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The SEC and Accounting, In Part through the Eyes of Pacioli

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ARTICLES

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Introduction

The fundamental accounting equation unequivocally states:

Assets = Liabilities + Owners' Equity.

Without periodic reports from business enterprises describing in some detail exactly how the specific assets, liabilities, and components of owners' equity underlying this equation have changed, investors cannot gauge a firm's financial performance and regulators remain powerless to prevent public companies from misleading investors and the general public about their financial health. As a result, following the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, the federal securities laws have required disclosure reports both from enterprises that seek to become public companies by offering their securities to the public and also from businesses that already had successfully done so. Until the late 1960s, these reports relied exclusively on financial statements and accompanying notes to provide financial disclosures. Because numbers almost never tell the full story, the financial statements and notes usually supplied only a sketch, rather than a full-color picture, of a public com-

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pany's financial condition and operating results. By mandating a textual discussion to accompany and analyze those numbers, the Management's Discussion & Analysis (MD&A) requirements rank as perhaps the most significant administrative initiative involving the intersection between accounting and disclosure in the Securities and Exchange Commission's (SEC) seventy-year history.[1]

In 1980, the SEC adopted integrated disclosure requirements[2] found in Regulation S-K[3] that apply to both so-called "issuers" that

1 The MD&A requirements trace their roots back to at least 1968. *See* Guides for Preparation and Filing of Registration Statements, Securities Act Release No. 4936, 33 Fed. Reg. 18,617, 18,620 (Dec. 17, 1968). While neither published as Securities and Exchange Commission (SEC) rules nor as bearing the Commission's official approval, the guides set forth the policies and practices that the Division of Corporation Finance followed in administering the registration requirements. In 1974, the SEC authorized amendments to both Guide 22, which at the time was entitled "Summary of Earnings" for registration statements under the Securities Act, and Guide 1, "Summary of Operations," for filings under the Securities Exchange Act. *See* Guidelines for Registration and Reporting, Accounting Series Release No. 159, 39 Fed. Reg. 31,894, 31,894–95 (Sept. 3, 1974) (reiterating that the guides do not bear the SEC's official approval); *see also* Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, Exchange Act Release No. 24,356, 52 Fed. Reg. 13,715, 13,716 (Apr. 24, 1987) (discussing the history of MD&A requirements).

2 *See* Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Act Disclosure Systems, Accounting Series Release No. 279, 45 Fed. Reg. 63,630 (Sept. 25, 1980). The rules apply to both filings under the Securities Act of 1933 and the Securities Exchange Act of 1934. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C.A. §§ 77a–77aa (West 1997 & Supp. 2004)); Securities Exchange Act of 1934, Pub. L. No. 72-291, 48 Stat. 881 (codified as amended at 15 U.S.C.A. §§ 78a–78mm (West 1997 & Supp. 2004)). As background, the federal securities laws require any enterprise proposing to offer securities to the public, often referred to as "issuers," to disclose certain information and to file financial statements with the SEC. 15 U.S.C. § 77s(a) (2000). In addition, so-called "registrants," which include those companies whose shares or debt obligations are listed on a national securities exchange, such as the New York Stock Exchange or the Nasdaq Stock Market, Inc., or which meet certain tests relating to total assets and number of shareholders, must file periodic reports and financial statements with the SEC to provide information to the investing public. *Id.* § 78m(a). Under existing rules, enterprises with ten million dollars or more in assets *and* 500 or more owners of any class of equity securities must file periodic reports with the SEC, even if their securities are not traded on a national securities exchange. *Id.* § 78*l*(g)(1), (h); 17 C.F.R. § 240.12g-1 (2004). Together, these initial and continuing disclosure obligations seek to prevent misleading or incomplete financial reporting and to enable investors to reach informed decisions.

3 17 C.F.R. §§ 229.10–.915. Regulation S-K applies to both enterprises desiring to offer securities to the public and to registrants that must file periodic reports with the SEC. *See id.* § 229.10(a). Item 5 of Form 20-F under the Securities Exchange Act of 1934 requires similar disclosures from foreign private issuers that either seek to

seek to become public companies and "registrants" that already hold that distinction. These rules continue to provide standard instructions for most enterprises filing forms under the federal securities laws. In particular, Item 303 of Regulation S-K, entitled "Management's Discussion and Analysis of Financial Conditions and Results of Operations," requires an issuer or registrant to discuss its liquidity, capital resources, operating results, and other information necessary to understand the financial statements.[4] Recognizing that the traditional dry recitation of numbers and the accompanying often boilerplate notes to financial statements rarely allowed an investor "to judge the *quality of earnings* and the likelihood that past performance is indicative of future performance,"[5] the MD&A seeks to give the reader an opportunity to view the enterprise "through the eyes of management."[6]

By insisting on more comprehensive and comprehensible disclosures regarding corporate accounting, the SEC—almost certainly unwittingly—reached across the centuries and the globe to validate further the work of an Italian Renaissance friar by the name of Luca Pacioli.[7] Anointed by accounting historians as the "Father of Accounting,"[8] Pacioli wrote the first known treatise that describes the process the business community today calls double-entry bookkeeping.[9]

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register securities or to file annual or transition reports under the Securities Exchange Act. *See id.* § 249.220f. Regulation S-B contains similar requirements for "small business issuers," *see id.* § 228.10(a)(1), essentially domestic or Canadian companies whose revenues and "public float," which generally means the aggregate market value of outstanding securities, fall below twenty-five million dollars. *Id.* §§ 228.10–.703.

4 *Id.* § 229.303.

5 Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Financial Reporting Release No. 36, 54 Fed. Reg. 22,427, 22,428 (May 24, 1989) (emphasis added), *available at* http://www.sec.gov/rules/interp/33-6835.htm.

6 *Id.*

7 Translators have used various spellings for this individual's first and last names. *See, e.g.*, Raymond de Roover, *Paciolo or Pacioli?*, 19 ACCT. REV. 68 (1944) (arguing additionally that because modern Italian commonly drops the "u," the forms "Paciuoli" and "Paciuolo" have become obsolete).

8 *See* Richard H. Macve, *Pacioli's Legacy*, *in* ACCOUNTING HISTORY FROM THE RENAISSANCE TO THE PRESENT 3 (T.A. Lee et al. eds., 1996).

9 *See id.* at 4. Double-entry bookkeeping flows from the fundamental accounting equation, which you may recall provides:

Assets = Liabilities + Owners' Equity.

Collectively, liabilities and owner's equity serve as the "sources" that allow an enterprise to finance its assets. Under double-entry bookkeeping, changes in either the mix of assets or their sources do not affect the equality of the fundamental accounting

When Pacioli published his text in 1494,[10] or 440 years before Congress created the SEC, double-entry bookkeeping had been used for

equation. To illustrate, an increase in an asset may come about in one of two ways: either another asset has been exchanged for it, or an additional source of funds has been supplied to acquire it. On the balance sheet, the increase in the asset column would either be offset by a decrease in the asset column or be balanced by an increase in the sources column. Likewise, a decrease in an asset may come about in one of two ways. If assets have been exchanged, we have the transaction already discussed, but stated in reverse order—the decrease in assets will be accompanied by an increase in assets reflecting the acquisition of the new asset. The other possibility is a decrease in the sources column, reflecting perhaps the use of an asset to pay a liability. Finally, there can be an exchange of sources, which would be reflected by equal increases and decreases in the sources column. Accountants use debits to reflect increases in assets or decreases in sources. By comparison, credits reduce assets or increase sources. Under the fundamental accounting equation and double-entry bookkeeping, the total debits must always equal the total credits.

In contrast, a checkbook register illustrates single-entry bookkeeping. A checkbook register allows us to keep track of a single asset, namely our checking account. Properly maintained, our checkbook tells us the balance in our checking account, when we deposited funds, and where we spent cash. The checkbook register, however, does not tell us what other assets we own or what liabilities we owe. For example, the checkbook register does not tell us whether we still own the clothes we wrote a check to purchase two years ago, that we own a car we recently purchased on credit, or what we still owe on the car. Double-entry bookkeeping permits more comprehensive financial reports. *See generally* DAVID R. HERWITZ & MATTHEW J. BARRETT, MATERIALS ON ACCOUNTING FOR LAWYERS 14–20 (3d ed. 2001) (explaining the distinction between single- and double-entry bookkeeping in greater detail).

10 Pacioli's description appears within a much longer text on arithmetic and geometry entitled *Summa de Arithmetica, Geometria, Proportioni et Proportioinalita*. *See* JOHN B. GEIJSBEEK, ANCIENT DOUBLE-ENTRY BOOKKEEPING 8 (Scholars Book Co. 1974) (1914); Macve, *supra* note 8, at 30. Pacioli discusses bookkeeping in part 1, section 9, treatise 11, under the translated title *Particulars of Reckonings and Their Recording*. GEIJSBEEK, *supra*, at 8. Modern historians currently believe that Pacioli began his treatise at age nineteen and then labored some thirty years before publishing his treatise at age forty-nine. *See* Michael J. Fischer, *Luca Pacioli on Business Profits*, 25 J. BUS. ETHICS 299, 301 (2000). Pacioli likely died in 1517, at seventy-two years of age. Macve, *supra* note 8, at 25 n.1. Earlier scholars placed his death in 1509. *See* GEIJSBEEK, *supra*, at 8.

