among the research analysts, investment bankers, and publicly traded companies. Research analysts perform company-specific and market research to determine and recommend actions that should be taken with regard to a company's security.⁶⁵ Traditionally, at large banks, the research analysts are separated from the investment bankers and other branches of the bank in order to assure their research and recommendations are not influenced by higher-ups in the banks with interests in the companies the analysts researched.⁶⁶ As investigations into corporate transgressions continue to unfold the problems created by conflicts of interests within the banking industry become apparent. The complaint against Enron added nine investment banks alleging that the banks provided bridge-financing to Enron SPEs, members of the bank held interests in the SPEs, and the analysts recommended Enron in order to protect their investments.⁶⁷ Analysts at Salmon Smith Barney who continually issued a buy recommendation for WorldCom's securities are also coming under fire.⁶⁸

II. LEGISLATIVE RESPONSE: THE SARBANES-OXLEY ACT

Some commentators questioned whether there would be any legislative response elicited by the bankruptcy of Enron.⁶⁹ By March 20, 2002 congressional members introduced more than 30 Enron-inspired bills.⁷⁰ The subsequent troubles created by WorldCom's financial statements sealed the need for action:⁷¹ in July 2002, President Bush signed into law the

62. Bean, *supra* note 53 (quoting *Arthur Young*, 465 U.S. at 818).

63. ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 31.

64. See Burton G. Malkiel, *Remaking the Market: The Great Wall Street?*, WALL ST. J., Oct. 14, 2002, at A16, 2002 WL 3408627.

65. *Id.*

66. *Id.*

67. BLOOMENTHAL, *supra* note 12, § 8:1, WL SEC-SOAP § 8:1.

68. *Id.*

69. See, e.g., Manuel A. Rodriguez, Comment, *The Numbers Game: Manipulation of Financial Reporting by Corporations and Their Executives*, 10 U. MIAMI BUS. L. REV. 451, 482 (2002) (predicting the then current administration would fail to enact meaningful regulations).

70. BLOOMENTHAL, *supra* note 12, § 1:9, WL SEC-SOAP § 1:9.

71. The complaint against WorldCom alleges that it “falsely portrayed itself as a profitable business during 2001 and the first quarter of 2002 by reporting earnings that it did not have.” In violation of GAAP, WorldCom capitalized (and deferred) rather than expensed (and immediately recognize) \$3.8 billion in costs. WorldCom intended to mislead investors and manipulate its “earnings to keep them in line with estimates by Wall Street Analysts.” Cutler et al., *supra* note 9, at 587 (discussing SEC v. WorldCom, Inc., Litigation

Sarbanes-Oxley Act.⁷² The purpose of the SOA is to “protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.”⁷³ To further this goal, the SOA addresses many of the issues raised by the corporate scandals.⁷⁴ In general, the SOA focuses on regulating the accounting and auditing industry, separating and defining the role of the parties involved in the production of a corporation’s financial statements, increasing disclosure requirements to improve information in the financial statements, and increasing liability for those responsible for the production of a corporation’s financial statements.

A. PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Self-regulation of the accounting industry⁷⁵ coupled with a standard-setting structure that is inefficient and easily influenced⁷⁶ contributed significantly to the number of firms that had to restate their financial statements. Remedy: the SOA authorizes the establishment of the Public Company Accounting Oversight Board (PCAOB) “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 for, public investors.”⁷⁷ The PCAOB will consist of 5 members appointed by the Commission.⁷⁸ The members of the PCAOB will be “prominent individuals of integrity and reputation.”⁷⁹ Further, the members must “have a demonstrated com-

Release No. 17,588, Accounting and Auditing Enforcement Release (“AAE”) Rel. No. 1585 (Jun. 27, 2002), www.sec.gov/litigation/litreleases/lr17588.htm.

72. Sarbanes-Oxley Act of 2002, Pub L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). This act also applies to any foreign public accounting firm that prepares or furnishes an audit report. *Id.* § 106(a) (codified at 15 U.S.C. § 7216).

73. *Id.*

74. A cursory comparison of the SOA to media headlines illustrates the reactionary nature of the SOA. Compare *id.* § 103(a)(2)(A)(i) (document retention), and *id.* § 103(a)(2)(A)(ii) (peer review), with Lee Walczak et al., *Scandals in Corporate America*, *Bus. Wk.*, July 22, 2002, at 64, 2002 WL 9362406.

75. For a historical explanation of the development and education of the accounting profession resulting in self-regulation of the accounting industry, see Harold Q. Langenderfer, *Membership Segments – Beyond Practice: Accounting Education’s History – A 100-Year Search for Identity*, 5-87 *AICPA J. Acct.* 302 (May 1987).

76. The FASB has come under fire in recent months for not requiring the expensing of stock options. This is after the FASB attempted to issue rules required the expensing of stock options, but Congress, subject to pressure from the high-tech industry, threatened to disband the FASB if such rules were issued. See ARTHUR LEVITT & PAULA DWYER, *TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON’T WANT YOU TO KNOW* 106-11 (Pantheon Books 2002).

77. Sarbanes-Oxley Act § 101(a) (codified at 15 U.S.C. § 7211). “The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress.” *Id.* The PCAOB is not an “agent or establishment of the United States government.” *Id.* § 101(b) (codified at 15 U.S.C. § 7211). The SEC “shall have oversight and enforcement authority of the Board.” *Id.* § 107(a) (codified at 15 U.S.C. § 7217). The PCAOB must file an annual report, including financial statements, with the Commission. *Id.* § 101(h) (codified at 15 U.S.C. § 7211).

