IMPACT OF THE SARBANES-OXLEY ACT ON ACCOUNTANT LIABILITY

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ABSTRACT

President Bush signed the Sarbanes-Oxley Act (SOA) into law on July 30, 2002. At that time he said that it brought about “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt”. The SOA was passed in response to corporate scandals involving Enron, WorldCom and others. It was intended to restore public confidence in our capital markets. Much of the SOA is directed at corporate and securities industry behavior. But the SOA also raises the regulatory bar far higher for the accounting profession, especially for accounts who audit public companies. The SOA created a new regulatory agency to oversee accountants’ work: the Public Company Accounting Oversight Board (PCAOB). The SOA also imposed high ethical standards, including prohibiting conflicts of interest and even potential conflicts of interest. Civil and criminal penalties for violations were increased. The net effect was to substantially increase the legal liability of accountants.

Business schools are trying to include SOA materials into their curricula. However, as the AACSB publication BizEd pointed out in August 2005, there is a lack of material that is appropriate for classes in accounting and business law. This paper will help to fill that need. It reviews the origins and current attitudes towards the SOA. To provide context it reviews the law of accountant liability. The paper then examines and assesses those parts of the SOA that impact accountant liability, particularly the new regulatory agency and also accountant independence. A new conceptual framework for regulation is suggested, in which it is seen that the SOA is essentially a form of regulation that seeks to prevent a harmful event from happening, as opposed to merely providing a remedy to those harmed by that event. Finally the SOA will be assessed and its future considered.

INTRODUCTION

As most readers know, the Sarbanes-Oxley Act\(^1\) (SOA) is the most far-reaching and significant new federal regulatory statute affecting accountants and corporate governance since the Securities Acts of 1933 and 1934. Corporate scandals involving Enron, WorldCom and others had shaken public confidence in American capital markets. Public outrage\(^2\) plus the obvious need for reform led to the passage of the SOA which was signed into law on July 30, 2002.

The SOA significantly increased the legal liability of accountants. A new federal regulatory agency, the Public Company Accounting Oversight Board was created to
oversee auditors’ work, with authority to conduct inspections, create new standards and punish violators. Conflicts of interest were prohibited, and a high wall was erected separating the audit function from consulting and other non-audit functions. Auditors’ civil and criminal liability were increased, and additional record-keeping burdens imposed. Audits of public companies became riskier for accountants but also more profitable, reflecting the greater amount of work and risk involved.

The topic of accountant liability is an important one in accounting and business law classes, especially at the Junior, Senior and Graduate level. The SOA significantly impacted this liability. However, business schools have had difficulty incorporating SOA material into their curricula. As the AACS publication BizEd recently pointed out, every school it surveyed “incorporated at least some SOX material in its courses” but there was a “lack of dedicated material on Sarbanes-Oxley” that was appropriate. Most of what has been written on the SOA deals with corporate compliance and is directed at lawyers and practicing accountants. Very little has been written that directly addresses the SOA’s impact on accountant liability that is also appropriate for business and accounting students. The contribution of this paper is to help fill that void.

ORIGINS AND ATTITUDES

To say that the SOA is controversial is an understatement. Consider the following titles and headlines: “Sarbanes-Oxley Is a Curse for Small-Cap Companies”, “Sarbanes-Oxley to Create Litigation Nightmare”, “The Sarbox Conspiracy” and “Dump This Destructive Deadweight”. These articles focus on the downside of increased regulation: its added cost and the diversion of management attention from its primary missions of competitiveness, innovation and profitability. On the other hand, other titles are positive: “Promoting Public Trust”, “Sarbanes-Oxley: A Bridge to Excellence”, “Private Companies Embrace Sarbanes-Oxley” and “Sox: Not So Bad After All”. These articles focus on the benefits of increased regulation: restoring investor confidence, improving business controls and processes and supporting ethical practices.

Reviewing the origins of the SOA will provide insight to the conflicting attitudes towards it. During the Summer of 2002 scandals at Enron, WorldCom, Global Crossing, Adelphia and others attracted great media attention. Investors suffered losses estimated at between $300 billion and $460 billion. There was great public demand for reform.