Over the years, scholars have translated Pacioli's Italian text into German, Dutch, Russian, English, and other languages. *See id.* at 3–4. The first "modern" English translation appeared in 1914, twenty years before the SEC's creation. *See id.* at 1. Only five modern English translations of the *Summa* generate much attention, beginning with the first modern English translation by John B. Geijsbeek in 1914. Other modern English translations include Crivelli (1924); Brown and Johnston (1963); Cripps (1994); and Gebsattel and Yamey (1994). *See* PIETRO CRIVELLI, AN ORIGINAL TRANSLATION OF THE TREATISE ON DOUBLE-ENTRY BOOK-KEEPING BY FRATER LUCAS PACIOLI (Nihon Shoseki, Ltd. 1974) (1924); R. GENE BROWN & KENNETH S. JOHNSTON, PACIOLO ON ACCOUNTING (1963); JEREMY CRIPPS, PARTICULARIS DE COMPUTIS ET SCRIPTURIS (1994); ANTONIA VON GEBSATTEL & BASIL YAMEY, EXPOSITION OF DOUBLE ENTRY BOOKKEEPING (1994). These later translations typically cite Geijsbeek's translation as more than two hundred years in Venice, then the world's commercial center.[11] So while he did not invent the process, accounting historians credit Pacioli for providing the first systematic written study of accounting. Pacioli's efforts, however, extend beyond mere description. The friar also set forth and endorsed basic principles that would ultimately develop into the field of financial accounting. Some of these principles, I argue, still resonate today. Taking a cue from the MD&A requirements and the SEC's efforts to give investors an opportunity to view a public company "through the eyes of management," this Article seeks to pull together two threads, namely Pacioli's prominence in accounting and the importance of the MD&A requirements, to evaluate the SEC's record on certain accounting issues.

Because writers in legal journals have largely ignored Pacioli's efforts,[12] Part I of this Article highlights and outlines some of the friar's contributions and accounting precepts. Part II applies some of these precepts in a critique of the SEC's record on accounting issues. Using this discussion as a springboard, Part III then offers additional reflections of the SEC's reliance, sometimes via congressional direction or acquiescence, on private-sector bodies to establish accounting principles and standards governing audits of public companies; the SEC's leadership regarding the MD&A requirements, most notably through an administrative action against Caterpillar, Inc.; and auditor independence. After identifying particular accomplishments in most of these areas notwithstanding often inadequate resources, Part IV concludes that the failure to safeguard auditor independence stands as the SEC's one glaring weakness during its first seventy years. Looking ahead, therefore, an enhanced focus on this particular problem seems necessary to ensure investor confidence and to help keep the U.S. securities markets as the world's leaders.

I. Pacioli's Legacy to Life, Business, and Accounting

A Franciscan friar and an experienced and renowned teacher, Pacioli spoke articulately, and with great insight, to the faithful, to merchants, and to his students.

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a reference. *See* Crivelli, *supra*, at vii; Brown & Johnston, *supra*, at 143; Cripps, *supra*, at bibliography; Gebsattel & Yamey, *supra*, at 163 n.4.

11 *Pacioli Revisited*, J. Acct., May 1987, at 196, 197.

12 Searching Westlaw's full-text database of "Journals & Law Reviews Combined" (JLR) in November 2004 produced only nine articles, and a Lexis-Nexis search of full-text "US Law Reviews and Journals, Combined" revealed only eleven articles mentioning Pacioli's name.

Pacioli used the printing press and Italian vernacular to document techniques that allow business owners to assess periodically an enterprise's profitability, while offering certain inbuilt checks that help to guard against errors and omissions. He recognized the need for honesty in business dealings, saw cash and liquidity as essential to an enterprise's survival and success, and advocated current value accounting. In addition, Pacioli urged his readers to integrate their professional lives and religious beliefs.

My favorite Pacioli lessons about life, business, and accounting include:

- "[A]bove all, remember God and your neighbor; never forget to attend to religious meditation every morning, for through this you will never lose your way . . . ."[13]
- "If you are in business and do not know all about it, your money will go like flies—That is, you will lose it."[14]
- "[I]t is always good to close the books each year, especially if you are in partnership with others. . . . Frequent accounting makes for long friendship."[15]
- "More bridges are necessary to make a good merchant than a lawyer can make."[16]
- "The law helps those that are awake, not those that sleep."[17]

Pacioli also offers some consolation to my students, who often get frustrated by my "learn-by-doing" approach:

- "Who does nothing, makes no mistakes; who makes no mistakes learns nothing . . . ."[18]

Because this symposium addresses the federal securities laws, in the interest of full disclosure, I should also reveal that Pacioli reportedly gave the following advice about teaching:

- "You have to learn to tell a thousand holy lies."[19]

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13 GEIJSBEEK, *supra* note 10, at 37. Interestingly, another translation uses the word "Mass" rather than "meditation." CRIVELLI, *supra* note 10, at 12 ("[B]ut, above all first always keep God before your eyes and never miss hearing Mass in the morning, bearing in mind that because of it time is never lost, as by charity riches are not wasted . . . .").

14 GEIJSBEEK, *supra* note 10, at 63 (introjecting a proverb).

15 *Id.* at 67.

16 *Id.* at 37 (referring to a proverb); *see also id.* at 77 ("The proverb says that we need more bridges to make a merchant than a doctor of laws can make.").

17 *Id.* at 37. When I share this epigram with my students I add "especially those law students who stay awake during class."

18 *Id.* at 53 (relating a "common proverb").

19 R. Emmett Taylor, *Pacioli*, 10 ACCT. REV. 168, 173 (1935).

I'm not quite sure what can be holy about lies.

Before turning from these epigrams to Pacioli's more systematic statements about accounting, first realize that this Franciscan friar showed extraordinary practical vision. Although, like other contemporaries, Pacioli sought in his treatise to apply mathematics to workday problems,[20] he went further and used state-of-the-art technology, namely the printing press, to disseminate his work. Equally significant, Pacioli selected the most user-friendly and accessible language, the Italian vernacular, over Latin, and chose Arabic numbers rather than Roman numerals.[21] These choices assured that his work could potentially reach the widest possible audience in the business community.

Turning to the content in Pacioli's treatise, keep in mind that during the fifteenth century business owners rarely, if ever, even attempted to determine if their businesses were operating profitably over a specific period, such as a year.[22] Pacioli's text corrected this deficiency and documented a method for periodically and objectively calculating an enterprise's profits.[23] For this contribution, commentators have deemed Pacioli's ideas central to the concept of profitability, indeed to the very definition of modern capitalism.[24] Quite ironically, then, this member of the Order of Friars Minor of St. Francis,[25] a professed religious man bound by a vow of poverty, drastically influenced the development of accounting.[26]

Further illustrating Pacioli's practical relevance, he advocated current value accounting rather than the historical costs generally used in financial accounting today.[27] When recording assets, Pacioli recommended using amounts "according to current prices."[28] Accordingly, he advised: "Make the prices rather higher than lower; for instance, if it seems to you that they are worth 20, you put down 24, so

20 Macve, *supra* note 8, at 10.

21 *Id.* Pacioli used Roman numerals only for dates in the accounting books. *Id.* at 12.

22 *Pacioli Revisited*, *supra* note 11, at 197.

23 *See* Fischer, *supra* note 10, at 299.

24 For a contrary opinion, see Macve, *supra* note 8, at 7, discussing another commentator's observation that the calculation of profit and loss arose more as a byproduct of the accounting requirement to balance the ledger than a prime objective and output of the system.

25 *See* GEIJSBEEK, *supra* note 10, at 8.

26 In 1508, Pope Julius II granted Pacioli a bull, which gave him authority to own property and exempted him from the Franciscan rule that, among other things, required its members to live "without property." Macve, *supra* note 8, at 10.

27 *See Pacioli Revisited*, *supra* note 11, at 197.

28 GEIJSBEEK, *supra* note 10, at 45.

that you can make a larger profit."[29] Pacioli's current value accounting, or more accurately, "target pricing," seeks then a more vivid portrayal of an enterprise's financial situation.[30] The historical cost approach rejects this methodology, however, because it sacrifices reliability. To illustrate this point, take the example of the Walt Disney Company, which in the 1930s acquired the raw land on which Disneyland now sits. Under the historical cost method generally used in financial accounting today, that land remains on Disney's books at its actual cost, even though the land has appreciated tremendously in value.[31] While accountants could seek to estimate the land's current fair market value, a wide range of estimated current values would likely emerge, which would reduce the reliability of the company's financial statements.

Reliability, however, remained quite important to Pacioli. He observed that, throughout Italy, "nothing was considered superior to the word of the good merchant, and oaths were taken on the word of a good merchant."[32] His treatise, above all, sought to further that end.

Recognizing that double-entry bookkeeping offers "inbuilt checks" that both can prevent errors or omissions and identify them when they occur,[33] Pacioli advised the good bookkeeper to ensure that the total debits equal the total credits, in essence describing what we refer to today as the "trial balance."[34] In addition to fostering accuracy, the bookkeeping process allowed a separation of duties between several clerks who could accomplish their assigned tasks, such as recording transactions or posting amounts to the accounts in the ledger.[35] Pacioli also recommended several controls that businesses could use to preclude fraud.[36] For example, he wrote that merchants could number the pages in the memorandum book, journal, and ledger to prevent someone from tearing out one of the pages.[37] "[O]n account of the bad faith of the present time," the good friar further advised bankers to require a receipt for all transactions.[38] Of course, not all of Pacioli's ideas survived the long trip to the twenty-

29 *Id.* at 45, 51; *see* Macve, *supra* note 8, at 7.

30 *See* Macve, *supra* note 8, at 7.

31 *See* Terry Lloyd, *Financial Language in Legal Documents*, *in* HERWITZ & BARRETT, *supra* note 9, at 420, 426.

32 GEIJSBEEK, *supra* note 10, at 33.

33 Again, for a contrary view, see Macve, *supra* note 8, at 7.

34 *See* GEIJSBEEK, *supra* note 10, at 73; *see also* HERWITZ & BARRETT, *supra* note 9, at 43–44 (describing the trial balance).

35 *See* Macve, *supra* note 8, at 21.

36 *See* GEIJSBEEK, *supra* note 10, at 39; *see also Pacioli Revisited*, *supra* note 11, at 197.

37 *See* GEIJSBEEK, *supra* note 10, at 39, 41, 73.