78. *Id.* § 101(e)(1), (4) (codified at 15 U.S.C. § 7211).

79. *Id.* § 101(e)(1) (codified at 15 U.S.C. § 7211).

mitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers . . . and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures.”⁸⁰

Under the SOA, the PCAOB is assigned various duties in order to regulate the accounting and auditing industry. The PCAOB must register the public accounting firms⁸¹ “that prepare audit reports for issuers.”⁸² Once registered, the PCAOB must regularly inspect the accounting firms and initiate “disciplinary proceedings concerning, and impose appropriate sanctions where justified.”⁸³ More general, the PCAOB has the duty of enforcing “compliance with [the SOA], the rules of the [PCAOB], professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants.”⁸⁴

The PCAOB has rule-making authority regarding auditing standards,⁸⁵ and may adopt or establish rules pronounced by certain “professional groups of accountants” that satisfy certain criteria.⁸⁶ This authority is subject to final approval by the Commission.⁸⁷

Targeting specific weaknesses in the auditing process, the SOA requires the PCAOB to adopt or establish certain rules. Generally, the PCAOB must adopt or establish rules regarding independence, quality control, ethics, auditing, and “other standards relating to the preparation of audit reports for issuers.”⁸⁸ Specifically, the SOA requires the adoption of

80. *Id.* The SOA also places certain limitations on the qualifications of members. Only two members may be or may have been certified public accountants (CPA); if the Chairman is a CPA, that person may not have practiced for the past 5 years; members must serve full time; no member may “engage in any other professional or business activity;” and members may not “share in any of the profits of, or receive payments from, a public accounting firm.” *Id.* § 101(e)(2)-(3) (codified at 15 U.S.C. § 7211).

81. The term “public accounting firm” refers to “a proprietorship, partnership, incorporated association, corporation, limited liability company . . . or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports,” and any “associated person” of such an entity. *Id.* § 2(a)(11)(A)-(B) (codified at 15 U.S.C. § 7201).

82. The SOA makes the preparation of or participation in the preparation or issuance of any audit report with respect to any issuer unlawful if the person is not a registered public accounting firm. *Id.* § 102(a) (codified at 15 U.S.C. § 7212). Once registered, accountants must submit reports to the PCAOB on an annual basis. *Id.* § 102(a) (codified at 15 U.S.C. § 7212).

83. *Id.* § 101(c)(1)-(4) (codified at 15 U.S.C. § 7211). The Board also has the authority to perform other duties that it determines are necessary for the effective regulation of the accounting and auditing industry. *Id.* § 101(c)(5) (codified at 15 U.S.C. § 7211).

84. *Id.* § 101(c)(6) (codified at 15 U.S.C. § 7211).

85. *See id.* § 103(a) (codified at 15 U.S.C. § 7213).

86. *Id.* § 103(a)(3); *see id.* § 103(a)(4) (codified at 15 U.S.C. § 7213) (listing the requirements an organization must possess before the PCAOB may adopt the standards issued by that organization). Although the SOA does not specifically mention the FASB, the Commission has designated it as a “professional group of accountants” satisfying the listed requirements. Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, S.E.C. Release No. 4773, 80 S.E.C. Docket 139, 2003 WL 1956186 (Apr. 25, 2003).

87. *Id.* § 107(b)(2) (codified at 15 U.S.C. § 7217).

88. *Id.* § 101(c)(2) (codified at 15 U.S.C. § 7211).

rules regarding document retention,⁸⁹ limiting the ability of a single auditor of a registered accounting firm from “managing” the earnings of a client with unfettered discretion,⁹⁰ and the level of understanding an auditor must have of a client’s internal control structure.⁹¹ An evaluation of the control structure should “include maintenance of records” that reflect the issuer’s transactions in a fair and accurate manner and provide assurance that the recorded transactions conform to GAAP.⁹² The auditor is also required to report any weaknesses found in the internal control structure.⁹³ Included with the quality control standards ultimately adopted by the PCAOB shall be rules relating to “monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports; consultation within such firm on accounting and auditing questions; supervision of audit work; hiring, professional development, and advancement placement of personnel; the acceptance and continuation of engagements; internal inspection;” and any other rules the PCAOB may establish.⁹⁴

B. DIVIDE, DEFINE, DELEGATE, AND DISCLOSE

In addition to creating the PCAOB, the SOA establishes rules regarding auditor independence,⁹⁵ corporate governance,⁹⁶ civil and criminal punishment for corporate fraud,⁹⁷ enhanced financial disclosure requirements,⁹⁸ and regulation of analyst conflicts of interests.⁹⁹ These provisions respond directly to conflicts of interests and apparent misunderstanding of the responsibilities and duties owed to the investing

89. *See id.* § 103(a)(2)(A)(i) (codified at 15 U.S.C. § 7213) (requiring a registered firm to “prepare and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions in such report”).

90. *See id.* § 103(a)(2)(A)(ii) (codified at 15 U.S.C. § 7213) (requiring a registered firm to “provide a concurring or second partner review and approval of such audit report (and other related information), . . . by a qualified person (as prescribed by the [PCAOB]) associated with the public accounting firm, other than the person in charge of the audit or by an independent reviewer”).