Congress was anxious to act. Senator Paul Sarbanes (Democrat, Maryland) then chair of the Banking Committee, sponsored a reform bill. Congressman Michael Oxley (Republican, Ohio) then chair of the Committee on Financial Services sponsored a different version in the House. A Conference Committee reconciled the differences, which is normal procedure. As public outrage at the unfolding scandals grew, Congress passed the conference bill by the overwhelming votes of 99 to 0 in the Senate and 423 to 3 in the House of Representatives. Congress had passed the most sweeping statute affecting securities regulation and corporate governance since the 1930s. President Bush said that it brought about “the most far-reaching reforms of American Business practices since the time of Franklin Delano Roosevelt”. Congress had acted with uncharacteristic haste and unanimity, just as it did when it passed the U.S.A. Patriot Act. And, as with that Act, second thoughts would later emerge.
The scandals that broke in 2001 and 2002 had their origins in the dot-com boom of the late 1990s. Technology companies and others argued that conventional accounting practices of the “old economy” did not apply to the “new economy” based on computers, telecommunications and the Internet. Cozy relationships between investment analysts, auditors and corporations were tolerated while the economy and stock market were booming.

The first major break, and probably still the best known, involved the Enron Corporation. Formed in 1985 as the result of mergers with energy pipeline companies, Enron quickly became a rising star on the investment horizon. By 2000 it had become the seventh largest U.S. company based on revenue. Fortune Magazine called it “The Most Innovative Company in America” each year from 1995 to 1999. However, Enron’s success was driven in large part by accounting fraud. It had utilized Special Purpose Entities (SPEs) to hide billions of dollars of debt. Generally Accepted Accounting Practices (GAAP) allows a company to use SPEs, and to keep the SPEs’ financial data off that company’s balance sheet. But GAAP allows this only if two rules are met: a third party must control most of the SPE’s equity and at least three percent of total capital must be equity. Enron made extensive use of SPEs, in many cases in violation of the GAAP rule. Billions of dollars of debt were hidden. Once the truth became known Enron collapsed. Investors were shocked that a company that had been touted as a star was in fact a fraud. Billions of dollars were lost to pension funds, mutual funds and individual investors.

Another prominent example of a corporate scandal involving accounting manipulation was Global Crossing. This company was formed in 1997. Its business plan consisted of laying fiber optic cables under the Atlantic and Pacific Oceans in order to capture telecommunications business. It too became a rising star and quickly achieved a market capitalization of almost $40 billion. However, like Enron, Global Crossing’s apparent success was driven in part by accounting fraud. It made extensive use of “pro forma reporting”, a method of reporting financial information that is not based on the conventional standards of GAAP. With pro forma accounting a company can inflate its earnings by applying accounting rules that it thinks are relevant. Global Crossing and others using pro forma accounting did disclose what they were doing, and also the financial results obtained using GAAP. But some top stock analysts used the rosier pro forma results instead of GAAP results without telling investors. Moreover, in the case of Global Crossing, that company did not even accurately report its pro forma results.

Prior to the SOA the accounting profession was largely self-regulated. The Securities Acts of 1933 and 1934 authorized the Securities Exchange Commission (SEC) to regulate accounting methods used in preparing and auditing financial statements included in SEC reports. However the SEC quickly delegated this authority to the accounting profession’s principal trade association, the American Institute of Accountants, which later became known as the American Institute of Certified Public Accountants (AICPA). The AICPA established the Auditing Standards Board (ASB) in 1978. Lynn Turner, former Chief Accountant at the SEC expressed strong criticism of the ASB at the Enron Congressional hearings.
“...those standards tend to be written to protect the accounting firms in case they get in trouble on an audit... it is not drafted with the public interest in mind... As long as you leave that standards setting process in the hands of the firms and of the firm’s legal counsel, you are going to get standards written to protect them in court, as opposed to standards written to ensure that they do audits that will protect the public.”

In the area of oversight and discipline the accounting profession had also largely been left to regulate itself. In 1977, after a series of accounting-related corporate scandals, the AICPA created the Public Oversight Board (POB). However the POB had no authority to sanction auditors for deficiencies or incompetence that it discovered, and it was funded by the AICPA. In 2000 the AICPA did not agree with the POB’s plan to review the Big Five accounting firms’ compliance with auditor independence standards, and so the AICPA cut off funding for the POB. In 2002 the members of the POB voted unanimously to disband.

Congress concluded that Enron, WorldCom and other scandals demonstrated that self-regulation by the accounting profession had been inadequate in the areas of standard setting and oversight. The need for improvement in these areas contributed to the passage of the SOA.