38 *Id.* at 65.

first century. For example, he urged a form of "internal auditing" when a merchant closes the books at the end of an accounting period to determine the profit for the period. In that regard, he suggested hiring "a helper" to read off all the journal items so that the merchant can check each one in the ledger, a process unimaginable for today's public companies.[39]

Notwithstanding his own vow of poverty, Pacioli astutely recognized that, among the things required to carry on a business, "cash or any equivalent" ranks as "[t]he most important."[40] Even today, liquidity, or an ability to pay debts as they come due, remains essential for a business to survive.[41]

Notwithstanding Pacioli's emphasis on the temporal, we should not forget that, as a professed member of a religious community, Pacioli viewed himself as a man of God. Because we have gathered at the University of Notre Dame, it seems especially appropriate to highlight that Pacioli viewed the spiritual and secular as inextricably intertwined. He believed that people should integrate, rather than segregate, their business and professional careers with their personal lives and religious convictions. Thus, his treatise, which taught the mundane details of bookkeeping, also instructed merchants to "begin their business with the name of God at the beginning of every book and have His holy name in their minds."[42] Pacioli also endorsed as "good custom" the practice "among true Christians," which at that time in Venice meant "Catholics," to mark their accounting books and records with the Sign of the Cross.[43] Such marks routinely appeared

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39 *See id.* at 69.

40 *Id.* at 33. Second, a successful businessman must be a good accountant and a ready mathematician. Third, the businessman must arrange his affairs in a systemic way so that he may get their particulars at a glance. *Id.*; *see Pacioli Revisited*, *supra* note 11, at 197.

41 GEIJSBEEK, *supra* note 10, at 33.

42 *Id.* at 33, 35. During the chapter on business records and letters, Pacioli observes:

> It is customary among merchants to write the year and the day and the place at the top at the beginning of the letter. But first, like a good Christian, you should always remember to write down the glorious name of our Savior—that is, the name of Jesus, or in its place the sign of the Holy Cross, in whose name our transactions must always be made . . . .

Id. at 75.

43 Pacioli writes:

> Among true Christians there is the good custom to mark their first books with that glorious sign from which every enemy of the spiritual flees and before which all the infernal spirits justly tremble—that is, the holy cross, by which in our tender years we begin to learn to read. . . . So that we call the

at the top of the various pages of his journals and ledgers.[44]

Pacioli's contributions should provide sufficient background to discuss the SEC's accounting and disclosure rules. In an effort to distill this overview of Pacioli's contributions, we might develop the following mnemonic list:

P Profitability
A Accessibility
C Current value
I Inbuilt checks
O Oaths (representing honesty)
L Liquidity (or cash)
I Integrated life

II. Pacioli's Possible Analysis of the SEC's Record on Accounting Issues

If Pacioli could attend this symposium, I would venture to guess he would offer both praise and criticism to the SEC for its record on accounting issues during the past seventy years. When referring to the SEC, let's assume that Pacioli would direct his comments to the Commission, its staff, the Commissioners—and to Congress, which establishes the laws that govern the Agency's activities and, at least as importantly, determines the funding for the Commission's operations.

The SEC's record on accounting issues encompasses dual efforts: its undertakings to establish both accounting principles and auditing standards, and its endeavors to require disclosures about financial matters. Based upon his treatise, Pacioli might evaluate the SEC's record on accounting principles and auditing standards, including its efforts to require supplemental disclosures about current value and to mandate internal controls and to require reports on the effectiveness of those controls. In addition, he might comment on the SEC's efforts to require officer certifications and the MD&A requirements, which direct issuers and registrants to discuss their liquidity and capital resources.

During this discussion, we should keep in mind the context within which the SEC operates. First, the term "accounting principles" refers to the "rules" governing the compilation of accounting data into financial statements and the form and content of those state-

first books with the Cross, or Memorandum with Cross, and the second Memorandum A, Journal A, Ledger A.

Id. at 39.

44 *See, e.g.*, *id.* at 35, 43, 49, 55.

ments. Accordingly, the term "generally accepted accounting principles," often abbreviated as GAAP, refers to those practices enjoying substantial support at a particular time. Perhaps surprisingly, GAAP commonly offers choices among permissible alternatives and often does not provide specific rules for treating various transactions. Subject to certain oversight by both the audit committee and the independent auditor, a public company's management selects the accounting principles that the enterprise will use from among the acceptable alternatives. In addition, management usually also decides in the first instance how the public company will report an event when no specific rule exists.[45]

Directors, investors, and creditors typically want assurances that the financial statements management prepares contain reliable representations about the enterprise's financial health. As a result, a certified public accountant or a public accounting firm serves as an auditor to examine, on an independent basis, the financial statements management has prepared. In an audit, the auditor seeks to gather evidence about, and then assesses, the various representations in these statements about the enterprise's assets and liabilities at a specific date and transactions during a particular accounting period. Ultimately, an auditor in this country wants to express an opinion as to whether the financial statements that management prepares fairly present the enterprise's financial condition, results of operations, and cash flows in accordance with GAAP in the United States, which this Article will refer to simply as GAAP, even though some lawyers and accountants use the acronym GAAPUS. During the audit, the auditor must act in certain ways and perform certain procedures, which accountants refer to collectively as *auditing standards*, before expressing an opinion on the financial statements.[46]

A. *Accessibility to the SEC's Accounting and Auditing Authorities and Financial Disclosures Filed with the SEC*

As you might surmise from the previous discussion, a complex web of accounting and disclosure rules exists today. Perhaps not as apparent, these rules require a veritable mountain of disclosure documents. If Pacioli were alive today, the SEC's award-winning website,

45 *See generally* DAVID R. HERWITZ & MATTHEW J. BARRETT, MATERIALS ON ACCOUNTING FOR LAWYERS 7 (3d ed. Supp. 2004) (discussing the difference between accounting principles and auditing standards).

46 *See generally id.* at 8 (describing the audit process and the role of auditing standards).

the Electronic Data Gathering and Retrieval System (EDGAR),[47] would likely catch his eye. This important innovation provides the investing public near-immediate access to the disclosure documents and financial statements that public companies file with the Commission. If disclosure functions as the heart for monitoring the financial health of public companies in the United States, then EDGAR supplies the lifeblood of that system.

The SEC has also devoted considerable energies to spelling out guidance on various accounting and disclosure issues. By regulation, most notably Regulations S-X, S-K, and S-B, the SEC sets forth the requirements for the financial statements that issuers and registrants must file with the Agency.[48] Fleshing out those regulations and the overarching federal securities laws are various administrative releases and other guidance from the both SEC and its staff, especially professionals in the Office of the Chief Accountant and the Division of Corporation Finance, regarding various accounting and financial reporting issues.

From 1937 to 1982, the SEC published more than three hundred Accounting Series Releases (ASRs) to inform the public about matters relating to accounting and auditing. These releases expressed opinions of the Commission and its Chief Accountant, who probably continues to qualify as the most influential accountant in the world, regarding various accounting and financial reporting issues.[49] In 1982, the SEC published the Codification of Financial Reporting Policies (the "Codification") to organize by topic the Commission's published positions in the ASRs related to financial reporting.[50] At that

47 2003 SEC. & EXCH. COMM'N ANN. REP. 11, *available at* http://www.sec.gov/pdf/annrep03/ar03full.pdf.

48 Regulation S-X contains lengthy and detailed requirements prescribing the specific items which issuers and registrants that do not qualify as "small business issuers" must disclose or address in financial statements which they file with the Agency. *See* 17 C.F.R. § 210 (2004). In addition, Regulation S-K presents standard instructions for filing forms under the Securities Act of 1933 and the Securities Exchange Act of 1934, including directions related to certain financial information which those forms require. *See id.* § 229. Regulation S-B, which applies to "small business issuers," *see supra* note 3, exempts some registrants from certain requirements in Regulations S-X and S-K. *See* 17 C.F.R. § 228.

49 As one of fourteen offices in the SEC, the Office of the Chief Accountant helps to develop, subject to Commission approval, policy and rules on accounting and auditing issues relating to the federal securities laws. Responsibility for recommending administrative proceedings relating to such matters and for assisting in such proceedings also rests with the Office of the Chief Accountant, which the Chief Accountant oversees. HERWITZ & BARRETT, *supra* note 45, at 20–21.

50 Codification of Financial Reporting Policies, Financial Reporting Release No. 1, 47 Fed. Reg. 21,028 (May 17, 1982).

time, the Commission also announced it would issue Financial Reporting Releases (FRRs) to update the Codification in the future and designated the original codification as FRR No. 1.[51] As a result, the Codification and the FRRs supplement, but do not supplant, the rules set forth in Regulations S-X, S-K, and S-B by providing background and rationale for certain regulatory requirements. Today, the SEC publishes FRRs when the Commission determines that the private sector has failed to deal with a particular type of item or problem area. As of December 31, 2003, the SEC had issued seventy-two FRRs. These releases and their predecessors, the ASRs, have frequently influenced accounting developments[52] while others have addressed various administrative or enforcement matters involving registrants, accountants, and accounting firms.[53]

Since 1975, the SEC has also published informal guidance concerning accounting matters.[54] On August 1, 2004, the SEC an-

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51 *Id.* at 21,029.

52 HERWITZ & BARRETT, *supra* note 45, at 20.

53 At the time the SEC announced the Codification and the FRRs, *see supra* note 50 and accompanying text, the Commission also published the first in a series of Accounting and Auditing Enforcement Releases (AAERs), which address administrative or enforcement matters only. The Commission, however, did not codify about one hundred ASRs involving administrative or enforcement matters. Instead, the Commission included a topical index to AAER No. 1 for easier reference. As of December 31, 2003, the SEC had published 1936 AAERs, including 240 during 2003. HERWITZ & BARRETT, *supra* note 45, at 21.