91. *See id.* § 103(a)(2)(A)(iii) (codified at 15 U.S.C. § 7213) (mandating an auditor to “describe in each audit report the scope of the auditor’s testing of the internal control structure and procedures of the issuer”).

92. *Id.* § 103(a)(2)(A)(iii)(II)(aa), (bb) (codified at 15 U.S.C. § 7213).

93. *Id.* § 103(a)(2)(A)(iii)(III) (codified at 15 U.S.C. § 7213).

94. *Id.* § 103(a)(2)(B)(i)-(vii) (codified at 15 U.S.C. § 7213).

95. *Id.* § 201(a) (codified at 15 U.S.C. § 78j-1(g), (h)) (prohibited non-audit services); *id.* § 202 (codified at 15 U.S.C. § 78j-1(i)) (audit committee pre-approval of all services offered by a registered public accounting firm to an audit client); *id.* § 203 (codified at 15 U.S.C. § 78j-1(k)) (requiring rotation of audit partners).

96. *Id.* § 301 (codified at 15 U.S.C. § 78j-1(m)) (responsibilities of audit committees); *id.* § 302(a) (codified at 15 U.S.C. § 7241).

97. The SOA’s criminal provisions are located in Title VIII, the Corporate and Criminal Fraud Accountability Act of 2002, *id.* §§ 801-807; Title IX, the White-Collar Crime Penalty Enhancement of 2002, *id.* §§ 901-906; and Title XI, the Corporate Fraud Accountability Act of 2002, *id.* §§ 1101-1107.

98. Sarbanes-Oxley Act § 401(a) (codified at 15 U.S.C. § 78m(i)) (disclosures in periodic reports).

99. *Id.* § 501(a) (codified at 15 U.S.C. § 78o-6).

public by persons connected to the production of a company's financial statements.

Arguably, the primary factor contributing to the large number of companies restating their financial statements was the lack of auditor independence. An auditor is under a public duty to approach an audit with a certain degree of skepticism and is required to employ measures designed to uncover fraud in the financial statements.¹⁰⁰ Conflicts of interests reduce an auditor's independence from the audit client and may prevent the auditor from approaching the audit with the requisite mental state: skepticism. As a consequence, the auditor fails his or her obligation owed to the investing public. Arthur Andersen's audit of Enron illustrates well the consequences of not maintaining auditor independence.¹⁰¹

In order to ensure auditor independence, the SOA regulates the relationships among the parties involved in the audit.¹⁰² Focusing on the auditor, the SOA limits the services that an auditing firm may provide a client. If a registered public accounting firm provides auditing services to a client, then the registered public accounting firm is forbidden from providing other services to the audit client.¹⁰³ In addition to restricting the types of services provided to an audit client, the SOA takes other measures to increase the presence of auditor independence.¹⁰⁴

Related to auditor independence and requisite for investor confidence are the financial statements of a company. Financial statements are meant to provide investors and creditors with insight into a company's financial status. A key principle providing accurate financial statements is disclosure. By not disclosing all material information, a company's financial statements do not paint an accurate picture of the company and

100. ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 37-38.

101. Arguing that Andersen's audit team approached the audit of Enron with a skeptical attitude is difficult considering that Enron paid Andersen around \$30 million in fees for non-audit services, which created a conflict of interest.

102. For a description of the parties to an audit, see discussion *supra* Part I.B.3.

103. Prohibited activities include "bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems and design implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit; and any other service that the Board determines, by regulation, is impermissible." Sarbanes-Oxley Act § 201(a) (codified in 15 U.S.C. 78j-1(g)). In addition to the list of non-audit services specifically forbidden, a registered public accounting firm may only provide non-audit services to an audit client with pre-approval from the PCAOB. *Id.* § 201(a) (codified in 15 U.S.C. 78j-1(h)).

104. See *id.* § 203 (codified at 15 U.S.C. § 78j-1(j) (requiring partner rotation no less than every five years). This provision requires only the rotation of the audit partner, not the rotation of the audit firm. The SOA does require that a study be performed regarding the possibility of the mandatory rotation of auditing firms. *Id.* § 207 (codified at 15 U.S.C. § 7232); see also *id.* § 206 (codified at 15 U.S.C. § 78j-i) (making it unlawful "for a registered public accounting firm to perform for an issuer any audit service . . . if a chief executive officer, controller, chief financial officer . . . or any person serving in an equivalent position for the issuer, was employed by that . . . accounting firm and participated . . . in the audit of that issuer during the 1-year period preceding . . . initiation of the audit").

mislead the users of those statements. As many investors have learned, the numbers may not always be the most important factor to consider when evaluating a company. Even if a company has stellar numbers in the financial statements there is a risk that the numbers are tainted by fraud and manipulation. Information regarding the corporate structure of a company can aid an investor or creditor when making a decision regarding the accuracy of the data contained in the financial statements and stability of a company.