THE CONTEXT OF ACCOUNTANT LIABILITY

The SOA is but the latest in a long line of legal authority involving accountant liability. In order to properly understand how the SOA fits into the context of accountant liability, it is necessary to review that larger scheme. Most accountant liability is based on contract, tort and statute law. The changes brought about by the SOA will be noted in the next section, which describes the Act.

Contract Law Liability

When an accountant does work for a client a contract of employment exists. This contract is often called an “engagement letter”. In common with all employment contracts, the engagement letter specifies the work to be performed and the compensation to be paid. An accountant is an agent of his/her client therefore agency law also applies to the relationship. Under agency law the accountant-agent owes his/her client important duties, including the fiduciary duty of loyalty, competence in performing the work, keeping the client informed, and following instructions. If an error is made, a question arises whether the accountant has acted with competence. Not all errors are the result of lack of competence.

The standard of competence used by the courts is that of a (hypothetical) reasonably competent accountant. It is essentially a negligence standard, described below. However, most courts agree that a reasonably competent accountant will follow Generally Accepted Accounting Practices (GAAP) and Generally Accepted Accounting Standards (GAAS). An accountant who follows GAAP and GAAS will almost always be held to have acted with competence.

An accountant owes these contractual duties to his/her client and also to intended third party beneficiaries. In order to be an intended third party beneficiary, the accountant must be informed and agree that a third party will use and rely on the accountant’s work product. The typical example is a corporation seeking a loan from a
bank that hires an accountant to prepare financial statements that the bank will use in evaluating the loan application.

Contract liability is important but it is limited. The client or intended third party beneficiary may lose money if the accountant breaches the duty of competence or some other duty, but the amount of money will be limited to the actual losses of just those two parties. In contrast, statutory liability can be vastly larger, as when a securities act violation makes an accountant and his/her firm liable for losses suffered by thousands of shareholders.

Tort Law Liability

The torts of primary concern in accountants’ liability are negligent misrepresentation and fraud. If an accountant fails to exercise the degree of care of a (hypothetical) reasonably competent accountant, and as a result he/she issues incorrect financial information, negligent misrepresentation has occurred. Someone claiming a loss would also have to show reliance and proximate cause. Fraud consists of issuing false financial information with knowledge that it is false and with intent to deceive someone. This intent to deceive is called scienter, and is also a requirement for liability under some of the provisions of the Securities Acts, discussed below.

Determining how a hypothetical reasonably competent accountant would act is not always easy. As noted above, this hypothetical accountant will always follow GAAP and GAAS. Also, if suspicions are aroused, he/she should go beyond those requirements. Expert witnesses may be called upon to inform a jury as to how the hypothetical competent accountant would act. If a court finds that negligent misrepresentation has occurred, the accountant will be liable for the financial loss that was reasonably foreseeable (proximately caused).

Two things make negligent misrepresentation a particularly dangerous legal theory of liability for use against an accountant. First, there can be more than one or two plaintiffs. In the discussion of contract liability, we noted that only the client or an intended third party can assert contract liability. Therefore the amount of the loss, and the amount of the accountant’s liability, are both limited. But with negligent misrepresentation, a whole class of plaintiffs, perhaps numbering in the thousands, can sometimes assert liability.

This concern for mass liability focused on an accountant, with the potential to destroy that accountant and his/her firm, led Justice Benjamin Cardozo, probably the most respected jurist of his day, to author his famous opinion in the case of Ultramares v. Touch in 1931. In that case Justice Cardozo created a special rule in negligence cases involving accountants. He held that mass liability should not exist; that only the client and an intended third party could hold an accountant liable for the accountant’s negligence. Cardozo’s impeccable logic and word craft shine brilliantly in this often cited part of his opinion:

If liability for negligence exists, a thoughtless slip or blunder … may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.
Cardozo was sensitive to the fact that at that time, before the Securities Acts, independent auditors were the only overseers of the accuracy of financial information relied upon by investors in our capital markets. If accounting firms were destroyed by mass liability for negligence, there would be no reliable affirmation of corporate profitability. The stock market had crashed only two years earlier. Maintaining investor confidence was critical then, just as it was after Enron, Global Crossing, Tyco and Adelphia.