54 In ASR No. 180, the SEC announced a series of Staff Accounting Bulletins (SABs) to present interpretations and practices which the Chief Accountant and the Division of Corporation Finance follow in administering the disclosure requirements in the federal securities laws. The Division of Corporation Finance, probably the most influential of the SEC's four divisions on accounting issues, strives to ensure that the financial information which registrants present to the public complies with the SEC's rules and regulations. Notice of the Institution of a Series of Staff Accounting Bulletins, Accounting Series Release No. 180, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,202, at 62,486 (Nov. 4, 1975). The SABs, however, do not constitute rules or interpretations of the Commission, and they do not carry the Commission's official approval. Nevertheless, the bulletins seek "to achieve a wider dissemination of the administrative interpretations and practices utilized by the Commission's staff in reviewing financial statements." *Id.* By 1981, the SEC's staff had issued thirty-nine SABs. Early that year, the SEC released SAB No. 40, which codified the material included in SAB Nos. 1 through 38 and superseded those releases, replacing them with an updated and indexed integrated package. Codification of SAB Nos. 1–38, Staff Accounting Bulletin No. 40, 46 Fed. Reg. 11,513 (Feb. 9, 1981). Today, the SEC staff incorporates all subsequently issued SABs into the codification by adding questions and staff interpretations under topic headings. By 2003, the staff had issued sixty-two additional SABs and occasional amendments. To update the existing codification and to enhance the guidance's integrity and usefulness, the staff issued SAB No. 103. Update of Codification of Staff Accounting Bulletins, Staff Accounting Bulletin No.

nounced plans to begin posting comment letters to both issuers and registrants regarding disclosure filings, including underlying accounting and disclosure issues, on its website.[55] The SEC and its staff have also issued various regulations, administrative releases, and other guidance on auditing issues, although to a much smaller extent than with regard to accounting authorities.[56]

103, 68 Fed. Reg. 26,840 (May 16, 2003), *available at* http://www.sec.gov/interps/account/sab103.htm. As of December 31, 2003, the SEC's staff had issued 104 SABs. HERWITZ & BARRETT, *supra* note 45, at 21–22.

In 1997, the Division of Corporation Finance began issuing Staff Legal Bulletins (SLBs), which sometimes discuss accounting-related issues. Like SABs, these legal bulletins represent the views of the Division's staff. Once again, however, the SEC has neither approved nor disapproved the SLBs, and they are not rules or interpretations of the Commission. As of December 31, 2003, the Division had issued fifteen SLBs and revised several earlier SLBs. *Id.* at 22.

In an effort to provide additional guidance, the staff of the Division of Corporation Finance posts and periodically updates several other sources of information about the statutes, rules, and regulations that the Division administers, some of which involve accounting issues, on the SEC's website at http://www.sec.gov under the *Information for [Accountants]* and *Staff Interps* links. These other sources include *Division of Corporation Finance: Current Accounting and Disclosure Issues* (dated Aug. 31, 2001); *Division of Corporation Finance: International Financial Reporting and Disclosure Issues* (dated Oct. 1, 2003); and *Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance* (dated Mar. 31, 2001). These outlines caution that they do not necessarily reflect the views or policies of the SEC, the Commissioners, or other members of the staff. Finally, the Division also responds each year to thousands of telephone inquiries, which often pose accounting issues. The Division posts and periodically supplements a manual of staff telephone interpretations that seeks to provide "general guidance," but warns that users should not rely on the responses as definitive. *See* HERWITZ & BARRETT, *supra* note 45, at 22.

55 Kenneth A. Gary, *Circumventing FOIA: SEC to Post Letters on Web Site*, 104 TAX NOTES 484 (2004). Section 408(a) of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 408(a), 116 Stat. 745, 790–91, directs the SEC to review reports that public companies file with the Commission at least once every three years. 15 U.S.C.A. § 7266 (West Supp. 2004). As a result, we can expect both the number and significance of the SEC's comment letters to increase in magnitude.

56 For example, Regulations S-X and S-B continue to address accountants' qualifications to serve as independent auditors. 17 C.F.R. §§ 210.2-01, 228.310 n.2 (2004). Specifically, Regulation S-X and, for small business issuers, Regulation S-B, expressly preclude an accountant from auditing a registrant's financial statements if the accountant, the auditing firm, or a member of the firm owns a direct, or material indirect, financial interest in the registrant or its parents, subsidiaries, or other affiliates, or holds a close connection with the registrant as a director, officer, or employee. *Id.* § 210.2-01(c)(1)–(2).

Similarly, FRRs sometimes involve auditing issues. *See, e.g.*, Strengthening the Commission's Requirements Regarding Auditor Independence, Financial Reporting Release No. 68, 68 Fed. Reg. 6006 (Feb. 5, 2003) (amending rules to enhance auditor independence), *available at* http://www.sec.gov/rules/final/33-8183.htm. AAERs

Having created this mass of rules and administrative materials, the SEC now faces the task of bringing more order to the whole. Pacioli, the man who devoted thirty years of his life to systematizing double-entry bookkeeping, would probably sympathize with the efforts of the SEC and its staff to bring clarity to the accounting and disclosure requirements—a daunting task by any standard. But our practical friar did take extra pains to make his treatise accessible to the ordinary businessman. Working solo and mired within the cultural and technological limitations of the fifteenth century, Pacioli nevertheless persevered in his task of reducing two centuries of bookkeeping practice to a concise and systematic compilation. Moreover, he wrote his accounting treatise in a language all merchants could understand. Finally, he used a printing press to ensure the widest distribution possible for his treatise. As a result, Pacioli might gently chide the SEC to harness technology to synthesize and simplify the steady stream of accounting rules and policies produced in recent years. At the very least, he might suggest one online database to provide ready access to all the accounting rules applicable to issuers or registrants, much as his treatise set forth the double-entry bookkeeping process generally used in Venice during his lifetime.

B. Current Value Accounting

Thus far, then, the SEC and Pacioli essentially see things eye-to-eye. Pacioli's use of current value or target pricing, however, would give rise to their first serious disagreement. In fact, if Pacioli followed his own advice and recorded a public company's assets, such as inventory, "according to current prices,"[57] and used higher prices rather than lower ones so that the company could report a larger profit,[58] he might find himself in jail or barred from practicing before the SEC. Under Staff Accounting Bulletin No. 101,[59] the lack of a market transaction would preclude revenue recognition.[60] In fact, Enron's "mark to market accounting" and the company's premature revenue recognition furthered that financial fraud. As only one example, Enron

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sometimes involve disciplinary proceedings which the SEC has brought against auditors for actions which the Commission considers substandard auditing practices.

57 *See supra* note 28 and accompanying text.

58 *See supra* note 29 and accompanying text.

59 Revenue Recognition in Financial Statements, Staff Accounting Bulletin No. 101, 64 Fed. Reg. 68,936 (Dec. 9, 1999), *available at* http://www.sec.gov/interps/account/sab101.htm.

60 *Id.* at 68,936–37; *see also* Revision of Topic 13, Staff Accounting Bulletin No. 104, 68 Fed. Reg. 74,436 (Dec. 23, 2003), *available at* http://www.sec.gov/interps/account/sab104rev.pdf.

reported a $111 million gain on the transfer to a related party of an agreement with Blockbuster Video to deliver movies on demand, even after Enron realized that no real profits would ever flow from the underlying agreement.[61]

That said, Pacioli would likely commend the SEC's efforts in 1975 to require large companies to disclose replacement cost data after inflation grew to double-digit rates in the 1970s.[62] Later, the FASB required supplemental information about the effects of changing prices.[63] When inflation rates returned to relatively low levels, the FASB superseded those rules and made voluntary the supplementary disclosures about current cost and constant purchasing power information.[64]

C. *Internal Controls*

You may recall that Pacioli advocated various "inbuilt checks" in his treatise on double-entry bookkeeping. These procedures would fall within the modern term "internal controls," a concept which includes both *administrative controls* and *accounting controls.* Accountants have historically referred to administrative controls as an enterprise's plan of organization, procedures, and records that lead up to management's authorization of transactions.[65] By comparison, accounting controls describe the plans, procedures, and records which the enterprise uses to safeguard assets and produce reliable financial records.[66] An enterprise's internal controls should segregate the responsibilities for authorizing and recording transactions and safeguarding assets between different individuals to detect errors and prevent fraud, thereby

61 *See generally* Matthew J. Barrett, *Enron, Accounting and Lawyers,* NOTRE DAME LAW., Summer 2002, at 14, 16, *available at* http://www.nd.edu/~ndlaw/alumni/ndlawyer/barrett.pdf.

62 Replacement Cost Data, Securities Act Release No. 5608, Exchange Act Release No. 11,608, 40 Fed. Reg. 40,550 (proposed Sept. 3, 1975); *see also* Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data, Accounting Series Release No. 190, 41 Fed. Reg. 13,596 (Mar. 31, 1976). In fact, the SEC's adoption of those rules documents a rare situation in which the SEC established its own rules for public companies. *See* HERWITZ & BARRETT, *supra* note 9, at 149.

63 *See* FINANCIAL REPORTING AND CHANGING PRICES, Statement of Financial Accounting Standards No. 33 (Financial Accounting Standards Bd. 1979).

64 *See* FINANCIAL REPORTING AND CHANGING PRICES, Statement of Financial Accounting Standards No. 89 (Financial Accounting Standards Bd. 1986).

65 HERWITZ & BARRETT, *supra* note 45, at 73.

66 *Id.*

insuring greater accuracy and reliability in the accounting records and financial statements.[67]

Individually and collectively, the recent financial scandals should help lawyers understand that Pacioli's inbuilt checks have not diminished in importance. Internal accounting controls work effectively only when those who bear responsibility for developing, implementing, and overseeing those controls stress the need to adhere to all policies and procedures and lead by adhering to those rules themselves, thereby setting the right "tone at the top." Strong administrative and accounting internal controls enhance the likelihood that the enterprise will engage in sound, beneficial transactions and reduce the chances that an enterprise will incur the enormous losses that can result from internal control failures.