The SOA contains provisions regarding both the qualitative and quantitative information that a company must disclose.¹⁰⁵ The quantitative disclosure requirements add little to increase the accuracy of the financial statements.¹⁰⁶ The qualitative disclosures provide investors and creditors with information pertinent to investment and credit decisions. Directors, officers, and beneficial owners are required to disclose the amount of their equity interest in the issuer.¹⁰⁷ The annual report must also disclose management's responsibilities for implementing and maintaining "an adequate internal control structure and procedures for financial reporting,"¹⁰⁸ an assessment of the effectiveness of those internal control structures,¹⁰⁹ whether the issuer adopted a "code of ethics for the senior financial officers . . . or persons performing similar functions,"¹¹⁰ and whether a financial expert sits on the audit committee.¹¹¹ The Commission is charged with evaluating the disclosures contained in the financial statements.¹¹²

Under Title III, the SOA delineates the responsibilities of corporate actors involved in the auditing process. Each issuer's audit committee is

105. Quantitative information relates to the numerical information found in the financial statements and information explaining how the numbers were calculated. Qualitative information relates to the characteristics and structure of an issuer that affects the quality of the quantitative information found in the financial statements.

106. See Sarbanes-Oxley Act § 401(a) (codified at 15 U.S.C. 78m(i)) (requiring companies to disclose and reconcile the financial statements with any correcting material adjustments identified by a registered public accounting firm). Essentially, this section requires an issuer's financial statements to conform to GAAP, which was required before the enactment of the SOA. Moreover, the SOA does not decide the fate of the use of SPEs and off balance sheet transactions, but requires the Commission to either conduct a study or issue final rules at a later date. *Id.* § 401(a) (codified at 15 U.S.C. 78m(j)); *id.* § 401(b) (codified at 15 U.S.C. 78m). The impact of these provisions will remain unrealized until the studies are complete and the final rules are enacted.

107. *Id.* § 403(a) (codified at 15 U.S.C. § 78p(16)(a)(1)). Personal loans to executives have also been prohibited, subject to certain circumstances. *Id.* § 402(a) (codified at 15 U.S.C. § 78m(k)).

108. *Id.* § 404(a)(1) (codified at 15 U.S.C. § 7262).

109. *Id.* § 404(a)(2) (codified at 15 U.S.C. § 7262).

110. *Id.* § 406(a) (codified at 15 U.S.C. § 7264); see also *id.* § 406(c)(1)-(3) (defining code of ethics).

111. *Id.* § 407(a) (codified at 15 U.S.C. § 7265); see also *id.* § 407(b)(1)-(4) (codified at 15 U.S.C. § 7265) (listing requirements for a financial expert).

112. *Id.* § 408(a) (codified at 15 U.S.C. § 7266). The Commission, in determining whether to evaluate the disclosures, will consider the issuance of material restatements; significant stock price volatility; market capitalization; "emerging companies with disparities in price earnings ratios;" the affect of the issuer on the economy; or any other relevant factors. *Id.* § 408(b)(1)-(6) (codified at 15 U.S.C. § 7266).

“directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.”¹¹³ Members of the audit committee must be members of the board of directors; otherwise, they must remain independent.¹¹⁴ Further, they are forbidden from accepting “consulting, advisory, or other compensatory fee from the issuer; or [from being] an affiliated person of the issuer.”¹¹⁵ The audit committee is also responsible for establishing procedures for “the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.”¹¹⁶

The “principal executive officer . . . and principal financial officer” are responsible for certifying the annual and quarterly reports filed under the securities laws.¹¹⁷ By signing the report, the officer certifies that he or she has reviewed the report;¹¹⁸ that the report “does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements . . . not misleading;”¹¹⁹ and that what the “financial statements, and other financial information included within the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.”¹²⁰ The signature also certifies that the signing officer is

responsible for establishing and maintaining internal controls; [has] designed such internal controls to ensure that material relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared; [has] evaluated the effectiveness of the issuer’s internal controls as of a date within 90 days prior to the report; and [has] presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.¹²¹

The signing officer is also certifying that “significant deficiencies in the design or operation of internal controls” and “any fraud, whether or not material, that involves management or other employees” have been disclosed to the “issuer’s auditors and the audit committee of the board of directors.”¹²² Finally, by signing the reports, the signing officers certify that they have “indicated in the report whether or not there were significant changes in the internal controls . . . subsequent to the date of their

113. *Id.* § 301 (codified at 15 U.S.C. § 78j-1(m)(2)).

114. *Id.* § 301 (codified at 15 U.S.C. § 78j-1(m)(3)(A)).

115. *Id.* § 301 (codified at 15 U.S.C. § 78j-1(m)(3)(B)(i)-(ii)).

116. *Id.* § 301 (codified at 15 U.S.C. § 78j-1(m)(4)(A)-(B)).

117. *Id.* § 302(a) (codified at 15 U.S.C. § 7241).

118. *Id.* § 302(a)(1) (codified at 15 U.S.C. § 7241).

119. *Id.* § 302(a)(2) (codified at 15 U.S.C. § 7241).

120. *Id.* § 302(a)(3) (codified at 15 U.S.C. § 7241).

121. *Id.* § 302(a)(4)(A)-(D) (codified at 15 U.S.C. § 7241).