The rule of Ultramares, limiting accountants’ liability for negligent misrepresentation only to the client or intended third party remained controlling precedent throughout the United States until the mid 1950s. Then some courts began to expanded the potential universe of plaintiffs in negligent misrepresentation cases beyond just the client and intended third party. The Restatement of Torts, Section 552 adopted a more expansive rule. Section 552 expanded liability to include claims brought “by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information ...”. The common example is an accountant who prepares a financial statement for a corporation applying for a loan from bank A. Under contract liability, discussed above, only the client and bank A could use negligence as a legal theory of liability. But under the Restatement rule, other banks are in the same “limited group of persons” for whose benefit the accountant has prepared the information. So if bank A turns down the loan, but bank B makes the loan, bank B can hold the accountant liable if negligent misrepresentation causes bank B to lose money.

The Restatement rule has gradually replaced the Ultramares rule as the majority rule used in most States. A few States, like California, briefly flirted with an even more expansive rule, sometimes referred to as the “foreseeability rule” under which almost anyone who suffers a loss as a result of an accountant’s negligent misrepresentation can hold that accountant liable, so long as that person’s reliance was foreseeable. However, this presents exactly the mass liability problem that Cardozo warned of. California quickly abandoned the foreseeability rule and no jurisdiction uses that rule today.

The other tort of concern to accountants is fraud. As noted above, fraud requires proof of scienter, the intent to deceive. Fraud is rare, and even where fraud exists it is hard to prove. But if fraud is proved, there is almost no limit on the size of the universe of potential plaintiffs. Any foreseeable plaintiff may recover. In addition, a court may award punitive damages in addition to compensatory damages. If a jury becomes incensed at an accountant’s behavior, it may award punitive damages that are substantially in excess of the plaintiff’s loss.

Statute Law Liability

The greatest potential liability facing accountants, particularly those doing work for public companies, is statute liability. We have seen how contract liability and negligent misrepresentation liability are limited to the client, an intended third party, or perhaps a limited class of intended users. But certain federal statutes, especially the securities acts, extend liability, in some circumstances, to any purchaser or seller of a security. The potential universe of plaintiffs can be enormous.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted following the massive crash of the New York Stock Exchange in 1929. This crash
ushered in the Great Depression which threatened the economic and political stability of the United States. The crash had been brought about in part by manipulation, false financial reporting, and fraud. Public opinion called for reform and stricter regulation. As a result, all those associated with the issue or sale of securities faced increased liability, including criminal liability. Included were accountants who prepared financial information regarding public companies.

The provisions of the securities acts affecting accountants are too numerous to cite here. However, two Sections are prominent and serve as examples. They are Section 11 of the Securities Act of 1933 and Section 10b of the Securities Exchange Act of 1934.

Section 11 of the Securities Act of 1933 presents great potential liability to accountants. The 1933 Act governs the issuance and sale of new securities, now referred to as Initial Public Offerings (IPOs). Most IPOs require registration with the Securities Exchange Commission (SEC) although some are exempt. If the registration statement contains a misstatement or omission of a material fact, then the issuer, underwriter and any expert who contributed to the misstatement or omission is presumed to be liable. Accountants who prepare financial information or issue opinions about financial information are considered experts and are liable for any errors they contribute to the registration statement. Because of the presumption of liability contained in Section 11, a plaintiff does not have to prove that the accountant was negligent or in any other way at fault. All the plaintiff has to prove is that the registration statement contained a material error and that he/she purchased the security and suffered a loss. The plaintiff need not prove any contractual relationship (privity) with the accountant, nor need the plaintiff prove reliance. Liability is presumed.

However, just as with most presumptions in law, this presumption is rebuttable. The accountant does have the opportunity to rebut the presumption of liability by proving that he/she acted with “due diligence”35. Due diligence is essentially the absence of negligence, that is, the exercise of reasonable care and competence as discussed above in the section on tort liability. Section 111(b)(3) of the Act states that in order to prove the defense of due diligence, a defendant must have “had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true…” In determining what a “reasonable investigation” consists of, Section 11(c) states that “the standard of reasonableness shall be that required of a prudent man in the management of his own property”. Because the universe of plaintiffs is so large, and liability is presumed, Section 11 of the 1933 Act presents enormous potential liability to accountants.