1. Foreign Corrupt Practices Act

Congress has legislatively mandated that public companies adopt and observe these crucial internal accounting controls. In the Foreign Corrupt Practices Act of 1977 (FCPA),[68] Congress responded to the discovery that U.S. companies had bribed foreign officials and engaged in disreputable conduct to secure business in other countries. The legislation contained two parts: antibribery provisions and accounting requirements. Presumably, Congress enacted the accounting rules to improve corporate accountability, on the theory that any failure in recordkeeping or internal controls threatened the disclosure requirements under the federal securities laws.[69] In any event, the FCPA imposes two distinct accounting requirements on all registrants, including those that do not engage in any operations outside

67 Illustrative internal controls include cash registers that display prices and totals to customers and allow management to total all transactions during a shift to discourage clerks from "pocketing" sales revenues; consecutive numbers on checks, purchase orders, and invoices to allow better accountability; rules that require certain employees, especially in banks and other financial institutions, to take continuous, two-week vacations each year to reduce the chance that those employees can hide any irregularities; arrangements that require at least two authorized individuals to sign any check exceeding a certain amount; the division of accounting functions so that different individuals write checks and reconcile bank statements against the cash account; and the separation of purchasing, receiving, and accounting functions so that the same individual does not order, accept, and pay for goods. *Id.*

68 Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended in scattered sections of 15 U.S.C.).

69 DONALD R. CRUVER, COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT 10 (2d ed. 1999).

the United States.[70] These provisions, which Congress codified in section 13(b)(2) of the Securities Exchange Act, create federally mandated, minimum record keeping and internal controls standards for all registrants.[71] Under the FCPA, therefore, bad accounting can in-

70 Note carefully that Congress did not limit the accounting requirements to situations involving foreign corruption; the two accounting provisions apply to all enterprises subject to the SEC's jurisdiction, including registrants that engage only in domestic operations. First, as to the record-keeping obligations, section 13(b)(2)(A) requires all registrants to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." 15 U.S.C.A. § 78m(b)(2)(A) (West 1997 & Supp. 2004). Following the FCPA's enactment, the SEC promulgated two rules to implement this record-keeping requirement. Rule 13b2-1 prohibits any person from falsifying any book, record, or account which section 13(b)(2)(A) requires. 17 C.F.R. § 240.13b2-1 (2004). In this regard, the SEC takes the position that an enterprise's "'books and records' include not only general ledgers and accounting entries, but also memoranda and internal corporate reports." *E.g.*, *In re* Gibson Greetings, Inc., Accounting and Auditing Enforcement Release No. 730, [1995–1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,245, at 63,126 (Oct. 11, 1995). Rule 13b2-2 forbids any officer or director from, directly or indirectly, making a materially false or misleading statement or failing to state a material fact to an accountant in connection with any audit or other filing which the Exchange Act requires. 17 C.F.R. § 240.13b2-2.

Second, all registrants must establish adequate internal accounting controls. Based upon then-existing professional auditing standards, section 13(b)(2)(B) requires registrants to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that the enterprise: (1) executes transactions in accordance with management's general or specific authorization; (2) records transactions in such a way as to permit the enterprise (i) to prepare financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (ii) to maintain accountability for assets; (3) permits access to assets only in accordance with management's general or specific authorization; and (4) compares recorded assets against actual assets at reasonable intervals and takes appropriate action regarding any differences. 15 U.S.C. § 78m(b)(2)(B). Significantly, the four clauses in section 13(b)(2)(B) came verbatim from Statement on Auditing Standards (SAS) No. 1, section 320, *The Auditor's Study and Evaluation of Internal Control*, which at that time discussed the objectives of internal accounting control. *See* A.A. Sommer, Jr., *Internal Controls*, 61 N.C. L. REV. 505, 507 (1983) (citing CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, § 320.28 (American Inst. of Certified Pub. Accountants 1976)). Although subsequent SASs have clarified and updated language in the auditing literature regarding internal control, keep in mind that SAS No. 1 sought to provide guidance to auditors to help them evaluate internal control during an audit. Via the FCPA, these provisions apply directly to registrants and, therefore, impose a statutory obligation on management to comply with the requirements. As a result, Congress transformed professional auditing standards into explicit statutory requirements. Accordingly, poor internal accounting controls can also violate the FCPA.

71 Congress amended the FCPA in 1988 to clarify certain provisions, facilitate compliance, and enhance disclosure. Foreign Corrupt Practices Act Amendments of

deed violate the federal securities laws.[72] Because Congress incorporated the FCPA into the Securities Exchange Act, the SEC enjoys

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1988, Pub. L. No. 100-418, 102 Stat. 1415 (codified as amended in scattered sections of 15 U.S.C.). For our purposes, those amendments affect the standards for record-keeping and internal controls compliance and criminal liability in two important ways. First, the 1988 amendments define the terms "reasonable detail" and "reasonable assurances" by which registrants must keep "books, records, and accounts" and maintain the requisite internal controls, respectively. The 1988 amendments provide that those terms mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." 15 U.S.C. § 78m(b)(7). Second, the 1988 amendments limit criminal liability to persons that "knowingly circumvent or knowingly fail to implement" an internal controls system or "knowingly falsify any book, record, or account" that the enterprise keeps pursuant to the accounting requirements. *Id.* § 78m(b)(4), (5); *see* CRUVER, *supra* note 69, at 33–34.

Although the 1988 amendments restrict criminal liability to intentional violations, the FCPA does not require the SEC to prove scienter to establish that either a registrant or an individual defendant violated section 13(b)(2) in injunctive or administrative proceedings. SEC v. World-Wide Coin Inv., Ltd., 567 F. Supp. 724, 749 (N.D. Ga. 1983). Indeed, the FCPA has enabled the SEC to bring administrative proceedings when inadequate systems, personnel, or equipment have caused a breakdown in an enterprise's accounting system. *See, e.g.*, *In re* Sound Advice, Inc., Accounting and Auditing Enforcement Release No. 696, [1995–1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,211, at 63,043 (Aug. 9, 1995). Several recent cases also illustrate how the SEC can impose civil penalties against registrants that violated the accounting requirements in FCPA. *See, e.g.*, SEC v. Int'l Bus. Mach. Corp., Accounting and Auditing Enforcement Release No. 1356, [1999–2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,863, at 63,554 (Dec. 21, 2000) (imposing a $300,000 civil penalty for violating the books and records provisions in section 13(b)(2)(A) after senior managers overrode IBM contracting procedures and then hid the details regarding $4.5 million improperly paid to certain Argentine officials via a third-party subcontractor in connection with a $250 million contract to integrate and modernize the computer system at a commercial bank that the Argentine government owned); SEC v. Oracle Sys. Corp., Accounting and Auditing Enforcement Release No. 494, [1991–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,953, at 63,301 (Sept. 29, 1993) (entering a permanent injunction prohibiting future violations and an order imposing $100,000 in civil penalties after an inadequate internal accounting control system caused Oracle to file materially inaccurate financial reports with the Commission, thereby violating the minimum record-keeping standards in section 13(b)(2)(A), and to fail to maintain accurate books and records as required in section 13(b)(2)(B)).

72 In Staff Accounting Bulletin No. 99, the SEC staff recently reminded registrants that immaterial, but intentional, misstatements can indeed violate the FCPA record-keeping and internal controls requirements. Among other factors, the bulletin urges registrants and their lawyers to contemplate the significance of the misstatement, how the misstatement arose, the cost to correct the misstatement, and the clarity of accounting guidance addressing the misstatement in assessing whether the enterprise has kept accurate books, records, and accounts in "reasonable detail." Materiality, Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,154 (Aug. 19, 1999), *available at* http://www.sec.gov/interps/account/sab99.htm.

general authority to promulgate implementing rules and regulations. Until the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "SOx"),[73] the FCPA's accounting provisions represented the most substantial legislative foray into the accounting arena since Congress enacted the original federal securities laws in the 1930s.

2. Missed Opportunities

Under authority granted in the FCPA, the SEC proposed rules in 1979 which would have mandated registrants to include a "Statement of Management on Internal Control" in annual reports filed with the Commission and sent to investors.[74] Once fully implemented, the rules would have required management to opine whether the enterprise's internal accounting controls provided reasonable assurance that the enterprise would accomplish the FCPA's objectives.[75] In addition, the proposal would have required an independent accountant to examine and report on management's statement.[76] As it turned out, the proposal provoked substantial opposition from unidentified commentators, and the SEC withdrew the rules in 1980.[77]

In 1985, a private-sector initiative again hoisted the banner for better financial reporting. The American Institute of Certified Public Accountants (AICPA), the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the National Association of Accountants (collectively the "sponsoring organizations") formed the National Commission on Fraudulent Financial Reporting (the "Treadway Commission"), seeking to identify causal factors that could lead to fraudulent reporting and to devise steps to reduce its incidence. In 1987, the Treadway Commission recommended that the SEC require all registrants to include a management report in the annual report to securityholders.[78] The

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73 Pub. L. No. 107-204, 116 Stat. 745 (codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

74 Statement of Management on Internal Accounting Control, Exchange Act Release No. 15,772, 44 Fed. Reg. 26,702, 26,702 (proposed May 4, 1979).

75 *Id.* During an interim period for dates beginning after December 15, 1979, and before December 16, 1980, the proposed rule would have required management to disclose any "material weaknesses in internal accounting control communicated by the independent accountants" that the registrant had not corrected and include a statement explaining why the enterprise had not corrected those weaknesses. *Id.*

76 *Id.*

77 Statement of Management on Internal Accounting Control, Accounting Series Release No. 278, 45 Fed. Reg. 40,134 (June 13, 1980).