122. *Id.* § 302(a)(5)(A)-(B) (codified at 15 U.S.C. § 7241).

evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.”¹²³

If an issuer is required to issue a restatement of its financial statements due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer are required to return “any bonus or other incentive-based or equity-based compensation” the person received “from the issuer during the 12-month period following the first public issuance or filing with the Commission . . . of the financial document embodying such financial reporting requirement.”¹²⁴ The CEO and CFO are also required to forfeit any profit from the sale of securities of the issuer during the 12-month period following the filing of the financial statements containing the misstatement.¹²⁵

Even if financial statements provide all the material information of a company’s stability and are free from fraud and manipulation, investors must still possess the faculties necessary to understanding financial statements. In addition to comprehending the complicated information contained in financial statements, performing market research is essential to making a sound investment in a security. Research analysts at large brokerage houses perform this research and can reduce all the information into three recommendations: buy, sell, or hold. Problem: some analysts own an equity interest in the shares they research creating a conflict of interest and there are conflicts of interests between the research analysts and investment bankers of the same brokerage houses. Solution: the SOA requires the Commission to issue rules regarding conflicts of interest among analysts “in order to improve the objectivity of research and provide investors with more useful and reliable information.”¹²⁶ Any rules that the Commission adopts should be designed to “foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts.”¹²⁷ To further this goal, the SOA restricts the “prepublication clearance or approval of research reports by persons employed by the broker or dealer” who are not directly involved in the research, specifically forbidding those persons involved in investment banking activities.¹²⁸ Persons involved in investment banking activities are also restricted from having influence over the performance evaluation and compensation of research analysts.¹²⁹ The SOA further isolates the analyst by forbidding retaliation against an analyst by an investment banker within the same brokerage firm for any “adverse, nega-

123. *Id.* § 302(a)(6) (codified at 15 U.S.C. § 7241).

124. *Id.* § 304(a)(1) (codified at 15 U.S.C. § 7243).

125. *Id.* § 304(a)(2) (codified at 15 U.S.C. § 7243).

126. *Id.* § 501(a) (codified at 15 U.S.C. § 78o-6(a)); *see also id.* (codified at 15 U.S.C. § 78o-6(c)(1)) (defining securities analyst).

127. *Id.* (codified at 15 U.S.C. § 78o-6(a)(1)).

128. *Id.* (codified at 15 U.S.C. § 78o-6(a)(1)(A)).

129. *Id.* (codified at 15 U.S.C. § 78o-6(a)(1)(B)).

tive, or otherwise unfavorable research report.”¹³⁰ The Commission is responsible for developing additional rules to insure that the proper informational barriers are established in the brokerage firms.¹³¹

Research analysts are also subject to certain disclosure requirements relating to potential conflicts of interest. The research analyst must disclose any equity or debt investment in the issuer;¹³² any compensation received from the issuer subject to the research;¹³³ and whether the issuer subject to the report has been a client of the registered broker, and if so, the types of services provided.¹³⁴

III. WILL THE SOA FILL IN THE GAAP?

Separation of ownership and control in the American corporation draws a line between investors (owners) and those charged with running the business (management, directors, executives). The line between the two can blur, become a gap; an information-void. Within this gap, executives and directors can manipulate the system by decreasing the amount and quality of information available to the public in order to distort the public's perception of a company's financial status. This information gap between the public and corporations is inherent to the American system of corporations, and the ability of any regulation to completely protect investors from fraudulent activities of executives is doubtful.

The problem is exacerbated when the checks on the financial reporting system fail. The auditors and analysts, both required to provide the public with objective information, were essentially working for the companies, which increased the gap between the owners and management. Analysts recommended securities in which they owned an interest. Auditors were not really auditing, but were providing other services such as consulting. The corporate compensation scheme created incentives to commit fraud, which exists in many forms:

Generally, “badges” of financial fraud include: reported results that do not comport with GAAP; pressures or incentives to commit fraud—including pressure to achieve unrealistic operating results, and incentive in the form of performance-based compensation (e.g. stock options, bonuses or other forms of performance-based compensation, the value of which is tied to achieving such unrealistic operating results); opportunity to commit fraud—resulting from lack of adequate controls, insufficient segregation of duties, or dominance—by one or more individuals—over critical elements of the accounting and reporting process; . . . misrepresentations about, among other things: (a) control activities having been performed properly, when in fact that have not; (b) the true nature of transactions or accounting events; (c) management's true intent in respect of transactions

130. *Id.* (codified at 15 U.S.C. § 78o-6(a)(1)(C)).

131. *Id.* (codified at 15 U.S.C. § 78o-6(a)(3)).

132. *Id.* (codified at 15 U.S.C. § 78o-6(b)(1)).

133. *Id.* (codified at 15 U.S.C. § 78o-6(b)(2)).

134. *Id.* (codified at 15 U.S.C. § 78o-6(b)(3)).

being entered into; (d) the reasonableness and support for management's judgments and estimates, when such are—in fact—known to be unreasonable, or are lacking in valid support; or (e) false evidence, misrepresented to be true and valid, regarding: absence of side letters¹³⁵

Common financial frauds also include revenue recognition involving timing manipulation, revenue recognition involving the creation of fictitious sales, manipulation of accounting receivables, revenue recognition involving irregularities concerning rights of return, and roundtrip revenue frauds.¹³⁶

In many instances the auditor is not purposefully aiding management to perpetuate a fraud, and management is committing a fraud upon the auditors. The purpose of such a fraud is to obtain an unqualified audit opinion from the auditors,¹³⁷ and to keep the auditors from knowing about and disclosing the accounting irregularities. Fraud on the auditors includes the following: misrepresentations by management; “[c]oncealment of fraudulent transactions by falsification, alteration and manipulation of documents . . . [s]ubordination of collusion to defraud among management and/or employees . . . [c]ollusion with third parties . . . [d]eceptions including planning the fraud to take advantage of known (or anticipated) patterns of auditing . . . [d]estruction of evidential matter and/or hiding key documents.”¹³⁸

Auditors are equipped with the tools and guidelines necessary to detect fraud,¹³⁹ but realistically, an auditor cannot design an audit to detect fraud in every situation.¹⁴⁰ The risk that fraudulent material misstatements exist in the financial statements increases when the audit team fails to perform auditing tests that were necessary at the time of the audit, and in hindsight, would have detected fraud.¹⁴¹

The SOA provisions create rules reminding different sections of the business community that they play a certain role in the American economy by redefining the positions, responsibilities, liabilities and obliga-

135. Dooley, *supra* note 26, at 62-63.

136. *Id.* at 62-75.