Section 10b of the Securities Exchange Act of 1934 also presents great potential liability to accountants and others. This Section applies to the purchase and sale of almost any security, not just the purchase of IPO securities. If the security has a connection with interstate commerce, the mails, or is traded on a national securities exchange, Section 10b applies. Any communication with investors that contains a material misstatement or omission violates this statute. However, the burden of proof that the plaintiff must sustain is substantially greater than under Section 11. Most important is that the plaintiff must prove that the accountant or other defendant acted with scienter. There was some uncertainty over this, as the SEC had issued Regulation 10b(5) which some argued relaxed the scienter requirement. But the U.S. Supreme Court case of
Ernst & Ernst v. Hochfelder resolved the matter in favor of requiring scienter in order to establish Section 10b liability. As noted above, proving scienter is difficult. Proving scienter might be somewhat easier today because of electronic discovery techniques. A “smoking gun” email or other electronic communication could provide the needed proof of intentional deceit. Modern search engines may make it easier to discover such an email.

THE SARBANES-OXLEY ACT AND ACCOUNTANT LIABILITY

The SOA is a large and complex statute that contains eleven titles. Title I creates a new regulatory agency to oversee auditors’ work, the Public Company Accounting Oversight Board (PCAOB). Title II deals with auditor independence and auditor conflicts of interest. These two titles contain the provisions of greatest relevance to accountants. Title III deals with corporate responsibility. Title IV provides for enhanced financial disclosures. Section 404 of this title requires a management assessment of internal controls. This Section has added substantial cost to audits and is the subject of much criticism and complaint.

Title V deals with financial analysts’ conflict of interest. Title VI deals with the authority of the Board. Title VII requires various studies and reports by the Government Accounting Office (GAO) and SEC relating to consolidation of public accounting firms and violations of securities laws. Title VIII increases penalties for corporate and criminal fraud. Section 804 makes a significant change in the law by extending the Statute of Limitations for certain securities act violations to two years after discovery or five years after the date of violation. Previously it had been one year and three years. This will be discussed below. Title IX increases penalties for white-collar crime. Title X requires the signing of corporate tax returns by chief executive officers. Title XI increases potential prison terms under the Federal Sentencing Guidelines and deals with corporate fraud and accountability. It also contains a provision prohibiting retaliation against informants. In all there are 1,107 separate Sections in this statute. Those that impact the legal liability of accountants will now be discussed.

The Public Company Accounting Oversight Board (PCAOB)

Title I of SOA created the PCAOB, and defines its authority. This represents the first time the accounting profession experienced direct external oversight by a government-sponsored organization. The Board consists of five members, appointed by the SEC for five year terms. Two must be or have been certified public accountants, and three can not be or have been CPAs. It is a private nonprofit organization but was established by Congress and has strong ties to the SEC. Section 109 describes the funding of the PCAOB and is of interest. Recall that in the section above titled “Origins and Attitudes” the precursor to the PCAOB, the Public Oversight Board (POB) had proven ineffectual in part because it lacked a reliable, independent funding source. Section 109(d) states that PCAOB funding will come from public companies, in proportion to their market capitalization. This is a funding source independent of accounting firms or their professional association.
Sections 104 and 105 may have the greatest impact on accountants’ liability of all sections of the SOA. These sections deal with inspections, investigations and disciplinary action that can be taken by the PCAOB against accounting firms and accountants. The PCAOB may in effect audit the auditors. Sections 104 and 105 give the PCAOB strong oversight power, in contrast to the flaccid or non-existent oversight power of the predecessor POB.

Section 104(b) requires the PCAOB to conduct inspections of accounting firms that perform audits on public companies. Larger firms are to be inspected more often: firms that perform audits for more than 100 public companies are to be inspected once each year. Accounting firms that perform 100 or fewer public company audits are to be inspected “not less frequently than once every 3 years”. This scaling of inspection frequency to audit firm size and activity is interesting. It is certainly a rational response to treat a Big Four accounting firm differently from a small accounting firm that might perform only a handful of public company audits each year. However the SOA does not provide a similar scaled response to the public companies themselves. Compliance requirements are the same for public companies large and small. Small companies have complained loudly that their cost of compliance with SOA is proportionally much greater than that of large companies.