78 NAT'L COMM'N ON FRAUDULENT FIN. REPORTING, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 44 (1987) [hereinafter TREADWAY REPORT].

management report would acknowledge management's responsibilities for the financial statements and internal control, discuss how management fulfilled its responsibilities, and provide management's assessment about the effectiveness of internal control.[79]

Following the Treadway Commission's urging, the SEC again proposed to adopt rules that would require registrants to include a report of management's responsibilities in annual reports filed with the Agency and sent to securityholders.[80] This time the effort simply lapsed into oblivion. Although the SEC never officially withdrew the proposal, by the early 1990s the proposed rules no longer appeared on the Agency's list of pending rulemaking activities.[81]

This SEC inaction put the proverbial ball back in the private sector's court. Luckily, the Treadway Commission also recognized that the sponsoring organizations had originally submitted various interpretations and philosophies regarding internal control. The Treadway Commission further suggested the sponsoring organizations "work together to integrate the various internal control concepts and definitions" underlying this "complex, dynamic, [and] constantly evolving" notion and "to develop a common reference point."[82] In 1989, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) initiated a project to implement this recommendation. About three years later, COSO issued a four-volume report, entitled *Internal Control—Integrated Framework* ("COSO Report"), which has quickly become the standard for defining and describing internal control and its objectives and components, and for measuring its effectiveness.[83]

Reacting to the COSO Report, the Public Oversight Board (POB)[84] of the AICPA, in its 1993 special report entitled *Issues Con-*

79 *Id.*

80 Report of Management's Responsibilities, Securities Act Release No. 6789, Exchange Act Release No. 25,925, 53 Fed. Reg. 28,009 (July 26, 1988).

81 Comm. on Law & Accounting, Am. Bar Ass'n, *"Management" Reports on Internal Control: A Legal Perspective*, 49 BUS. LAW. 889, 899 n.51 (1994).

82 TREADWAY REPORT, *supra* note 78, at 48.

83 COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, INTERNAL CONTROL—INTEGRATED FRAMEWORK (1992).

84 In 1977, the AICPA formed the SEC Practice Section (SECPS) as part of the Institute's Division for CPA Firms and established the POB, a five-member, autonomous body, to oversee the SECPS. In that capacity, the POB monitored the quality control programs at the public accounting firms that audited public companies. Every three years, the SECPS required each member firm to undergo peer review. In addition, POB studied litigation against member firms alleging audit failures involving public companies to determine whether those firms needed to take corrective actions to strengthen their quality control systems or to address personnel deficien-

fronting the Accounting Profession,[85] recommended that the SEC require registrants to include two reports—the first by management and the second from the registrant's independent accountant—on the effectiveness of the enterprise's internal control system relating to financial reporting. The AICPA's Board of Directors applauded the POB's suggestion.[86] Lawyers, however, expressed concern and caution. The Committee on Law and Accounting of the American Bar Association's Business Law Section warned against an enterprise voluntarily issuing a report on its internal control because "such reports are 'liability documents' of uncertain but potentially broad scope."[87] The SEC took no action until Congress enacted Sarbanes-Oxley. This chronology does not intend to diminish the SEC's eventual adoption of its new internal control rules under Sarbanes-Oxley. At the same time, knowing, as we do, about the recent internal control failures, we should not completely overlook the Agency's historical blind spot on this issue.

3. Sarbanes-Oxley

Given that the well-publicized frauds at Enron, WorldCom, Tyco, and other companies all involved failures in internal control—a problem Pacioli warned about 440 years ago—such scandals probably would not have surprised Pacioli. Indeed, he might even ask: "When will they ever learn?" Pacioli might observe that each scandal illustrates, to lawyers and investors alike, how lax or inadequate internal control can injure a company's reputation and market value, and expose all constituencies in a corporation to financial harm, including enormous criminal and civil legal liability.

At least two major internal control failures occurred at Enron. First, when Enron's board of directors approved a policy that allowed

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cies. The POB also interpreted its responsibilities to include monitoring any development that may affect public confidence in the integrity of the audit process. In 2002, the POB voted to terminate its own existence. HERWITZ & BARRETT, *supra* note 9, at 179; Pub. Oversight Bd., *About the POB*, at http://www.publicoversightboard.org/about.htm (last visited Feb. 4, 2005).

85 PUB. OVERSIGHT BD., IN THE PUBLIC INTEREST: ISSUES CONFRONTING THE ACCOUNTING PROFESSION 54 (1993).

86 Comm. on Law & Accounting, *supra* note 81, at 901. In late 1995, the AICPA's Auditing Standards Board issued SAS No. 78, effective for audits involving financial statements for periods beginning on or after January 1, 1997, which amends SAS No. 55 to incorporate the COSO Report's definition and description of internal control. *See* CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL STATEMENT AUDIT: AN AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 55, Statement on Auditing Standards No. 78 (American Inst. of Certified Pub. Accountants 1995).

87 William P. Hackney, *A Sample Report on Internal Controls*, BUS. L. TODAY, Jan.–Feb. 1994, at 43, 43; *see* Comm. on Law & Accounting, *supra* note 81, at 929.

the company to enter into transactions with certain entities owned by Enron officers, the implementing procedures explicitly required management to use a "Deal Approval Sheet." By requiring certain disclosures and the approval of Enron's chief executive officer, the Deal Approval Sheets sought to ensure that the terms in any underlying contracts would closely resemble the arrangements that would have materialized in an arm's-length negotiation. In fact, the chief executive officer's signature does not appear on the sheets for several specific transactions. Moreover, the absence of sheets for other deals suggests that Enron did not complete any such document in those transactions. Second, Andrew Fastow, Enron's former chief financial officer, and, for a time, the general partner of several partnerships that entered into agreements with Enron, reportedly earned more than thirty million dollars from his investments in those enterprises. Even though the board seemed to recognize the conflict of interest inherent in such related-party dealings, the board failed to require that Mr. Fastow report his profits from the partnerships to the company. Such disclosures almost certainly would have alerted the board to the possibility that the underlying transactions unfairly benefited Mr. Fastow to the detriment of Enron and its shareholders.

At WorldCom, senior financial officers circumvented internal controls and recorded adjusting journals entries that transferred various expenses to accounts for long-lived assets. By comparison, management at Tyco signed undisclosed compensation arrangements, abused employee relocation loan programs, issued unapproved bonuses, recorded unauthorized credits to employee loans, approved self-dealing transactions, arranged unreported perquisites, and committed other misuses of corporate trust. When Tyco's board of directors learned about these practices, it dismissed the company's general counsel, presumably at least in part because he failed to monitor Tyco's internal controls and report deficiencies to the board.

These scandals provoked legislative and regulatory responses that emphasized what Pacioli viewed as absolutely essential: the need to implement a system of "inbuilt checks." Congress reacted to the revelations about lax internal controls at these and other publicly traded companies by enacting SOx section 404, which requires that the SEC create and enforce regulations intended to foster a more stringent internal control environment in public companies.[88] Speaking to an

88 Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C.A. § 7262 (West Supp. 2004). These new rules apply to large public companies beginning with fiscal years ending after November 15, 2004. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securi-

American Bar Association meeting of corporate lawyers, the SEC's Director of the Division of Corporation Finance asserted that these rules mark the most important development in Sarbanes-Oxley and will cause the biggest impact on attorneys. The Director also opined that an effective implementation of the rules will require a greater commitment of money and time than any other regulation resulting from SOx.[89]

SOx section 404(a) directed the SEC to adopt rules requiring public companies to include a report from management on the company's internal control over financial reporting in each annual report that (1) states management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and (2) contains an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting.[90] Section 404(b) requires that each registered public accounting firm that prepares or issues an audit report for a registrant to attest to, and report on, management's assessment of internal controls over financial reporting.[91] In making such attestations, auditors must com-

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ties Act Release No. 8392, Exchange Act Release No. 49,313, 69 Fed. Reg. 9722 (Mar. 1, 2004), *available at* http://www.sec.gov/rules/final/33-8392.pdf. On November 30, 2004, the SEC gave accelerated filers with (a) less than $700 million in outstanding common equity held by non-affiliates and (b) fiscal years ending before March 1, 2005, an additional seventy-five days to comply with these new rules. *See* Order Under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption from Specified Provisions of Exchange Act Rules 13a-1 and 15d-1, Exchange Act Release No. 50,754, 69 Fed. Reg. 70,291 (Dec. 3, 2004), *available at* http://www.sec.gov/rules/exorders/34-50754.htm. All other public companies must include a management report on internal control and related auditor's report beginning for fiscal years ending on or after July 15, 2005. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 69 Fed. Reg. at 9722.

89 HERWITZ & BARRETT, *supra* note 45, at 74.

90 15 U.S.C.A. § 7262(a).

91 *Id.* § 7262(b). Importantly, the registered public accounting firm making the attestation cannot do so as part of a separate engagement. Therefore, the auditor expressing an opinion on the company's books must also prepare the attestation report regarding internal controls. Some commentators estimate that compliance with the new SEC rules will cause many public companies to face at least a one-third increase in their annual audit's cost. Mandatory reporting on internal controls may also open the door to heightened auditor liability because auditors formerly tested internal controls before the end of each reporting period, but now they must attest to their quality as of the last date of the reporting period. Thus, auditors cannot claim that errors in their reports result from management making changes to internal controls after the auditor's review. HERWITZ & BARRETT, *supra* note 45, at 76.

ply with standards that the newly created Public Company Accounting Oversight Board (PCAOB) will issue or adopt.[92]

Under the final rules promulgated by the SEC, management's internal control report must include (1) a statement of management's responsibility for establishing and maintaining adequate internal control over the company's financial reporting, (2) management's assessment of that effectiveness as of the end of the company's most recent fiscal year, (3) a statement identifying the framework that management used to evaluate the effectiveness of this internal control, and (4) a statement that the company's auditor has issued an attestation report on management's assessment.[93] In addition, the company must include the auditor's attestation report in the company's annual report. Management must also perform quarterly evaluations of changes in internal controls that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting and report their findings. Specifically, management may not label internal controls effective if these quarterly evaluations identify one or more material weaknesses.