137. At the close of an audit and auditor renders an opinion on the quality of the financial statements. There are four types of opinions: 1) an unqualified opinion “represents the auditors finding that the company’s financial statements fairly present the financial position of the company, the results of its operations, and changes in its financial position for the period under the audit,” in conformity with GAAP; 2) a qualified opinion represents the auditor’s opinion that the financial statements deviate from GAAP or they contain material misstatements; 3) an adverse opinion reflects an auditor’s determination that the financial statements do not fairly present the financial status and operations of the company; and 4) a disclaimer of opinion expresses the auditors inability to draw a conclusions. *United States v. Arthur Young & Co.*, 465 U.S. 805, 818-19 n.13 (citing 1 AICPA, *Statement on Auditing Standards* §§ 510, 511.01 & 512-14).

138. Dooley, *supra* note 26, at 81.

139. See *ISSUES IN REVENUE RECOGNITION*, *supra* note 22, at 41-48 (describing tests an auditor can perform).

140. *Id.* at 31

141. See, e.g., *In re Arthur Andersen & Co.*, Exchange Act Release No. 17,878, 22 SEC Docket 1346 (June 22, 1981), 1981 WL 30839, at *2-7.

tions of the auditor, board of directors, audit committee, and analyst; and that the economy can function properly only when various parties conduct themselves according to the rules of the game. Nevertheless, the SOA may simply amount to mere threats and may fail to effectively persuade corporate actors to be mindful of their duties owed to investors. Interestingly, the rules addressing intra-firm consultation, partner rotation, and second partner review are not novel methods advocated to enhance the accuracy of financial statements.¹⁴²

The structure that existed pre-SOA created an information gap between investors and corporate America. As discussed, the SOA successfully addresses the weaknesses created by the then-existing structures that permitted the Enrons and WorldComs to emerge en masse. The effectiveness of the SOA will not be revealed until some time after the PCAOB has had time to organize, adopt standards, and commence efficient operations. Unfortunately, the accounting standards ultimately adopted by the PCAOB and the enforcement mechanisms created by the SOA will fail to achieve the desired goal: a capital market free of fraud, deceit, and manipulation. The SOA may be able to restore investor confidence in what they perceive to be a securities market that is not as susceptible to fraud, deceit, and manipulation.

Beginning as early as 1920 the duty of a corporation's managers and executives to increase shareholder wealth has been accepted legal doctrine.¹⁴³ Conflicts of interests are created when the managers and directors interest in the company is directly related to the value of the company's stock. Relating management's compensation to the value of the stock price through stock options, for example, results in a significant problem: the greed pervasive in corporate America and the belief that even if caught, the punishment will be minimal compared to the potential attainable wealth. The SOA does contain provisions increasing the criminal and civil liability for persons found in violation of the securities laws.¹⁴⁴ But the effectiveness of these provisions is doubtful.¹⁴⁵ The SOA attempts to limit the structures increasing the risk of greed-motivated decision-making and increases the stakes for those in management that continue to play with the numbers in financial statements. The SOA does not instill ethics in the leaders of corporate America and the ability

142. In 1981, as part of a settlement, Arthur Andersen agreed to implement programs within the firm regarding partner rotation, second partner reviews, intra-firm consultation, and continued education in accounting matters. *Id.* 1981 WL 30839, at *23.

143. C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century*, 51 U. KAN. L. REV. 77, 80 (2002).

144. *See, e.g.*, Sarbanes-Oxley Act § 802 (codified at 15 U.S.C. § 1519); *id.* § 902(a) (codified at 18 U.S.C. § 1349).

145. *See* Recent Legislation: *Corporate Law—Congress Passes Corporate and Accounting Fraud Legislation—Sarbanes Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.), 116 HARV. L. REV. 728, 728-29 (arguing the deterrent effect of the criminal provisions in Titles VIII and IV will be minimal because they merely echo the pre-existing criminal statutory scheme). The article concludes that the increased sentencing provisions will increase the rate of guilty pleas but provide no real deterrent effect. *Id.* at 734.

of any legislation to do so is doubtful. While the SOA provides significant reforms, any change is dependent upon the participants maintaining high ethical standards. "This responsibility begins with today's business leaders—chief executive officers, chief financial officers, and other members of senior management. Good business ethics, along with a compensation system that rewards ethical behavior, are critical to restoring and reinforcing the public's confidence in our system."¹⁴⁶

The process of rebuilding investor confidence also requires trust in the government organizations in charge. Confidence in the Commission and the recently established PCAOB was questioned by the events surrounding the appointment of Mr. Webster to the head of the PCAOB.¹⁴⁷ Harvey Pitt's willingness to hide the truth from America is indicative of a problem plaguing corporate America: dishonesty. President Bush needs to appoint a leader who demonstrates ethics and honesty, someone who can lead by example and set the proper tone at the top.