If a regular PCAOB inspection reveals violations, an investigation may follow. Section 105(b) authorizes the PCAOB to perform investigations that include subpoenaing of witnesses and documents. The PCAOB may require the testimony “of the firm or any person associated with a registered public accounting firm”. In order to perform audits of public companies, accounting firms must register with the PCAOB, per Section 102. If a person or firm fails to cooperate with the investigation, registration may be suspended or revoked. The teeth of this section are found in Section 105(c)(4): in addition to suspension or revocation of registration, the PCAOB may impose a “civil money penalty” of “not more than $750,000 for a natural person or $15,000,000 for any other person” for violations that consist of “intentional or knowing conduct, including reckless conduct” or “repeated instances of negligent conduct”. Note the conjunctive “or”. Even a negligent, unintentional violation, if repeated, can bring on these severe penalties. If the violation is not intentional or knowing, the penalties are less severe but still substantial: up to $100,000 for a natural person or $2,000,000 for others. Natural persons are, of course, accountants and other employees of an accounting firm. The “other persons” are the firms themselves. The PCAOB’s inspections began in May 2004 and it is currently inspecting the eight largest U.S. public accounting firms and also a number of smaller firms.

Section 103 gives the PCAOB the independent standard-setting authority that Lynn Turner (see above in the “Origins and Attitudes” section) and others complained was lacking previously. Section 103(a)(1) gives the PCAOB authority to create “attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms…”. They must preserve audit papers and “other information related to any audit report, in sufficient detail to support the conclusions reached in such reports” for at least 7 years. Storing these records for 7 years brings accountants into compliance with the requirements of Section 103; a failure to store them for at least 5 years can result in criminal liability that carries a maximum of 10 years in prison, per Section 802, discussed below.
Another Section in Title I that may be of interest to academics is Section 109(c)(2). That Section states that “all funds collected by the Board as a result of the assessment of monetary penalties shall be used to fund a merit scholarship program for undergraduate and graduate students enrolled in accredited accounting degree programs...” Academic Accounting departments may wish to contact the PCAOB regarding that provision.

The Board has been creative in seeking complaints. It recently created a new online form (www.pcaobus.org/tips), an email address (tips@pcaobus.org) and a toll-free phone number (800.741.3158). It is interested in receiving tips on potential violations of the SOA, especially if they are relevant to one of the PCAOB’s inspections. Information can be provided anonymously.43

Auditor Independence

Title II of the SOA addresses auditor independence. Lack of auditor independence from the companies they are auditing is generally credited with contributing to audit failures and accountant-related corporate scandal.44 Many accounting firms collected substantial professional fees for non-audit related services performed for their audit clients. In some cases the non-audit fees exceeded the audit fees. For example, Arthur Anderson collected $21 million annually for audit services and $29 million annually for consulting services45. An auditor in that position would not be inclined to push too hard on the audit side for fear of losing the even more lucrative consulting side. Such an auditor faces a clear conflict of interest. In order to eliminate that conflict, SOA puts up a high wall separating audit work from other accounting work.

Section 201 provides a laundry-list of nine specific services that an auditor may not perform for a public company audit client. These include bookkeeping, financial information system work, appraisal or valuation, actuarial services, internal audit outsourcing, management or human resource services, investment banking, legal work related to the audit and “any other service that the Board determines, by regulation, is impermissible.”

Section 203 requires audit partner rotation. The “lead (or coordinating) audit partner (having primary responsibility for the audit)” may not work for more than 5 years on audits for the same public company. In this way the SOA hopes to curtail the natural congenial relationships that may develop over many years between corporate managers and auditors. These relationships pose a potential conflict of interest. Also, the knowledge that a new audit partner will be reviewing his/her work may tend to make the audit partner behave more correctly. However, at least one commentator feels that audit partner rotation does not go far enough46.

Title II contains a section that has not drawn much attention, but is potentially very significant. Section 207 calls for the Comptroller General of the U.S. to conduct a study of the “potential effects of requiring the mandatory rotation of registered public accounting firms.” This goes far beyond merely rotating auditing partners within the same firm. Perhaps Congress is waiting to see how effective SOA will be, and whether even more stringent regulation will be required.