For purposes of implementing SOx section 404, the SEC has defined "internal control over financial reporting" as a process designed by, or under the supervision of, a company's principal executive and principal financial officers. The company's board of directors then implements this process to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. These controls include procedures to ensure a company maintains records that reasonably reflect the company's transactions and dispositions of assets, and provide assurance that the company's records of transactions permit preparation of financial statements in accordance with GAAP. Further, internal control should ensure that appropriate management and directors authorize a company's receipts and expenditures and provide reasonable assurance that unauthorized acquisition, use, or disposition of the company's assets cannot occur without detection.

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92 15 U.S.C.A. § 7262(b); *see infra* notes 136–40 and accompanying text.

93 *See* 17 C.F.R. §§ 228.307, .308, 229.307, .308 (2004); *see also* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 18, 2003) (providing related commentary), *available at* http://www.sec.gov/rules/final/33-8238.htm.

D. *Officer Certifications*

Based upon the ethical views that Pacioli espoused in his *Summa*, he would likely applaud the SEC's efforts, later codified in Sarbanes-Oxley, to personalize the conduct of business and the accuracy of the financial accounting process by requiring officer certifications regarding financial statements and internal controls.

Immediately after the original revelations that WorldCom had engaged in a staggering $3.8 billion fraud, an amount which the company subsequently pegged at about eleven billion dollars, the SEC responded. The Agency issued an order requiring the senior officers of more than 900 of the nation's largest public companies to file sworn statements regarding the accuracy of their company's financial statements.[94] Congress codified similar duties in SOx section 302. This provision directed the SEC to issue rules requiring each public company's chief executive and financial officers to certify in every quarterly and annual report filed with the SEC that, among other things, based on such officer's knowledge the report does not contain any material misrepresentations or omissions. Further, these same officers must certify that the financial statements and other financial information included in the report fairly present, in all material respects, the entity's financial condition and operation results.[95] This certification very much parallels an auditor's unqualified opinion, but with one very important exception: a reference to GAAP does not limit the executives' certification. In other words, conformity with GAAP may not satisfy the obligation to provide full and fair disclosure under the federal securities laws. For example, some of Enron's aggressive accounting treatment may have complied with GAAP, but nevertheless would have violated this certification requirement had it existed before the company's collapse. The SEC promptly complied with the statutory mandate to issue such rules within thirty days.[96] SOx section 906 adds a provision to the criminal laws containing a separate certification requirement that creates new criminal penalties for a knowingly false certification.[97]

94 Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, File No. 4-460 (June 27, 2002), *available at* http://www.sec.gov/rules/other/4-460.htm.

95 15 U.S.C.A. § 7241.

96 Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 8124, Exchange Act Release No. 46,427, 67 Fed. Reg. 57,276 (Sept. 9, 2002), *available at* http://www.sec.gov/rules/final/33-8124.htm.

97 18 U.S.C.A. § 1350 (West Supp. 2004). The SEC has also adopted rules addressing the mechanics necessary to satisfy these provisions. Management's Report

E. Liquidity and Cash Flows

Our Franciscan friar considered liquidity paramount for any business. Accordingly, he would undoubtedly find satisfaction in the MD&A requirements. As set forth in Item 303 of Regulation S-K, those requirements instruct registrants to discuss their financial condition, including liquidity and capital resources, changes in financial condition, and results of operations, in both the annual report sent to shareholders and the periodic reports filed with the SEC.[98] As a result, MD&A mandates disclosure of both historical and certain forward-looking information, including any "currently known trends, events, and uncertainties" that a registrant reasonably expects will have a material impact on its liquidity, financial condition, or operating results.[99] Such historical and prospective disclosures enable investors and other users to assess not only the registrant's liquidity, financial condition, and operating results, but also its prospects for the future.[100]

These mandatory disclosures, and the SEC administrative actions to enforce these requirements when registrants fail to disclose known liquidity problems,[101] simply highlight what Pacioli recognized long ago: without liquidity a business fails. In recognition of the importance of cash and cash flows, however, Pacioli might well encourage Congress and the SEC to refer specifically to the "statement of cash flows" in various statutes and regulations requiring financial statements or related disclosures. At the time that the SEC adopted Item 303 in 1980, the statement of changes in financial position, which described the sources of the changes in an enterprise's financial condition and which was sometimes referred to as the "funds statement," stood as one of the required financial statements. For fiscal years ending after July 15, 1988, the statement of cash flows replaced the state-

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on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36,636.

98 17 C.F.R. § 229.303. Item 303 of Regulation S-B imposes similar obligations on small business issuers. *Id.* § 228.303.

99 *Id.* § 229.303.

100 Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Financial Reporting Release No. 36, 54 Fed. Reg. 22,427, 22,428–29 (May 24, 1989), *available at* http://www.sec.gov/rules/interp/33-6835.htm.

101 *See, e.g.*, *In re* Am. W. Airlines, Inc., Accounting and Auditing Enforcement Release No. 562, [1991–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,022, at 63,389-86 (May 12, 1994) (discussing a case where registrant failed to disclose serious financial difficulties that made continuing operations unlikely); *In re* Salant Corp., Accounting and Auditing Enforcement Release No. 561, [1991–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,021, at 63,389-78 (May 12, 1994) (same).

ment of changes in financial position.[102] More than sixteen years after that development, Congress and the SEC continue to use terminology that refers to "changes in financial condition," rather than "cash flows" or "the statement of cash flows," in various statutes and administrative rules that involve "financial condition, *changes in financial condition,* and results of operations."[103] Presumably, the quoted language refers to financial information contained on the balance sheet, the statement of cash flows, and the income statement. To stress the importance of cash and cash flows to assessing an enterprise's financial performance, both Congress and the SEC should amend these statutes and administrative rules and regulations to specifically refer to the "statement of cash flows."

III. Other Reflections

Pacioli's possible insights about accessibility, current value accounting, internal controls, officer certifications, and liquidity have all found expression, at least to some extent, in the SEC's regulatory scheme. Insofar as the SEC, whether by congressional direction or administrative action, also relies on, or has looked to, private sector bodies to establish—or recommend—accounting principles and auditing standards, this Part will also evaluate the relative effectiveness of the Financial Accounting Standards Board (FASB), the AICPA, the Independence Standards Board (ISB), and the PCAOB. In addition, we might examine the Agency's efforts to design, enforce, and improve the MD&A requirements through an administrative action against Caterpillar, Inc. Finally, this Part will discuss some issues regarding auditor independence, as these seem extremely relevant in light of both Pacioli's efforts and investor confidence.

A. *Private Sector*

For those issuers and registrants that must file financial statements with the SEC, the federal securities laws authorize the Agency to prescribe appropriate accounting rules and auditing standards.[104] To promulgate accounting principles the SEC historically deferred, first, to the accounting profession and, later and more successfully, to

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102 *See* STATEMENT OF CASH FLOWS, Statement of Financial Accounting Standards No. 95, §§ 1, 34 (Financial Accounting Standards Bd. 1987).

103 *See, e.g.*, Sarbanes-Oxley Act of 2002 § 401(a), 15 U.S.C.A. § 78m(j) (West Supp. 2004) (emphasis added); 17 C.F.R. § 229.303(a).

104 15 U.S.C. §§ 77s(a), 78m(b)(1) (2000); *see also* Joel Seligman, *Accounting and the New Corporate Law*, 50 WASH. & LEE L. REV. 943, 945 (1993) (discussing SEC authority to regulate accounting and auditing).

the broad private sector.[105] For auditing standards, on the other hand, until Sarbanes-Oxley, the SEC largely disregarded the broad private sector and relied exclusively on the accounting profession to establish auditing standards. In my view, the latter self-regulatory strategy with respect to auditing standards failed miserably, significantly contributed to the recent corporate accounting scandals, and resulted in the creation of the PCAOB under Sarbanes-Oxley.

1. Accounting Principles

Since its inception, the SEC has almost always preferred deference to the accounting profession and financial community over governmental action to establish accounting principles. As early as 1938, the SEC publicly stated its administrative policy regarding financial statements,[106] intimating that it expected registrants to follow its rules, regulations, or other official releases.[107] In those matters where the SEC had not previously expressed a position and where the registrant and the Commission disagreed about the proper accounting principles, the Commission announced it would accept disclosure in lieu of correction of the financial statements themselves only if the registrant's treatment enjoyed substantial authoritative support.[108] Most significantly, however, the Commission indicated it would consider financial statements prepared in accordance with accounting principles that did not enjoy substantial authoritative support as misleading or inaccurate, notwithstanding disclosures in the auditor's report or in the notes to the financial statements.[109] This approach begged the question of whether *any* accounting principle enjoyed substantial authoritative support.

The accounting profession's first formal efforts to develop accounting principles occurred in 1939, when the AICPA created the

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105 Occasionally, the SEC has exercised its power to prescribe accounting methods directly. *See supra* note 62.

106 Administrative Policy on Financial Statements, Accounting Series Release No. 4 (Apr. 25, 1938), *reprinted in* 11 Fed. Reg. 10,913 (Sept. 27, 1946), *and in* Codification of Financial Reporting Policies § 101, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,921, at 62,651 (May 7, 2003).

107 *Id.*, *reprinted in* 11 Fed. Reg. 10,913 (Sept. 27, 1946), *and in* Codification of Financial Reporting Policies § 101, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,921, at 62,651 (May 7, 2003).

108 *Id.*, *reprinted in* 11 Fed. Reg. 10,913 (Sept. 27, 1946), *and in* Codification of Financial Reporting Policies § 101, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,921, at 62,651 (May 7, 2003).