A recurrent theme in the literature discussing management's role in the audit process is the importance of the tone within the company.¹⁴⁸ A lax tone at the top results in a lax tone at the bottom, encouraging activities that may result in low-quality financial reporting. A proper tone should also exist within the agencies responsible for enforcing the securities laws. The resemblance between the 1929 market crash and the most recent downturn in the economy may be attributed to a relaxation in enforcement and monitoring activities by the Commission and other organizations responsible for monitoring the activities of companies. Provisions of the SOA greatly enhance the powers of the Commission to regulate and monitor the financial reporting of registered companies. The Commission, recently, is signaling a more aggressive enforcement of the securities laws.¹⁴⁹ To perpetuate the effectiveness of securities regulations, the Commission and the PCAOB should heed the warning, "[l]essen our vigilance, of course, and we should be back to where we started."¹⁵⁰

Encouraging good business ethics is difficult, and recent quarterly results demonstrate that regardless of the corporate scandals emerging at a high rate and in light of the proposed regulations, corporations are still spinning their numbers.¹⁵¹ The methods may be legal, but critics of the accounting methods used by these corporations argue that the methods

146. 2001 ANNUAL REPORT, *supra* note 21, at 5 (report of the FAF Chairman, Manuel H. Johnson).

147. See Michael Schroeder, *Webster Makes it Official and Quits Accounting Board*, WALL ST. J., Nov. 13, 2002, at A3, 2002 WL 3411534.

148. See, e.g., ISSUES IN REVENUE RECOGNITION, *supra* note 22, at 4.

149. See, e.g., Charles Gasparino & Jerry Markon, *Martha Stewart is Given Notice of Possible Charges by the SEC*, WALL ST. J., Oct. 9, 2002, at A1, 2002 WL 3409487.

150. ROBERT E. KLINE, JR., ACCOUNTING AND THE COMMISSION'S ENFORCEMENT PROGRAM, AN ADDRESS BEFORE THE CHI CHAPTER OF DELTA SIGMA PI, JOHNS HOPKINS UNIVERSITY, BALTIMORE, MARYLAND (Oct. 12, 1939), *reprinted in* FEDERAL SECURITIES LAW AND ACCOUNTING, *supra* note 50, at 111.

151. David Henry & Heather Timmons, *Still Spinning the Numbers*, BUS. WK., Nov. 11, 2002, at 120, 2002 WL 100750179.

are “out of step with the climate.”¹⁵² Whether the accounting methods employed by these companies are legal, the inappropriateness of their use is clear. The problem with these financial statements is indicative of the issues surrounding the rules-based accounting standards in the United States. The rules-based approach allows accountants to comply with the letter of the law but to ignore the spirit and purpose of financial accounting. By following the strict rules and ignoring the spirit of accounting practices, accounting is used to conceal rather than to reveal the true status of a corporation’s financial stability—hardly a new phenomenon.¹⁵³

While effectively addressing many of the issues regarding the auditing process, conflicts of interests, and independence, the SOA does little to remedy the problems created by the current substantive accounting standards. The SOA does require the Commission to conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system.¹⁵⁴ The study will examine “the extent to which principles-based accounting and financial reporting exists in the United States; the length of time required for change from a rules-based to a principles-based financial reporting system; the feasibility of and proposed methods by which a principles-based system may be implemented; and a thorough economic analysis of the implementation of a principles based system.”¹⁵⁵

The rules-based system existing in America has failed, no doubt; but the question is whether the implementation of a principles-based approach will resolve the problems in the accounting profession and accounting standards. Advocates say the simpler standards “will paint a clearer picture for investors . . . will allow auditors to focus on whether the bookkeeping for a deal makes good business sense . . . will put the burden on corporate clients to prove that their aggressive accounting meets the standard,” and that “[w]hat we’ve got now’ . . . ‘invites Wall Street and others to create transactions that dot every ‘i’ and cross every ‘t,’ but violate the intent of the rules and fuzz up what’s really going on.’”¹⁵⁶ Those opposed to the implementation of a principles-based accounting system argue that a principles-based system will lead to a significant increase in litigation against issuers and auditors.

Even if a principles-based accounting system is adopted, the success of the securities laws is dependent on the accountant himself. The responsibility of accountants and their importance to a successful securities market has been recognized since the enactment of the securities laws:

152. *Id.*

153. ANDREW J. CAVANAUGH, STANDARDS OF DISCLOSURE IN FINANCIAL STATEMENTS, ADDRESS BEFORE THE MIDDLE ATLANTIC STATES ACCOUNTING CONFERENCE (June 7, 1941), reprinted in FEDERAL SECURITIES LAW AND ACCOUNTING, *supra* note 50, at 138.

154. Sarbanes-Oxley Act § 108(d) (codified at 15 U.S.C. § 77s).

155. *Id.* § 108(d)(1)(i)-(iv) (codified at 15 U.S.C. § 77s).

156. Mike McNamee & Kerry Capell, *FASB: Rewriting the Book on Bookkeeping: Will Broader, Simpler Rules Prevent Future Enrons?*, BUS. WK., May 20, 2002, at 123, 2002 WL 9361333.