Other Sections That Impact Accountant Liability
While Titles I and II deal directly with audit practice and accountant liability, other sections of the SOA also relate to accountant liability. These include Section 802, which increased criminal penalty for “destruction, alteration, or falsification of records in Federal investigations” to a maximum of 20 years in prison. Accountants are also required by this section to “maintain all audit or review workpapers for a period of 5 years”, and an accountant who “knowingly and willfully” violates this record-keeping requirement faces a maximum sentence of 10 years in prison. Section 806 increases the maximum sentence for securities fraud to 25 years in prison. Section 804 increases the Statute of Limitations cut-off for bringing private actions under the Securities Act of 1934 to 2 years from date of discovery and 5 years from date of violation. Previously it had been 1 year and 3 years. This Section has been extensively litigated, with many private plaintiffs arguing that these longer cut-offs should be applied retrospectively as well as prospectively. However in a recent case titled In re Enterprise Mortgage Acceptance Co. LLC, decided on December 6, 2004, the Second Circuit Court of Appeals resolved this issue in favor of prospective application only. Section 805 may lead to stiffer jail sentences, as it requires the U.S. Sentencing Commission to review its sentencing guidelines for violations of the SOA.

The very last section of the SOA, Section 1107, makes it a crime to retaliate against whistleblowers. The maximum sentence is 10 years in prison. Retaliation includes “any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense”. This last section may be of assistance to an accountant such as an internal auditor who discovers a violation and reports it.

A NEW CONCEPTUAL FRAMEWORK FOR REGULATION: THE PREVENTIVE/REMEDIAL DICHOTOMY

While considering the regulatory aspects of the SOA I was struck by the preventive nature of this Act. PCAOB inspections of public auditors, creation and enforcement of stringent auditing standards and the strong separation between the auditing and consulting functions of accounting firms all operate to prevent the accounting-related corporate meltdowns experienced by Enron and other companies. It seems that all regulation can be divided into two categories: preventive or remedial.

Consider for example the problem of industrial accidents. Two regulatory responses have emerged. First, workers’ compensation was developed, around the turn of the twentieth century. Then, in 1970 Congress created the Occupational Safety and Health Act (OSHA) to deal with the same problem. Workers’ compensation is an example of remedial government regulation. It provides a remedy after the injury has occurred. This was an improvement over the previous situation in which the injured worker was not likely to be able to recover at law for his/her injuries. (Most negligence lawsuits against the firm were barred at that time by three legal defenses: contributory negligence, assumption of risk, and the fellow servant rule. Injured workers were left without funds to pay for medical care or wage loss.) Workers’ compensation, with its no-fault provision, guaranteed that an injured worker
would be fully covered with regard to medical expenses and would also receive partial wage loss compensation, so long as the injury arose out of employment.

Congress recognized in 1970 that a superior solution to the problem of industrial accidents is to prevent them from happening in the first place. OSHA uses this preventive approach. By mandating safety standards and inspections, injuries are prevented. This was a complete reversal of perspective from workers’ compensation, which viewed industrial accidents as inevitable and merely sought to ameliorate the financial impact on victims.

All regulatory schemes contain elements that are either preventive of remedial, or perhaps a combination of both. For example, the Securities Acts of 1933 and 1934 are predominantly remedial, in that they provide remedies to investors who suffer loss from misrepresentation and fraud. They are also preventive in that they also require extensive periodic disclosure of financial information so that investors can avoid losses resulting from investments with poor or inadequate financial fundamentals.

While preventive regulation is clearly more desirable from a societal point of view, it is often less popular with those affected than remedial regulation. When the government steps in to provide a remedy after the damage has already been done everyone recognizes the problem and the need for remedy. But preventive regulation is often viewed as needless government meddling and interference. Business’ complaints about OSHA are an example. Also, with remedial regulation victims may receive money or benefits from the government, for example with workers’ compensation. On the other hand, preventive regulation typically requires firms to spend money for compliance. It also diverts some managerial attention from core business objectives. These are exactly the complaints being leveled against the SOA.

The SOA is an excellent example of regulation that is predominantly preventive in nature. PCAOB’s inspections of public auditing firms and its promulgation of standards to promote accurate financial reporting and avoid conflicts of interest directly parallel OSHA’s preventive approach. No one should be surprised that the same kind of objections and complaints that are made regarding OSHA’s activities are also made regarding SOA compliance. Nevertheless, the conclusion is irresistible that preventing harm is better than remedying its effects. It has been variously estimated that the corporate scandals of 2000 and 2001 have cost investors’ between $300 billion and $460 billion. While compliance with SOA certainly has costs, it is highly unlikely that these costs even approach the magnitude of investors’ recent losses.

CONCLUSION

We have seen that the SOA substantially changed the liability environment in which auditors of public companies must operate. Before the SOA liability would typically come about only after a corporate collapse. But while auditors knew that the resulting liability would be great, they also knew that for any given audit it was very unlikely to occur. Now, as William McDonough, Chair of the PCAOB has said “under the new system, auditors understand that their work is much more likely to be reviewed within months or even weeks by the PCAOB’s well-experienced, full-time inspectors.” It is now far more likely that violations will be caught.
Auditors are now much more sensitive to conflicts of interest. The SOA lists specific conflicts to avoid, such as consulting work and other non-audit work. It also gives the PCAOB authority to outlaw additional conflicts. This has changed the fundamental economic structure of the public accounting profession. Audits can no longer be “loss leaders” supporting other more profitable work. Congenial personal relationships between auditors and corporate officers are now discouraged and the term of a “lead accountant” auditing a public company is now limited to 5 years. Audits have become more adversarial, and more expensive.54

Accountants now face greater risk when performing audits of public companies. A PCAOB inspection could result in suspension or termination of the accountant’s and/or the firm’s registration status. Without registration, the accountant or firm is prohibited from performing audits of public companies. In a worst case scenario, prison terms of 10 years could result from willfully failing to maintain all audit workpapers for five years. An accountant could spend 20 years in a federal prison for willfully destroying or altering documents.

No longer will auditing standards be formulated by an industry-friendly body like the Auditing Standards Board of the AICPA. They will now be formulated by the tough-minded PCAOB. The more stringent standards and practices mandated by the SOA might become accepted as best practices and be imposed even in ordinary negligence lawsuits.

All these changes might seem disheartening to accountants and especially those auditing public companies. And yet there is a very bright and hopeful side to the changes that the SOA has brought about. Progressive firms like Deloitte & Touche view the SOA as “a bridge to excellence”55. Their booklet by that title states “corporate leaders who embrace the spirit of the law – strong ethics, good governance, reliable reporting – will get a re-energized company, reassured investors, and maybe even reduced costs”56. Business Week Online recently reported a decline in “vehement railing against Sarbanes-Oxley” as corporations begin to see benefits of improved business controls and processes.57

It is clear that the SOA is here to stay. It addresses the critical need to restore investor confidence following unprecedented business scandals. While it has increased the cost of compliance for corporations and added to auditors’ legal liability, it has also brought about more reliable financial reporting, improved internal control processes and eliminated many conflicts of interest. It has also led to a greater emphasis on ethical behavior. Moreover, the SOA represents the best kind of regulation: that which seeks to prevent a harmful event, not just to provide a remedy to those injured by that event.

The benefits of the SOA appear to outweigh its costs. Moreover it is unlikely that Congress will significantly weaken it. It would be politically inopportune to appear to side with the corporate abusers. However, it is well recognized that the SOA was drafted in haste, and fine-tuning will no doubt occur. One measure that is almost certain to be adopted is a reduction of the regulatory burden and cost on small corporations. Congressman Oxley has recently said that if he could do it all again, he would provide “a bit more flexibility for small and medium-size companies”58.

ENDNOTES
5 The SOA is also referred to as SOX and Sarbox.
9 S. Forbes (September 5, 2005). Dump This Destructive Deadweight, Forbes Magazine, 31-32.
10 It is said that President Eisenhower once said, in frustration, “bring me a one-handed economist”.
16 Infra, note 27.
17 Id. at 135.
22 Id.
24 Supra note 18 at 246.
Id.


This function had previously been performed by the AICPA’s Committee on Auditing Procedure and later by the Auditing Standards Executive Committee.

Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 107th Congress 532 (2002) at 217.

Id. at 941. Testimony of Charles Bowsher, former Chairman of the POB and former Comptroller General of the U.S.


For example, Section 10b of the Securities Exchange Act of 1934.


SOA Sec. 101. This Board is often pronounced “peekaboo”.


SOA Section 105(c)(5).

Oversight of the Public Company Accounting Board: Hearing Before the Subcommittee on Capital Markets etc., 108th Congress 6 (2004), statement of William McDonough, Chairman of the PCAOB, at 45.


Workers’ compensation programs with similar no-fault provisions originated in Germany in the early 1800s.

Occupational Safety and Health Act, 29 USC 651 et seq. (1970).

Sometimes referred to as the “three evil sisters”.
53 Testimony of William McDonough before the Committee on Financial Services, U.S. House of Representatives, April 21, 2005 at page 15.
55 *Supra*, note 12.
56 *Id.*
57 *Supra*, note 14.