In the light of our securities laws, the accountant has a responsibility for financial information . . . important to the . . . opinion as to whether a security should be bought or sold. The success . . . of the basic principle underlying the Securities Act, that complete and fair disclosure of all material facts should be made, is dependent on no one more than on the accountant.¹⁵⁷

This sentiment has been repeated over the years,¹⁵⁸ and is just as true today. Accountants should perform their professional responsibility to the investing public by providing the public with objective and accurate information that will aid investors in their investment decisions.

IV. CONCLUSION

The circumstances surrounding the market crash in 1929 are disturbingly similar to the circumstances surrounding the recent collapse of the stock market and the downturn in the economy. Unprecedented growth in the volume of securities-trading and record-setting economic growth preceded both crashes. There was a limited amount of information available to investors and what was available was not necessarily accurate. Subsequent to the revelation that the securities markets and corporate America were rife with corruption, stock prices plummeted, fortunes were lost, and investors lost confidence in the American capital markets. The realization of pervasive insider trading crippled investors' confidence in the market. The average investor, not privy to inside information, was at a comparative disadvantage to those who managed and operated the companies. During the roar of the twenties, the relationship between investors and the companies in which they purchased was seen as "we," not "us and them." At a basic level, investors felt that the securities market was unfair and the gap between investors and corporate America was revealed. To close the gap, the government enacted regulations forbidding insider trading and other activities in the securities market. These laws could not guarantee a capital market free from fraud and manipulation, but they did reduce the existence of securities manipulation. More importantly, the regulations helped create a perception of a fraud-free securities market and eventually restored investor confidence.

As the facts surrounding the demise of Enron, WorldCom, Arthur Andersen, and other large, once well-respected companies surfaced, the gap between investors and corporations was once again revealed. Executives, board members, and management failed in their responsibilities owed to the shareholders of the corporation. Analysts recommended stocks, not based on an objective evaluation of the company, but because they either

157. GEORGE C. MATHEWS, SEC ACCOUNTING ISSUES AND CASES, ADDRESS BEFORE THE MILWAUKEE CHAPTER, WISCONSIN SOCIETY OF CERTIFIED ACCOUNTANTS (Jan. 8, 1937), *reprinted in* FEDERAL SECURITIES LAW AND ACCOUNTING, *supra* note 50, at 63.

158. *See* ANDREW J. CAVANAUGH, STANDARDS OF DISCLOSURE IN FINANCIAL STATEMENTS, ADDRESS BEFORE THE MIDDLE ATLANTIC STATES ACCOUNTING CONFERENCE (June 7, 1941), *reprinted in* FEDERAL SECURITIES LAW AND ACCOUNTING, *supra* note 50, at 141.

held a financial interest in the security or received pressure from above. The auditors failed the investing public in every aspect. Auditing services became secondary to, and less profitable than, the non-audit services that the large accounting firms were providing audit-clients, effectively destroying any possibility for the auditor to retain a skeptical attitude during the audit. The lack of effective accounting regulations and standards only aided the auditors and accountants in their ability to manipulate the information contained in the financial statements. The impression of corporate America is that everyone involved in the financial operations of the companies was working together for their own financial benefit at the expense of the investor.

The objective of the SOA is to restore investor confidence in the American economy. The SOA seeks to achieve this goal by addressing the specific factors contributing to the loss of nearly \$8 trillion of stock market wealth. First, the PCAOB has been established and ordained as the regulator of registered public accounting firms. Many of the remaining provisions share a common theme: demarcate, define, and disclose. The SOA draws a distinct line between the parties involved in the auditing process and delineates their duties, responsibilities, and liabilities during the independent audit and for the resulting financial statements. A barrier is also placed between the research analysts and the investment bankers in order to increase the objectivity of their recommendations. If a conflict of interest still exists among any of the executives, board members, analysts, or auditors, then disclosures must be made in the financial statements submitted to the Commission.

The SOA does not resolve the problems created by the existing financial accounting system in the United States. The GAAP contain nearly 100,000 pages of rules, pronouncements, standards, and principles.¹⁵⁹ Clearly the current system does not work, and accountants can easily manipulate GAAP to place a corporation in a more favorable light. Further, many of the standards are confusing and difficult to apply in new situations.¹⁶⁰ The flexibility of GAAP allows accountants and auditors to manipulate earnings without violating the standards. A principles-based approach may help alleviate some of the problems created by the rules-based accounting standards, but neither system can completely close the information gap between investors and issuers. Even with a perfect system of financial accounting, the conscience of an auditor or accountant remains the most significant check on the accuracy of financial statements and is difficult to regulate.¹⁶¹

159. McNamee & Capell, *supra* note 156.

160. Addressing accounting issues as they occur has been the philosophy of the Commission and the standard setting bodies from the beginning. See MATHEWS, *supra* note 157, at 59-60.

161. During hearings on the Securities Act of 1933, General Carter, testifying on behalf of the accounting profession, was asked if there was any relation between the corporate comptrollers, who previously testified that they were responsible for the accuracy in the financial statements, and the auditors. "General Carter answered: 'None at all. We audit the controllers.' Senator Berkley then asked, 'Who audits you?' to which General Carter

quickly replied, '*our conscience.*'" DONALD C. COOK, THE CONCEPT OF INDEPENDENCE IN ACCOUNTING, ADDRESS BEFORE THE AMERICAN INSTITUTE OF ACCOUNTANTS (OCT. 3, 1950) (emphasis added), *reprinted in* FEDERAL SECURITIES LAW AND ACCOUNTING, *supra* note 50, at 201.