109 *Id.*, *reprinted in* 11 Fed. Reg. 10,913 (Sept. 27, 1946), *and in* Codification of Financial Reporting Policies § 101, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,921, at 62,651 (May 7, 2003).

Committee on Accounting Procedure (CAP) to determine the proper accounting approach or approaches in particular areas of concern.[110] The CAP published its views in the form of Accounting Research Bulletins (ARBs), which the Institute widely circulated.[111] Unfortunately, the ARBs did not carry great weight in the profession. Because no significant amount of research supported the ARBs, they simply represented a consensus of committee members and reflected the members' experiences and viewpoints.[112]

In an effort to give more effective leadership in the determination of accounting principles, the AICPA established the Accounting Principles Board (APB) in 1959.[113] The Board's greatly expanded ability to research questions thoroughly allowed the APB to consider and reach some conclusions on basic concepts and accounting principles.[114] Nevertheless, the APB suffered from some of the same deficiencies that marked its predecessor. This time around, however, the process also proved a stumbling block. The compromises needed to secure the required two-thirds vote of the members often led to results that failed to satisfy anyone and sometimes produced long delays before the APB could reach any conclusion. A continuing disquiet about whether the practicing members could sufficiently divorce themselves from their major clients' interests on various issues also plagued the APB.

Leaders in the accounting profession eventually concluded that the system did not work and urged a total overhaul. In response, in 1971 the AICPA's Board of Directors appointed a Study on the Establishment of Accounting Principles, under the chairmanship of Francis M. Wheat, a distinguished securities lawyer and former SEC Commissioner. In 1972, pursuant to that study group's recommendations, the

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110 *See* HERWITZ & BARRETT, *supra* note 45, at 23.

111 *Id.* At that time, however, these pronouncements did not bind the profession, much less anyone else. Each ARB bore the concluding comment that "the authority of the bulletins rests upon the general acceptability of opinions so reached." *See, e.g.*, AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN NO. 45, LONG-TERM CONSTRUCTION-TYPE CONTRACTS 1 n.1 (1955).

112 HERWITZ & BARRETT, *supra* note 45, at 23–24.

113 *Id.* at 24. "The APB's membership included AICPA members, mostly in public practice, with representatives from each of the largest accounting firms, at that time the 'Big Eight,' a number of smaller firms and academia." *Id.*

114 *Id.* The Board also tried to resolve the more important problem areas involving accounting practices and financial reporting in an attempt "to narrow the areas of difference and inconsistency in practice" in as expeditious a manner as practicable. *Id.* By the time the AICPA dissolved the APB in 1973, the Board had issued thirty-one "Opinions" and four "Statements," which defined and narrowed the acceptable perimeters of accounting methodology. *Id.*

accounting profession created the FASB, a new body to replace the APB as the organization responsible for determining and promulgating accounting principles. The FASB differs from the CAP and the APB in one major respect: the FASB exists independently from the AICPA. The sixteen trustees of the Financial Accounting Foundation (FAF),[115] an independent charitable corporation, appoint the FASB's seven full-time members to staggered five-year terms.[116] To assure independence, the FASB's members must terminate all other employment ties in exchange for a generous salary, which amounted to $556,000 for the chairman and $452,000 for the six other members in 2003.[117]

In 1973, the SEC designated the FASB, which had just become the most authoritative private rulemaking body for financial accounting pronouncements, as having substantial authority to establish ac-

115 After 2002 amendments to the FAF's trustee selection process, its eight different sponsoring organizations, which represent various constituencies, each submit names of at least two nominees as prospective trustees when an opening arises in a seat assigned to that organization. If the trustees do not find the nominees acceptable, they may consult with that particular organization and appoint another individual as long as that person's background meets the requirements for that seat. The sponsoring organizations, their constituencies, and the number of seats assigned to that organization appear in the following table.

Sponsoring Organization	Constituency	Trustees
AICPA	Auditors	3
Government Finance Officers Association and the National Association of State Auditors, Comptrollers and Treasurers	State and local governmental bodies and regulatory agencies	3
American Accounting Association	Accounting educators	1
Association for Investment Management and Research	Financial analysts	1
Financial Executives Institute	Business executives and financial officers	1
Institute of Management Accountants	Corporate accountants	1
Securities Industry Association	Investment bankers	1

Collectively, therefore, the sponsoring organizations submit nominees for eleven of the sixteen seats on the FAF's Board. The trustees directly appoint the five remaining "at large" seats. Press Release, Financial Accounting Foundation, Financial Accounting Foundation Increases Its Independence Through Amended Trustee Appointment Process (July 25, 2002), *available at* http://www.fasb.org/news/nr072502.shtml.

116 The Board's members typically include three public accountants, two corporate executives, one financial analyst, and one academic. HERWITZ & BARRETT, *supra* note 9, at 154.

117 HERWITZ & BARRETT, *supra* note 45, at 25.

counting principles.[118] With the expectation that FASB's conclusions would promote the interests of the investing public, the SEC explicitly expressed its intention to continue to look to the private sector for leadership in establishing and improving accounting principles.[119] In doing so, the Agency did not completely cede accounting rulemaking to the private sector. The SEC, however, thereafter rarely exercised its powers to establish accounting principles directly.[120]

Congress endorsed this delegation of power to promulgate accounting principles for purposes of the federal securities laws in Sarbanes-Oxley. That legislation explicitly gave the SEC discretion to recognize any accounting principles established by a private standard-setting body that meets certain criteria[121] as "generally accepted" for those purposes. In 2003, the SEC determined that the FASB and the FAF, its parent organization, satisfied those criteria, and duly recognized the FASB's financial accounting and reporting standards as generally accepted for purposes of the federal securities laws.[122] The SEC's statement of policy that announced this designation directs the FAF and the FASB to give the SEC timely notice of any plans to appoint a new member to either the FAF or the FASB;[123] calls upon the

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118 Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 39 Fed. Reg. 1260 (Jan. 7, 1974), *reprinted in* Codification of Financial Reporting Policies § 101, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,921, at 62,651 (May 7, 2003).

119 *Id.*, *reprinted in* Codification of Financial Reporting Policies § 101, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,921, at 62,651 (May 7, 2003).

120 In 1978, for example, the SEC decided to reject the FASB's approach to income recognition in the oil and gas industry. HERWITZ & BARRETT, *supra* note 9, at 149.

121 Sarbanes-Oxley Act of 2002 § 108, 15 U.S.C.A. § 7218 (West Supp. 2004).

122 Commission Statement of Policy Reaffirming the Status of FASB as a Designated Private-Sector Standard Setter, Financial Reporting Release No. 70, 68 Fed. Reg. 23,333 (May 1, 2003), *available at* http://www.sec.gov/rules/policy/33-8221.htm. Now that the SEC has, for federal securities law purposes, designated the FASB as the private standard-setting body that may establish GAAP, SOx section 109 now requires registrants to pay annual fees to support both the FASB and the PCAOB. *See* 15 U.S.C.A. § 7219. Prior to that, the FAF and the FASB relied upon contributions and publication sales to fund their operations. Declining contributions to the FAF, the potential loss of revenues from the FASB's print publications, and increasing pressures to offer free, electronic access to the FASB materials presented potentially serious financial problems. The new funding mechanism should help to ensure the FASB's independence in the standard-setting process.

123 From time to time, the SEC has recommended individuals for membership on the FASB and consulted in the appointment process. Especially during the selection of Edmund Jenkins as the FASB's chairman in 1997, then SEC Chairman Arthur Levitt provided names of potential candidates, was kept informed throughout the process, and effectively cleared Jenkins's appointment.

FASB to provide timely guidance to public companies, accounting firms, regulators, and other interested parties on accounting issues that the SEC considers significant to investors; and allows the SEC to revise the policy statement if the Commission determines that the FAF no longer meets the statutory criteria or the SEC's expectations.[124] In that regard, the SEC stated that it would continue to monitor the FASB's procedures, qualifications, capabilities, activities, and results.[125]

2. Auditing Standards

As a practical matter, accounting principles are only as effective as the auditing standards that seek to ensure their application. The federal securities laws also effectively give the SEC the power to dictate standards for audits involving reporting companies. Even more so than with respect to accounting principles, the SEC had historically deferred to the accounting profession to set auditing standards. While the accounting profession had turned the responsibility to develop and promulgate GAAP over to the FASB, the AICPA retained the corresponding duty to establish auditing standards through its Auditing Standards Board (ASB), which sets the rules that the AICPA's professional standards require members to follow in audits. By and large, then, the accounting profession, through the ASB, essentially self-regulated auditing. By establishing the PCAOB and giving it, subject to SEC approval, the power to set professional standards for audits of public companies, Sarbanes-Oxley supplanted this model.

Even before Sarbanes-Oxley, most commentators believed that Congress had given the SEC the power to establish auditing standards.[126] After all, the federal securities laws expressly authorized the SEC to establish rules requiring independent accountants to audit financial statements registrants file with the Commission. Compared to matters involving accounting principles, however, the SEC exhibited even greater deference to the accounting profession regarding auditing standards, largely because the ASB willingly addressed issues that the SEC deemed significant.

Modern audit procedures trace their development to a famous scandal and failed audit involving McKesson & Robbins, Inc., a com-

124 Commission Statement of Policy Reaffirming the Status of FASB as a Designated Private-Sector Standard Setter, 68 Fed. Reg. at 23,333.

125 *Id.*

126 *See, e.g.*, Seligman, *supra* note 104, at 945.

pany whose shares were traded on the New York Stock Exchange.[127] In response to the McKesson & Robbins fraud, the AICPA established the Committee on Auditing Procedure (the "Committee") to develop a set of auditing standards. The Committee's first Statement on Auditing Procedures (SAP) specifically required auditors to observe inventories and to confirm receivables.

After the McKesson & Robbins fiasco, the SEC held administrative hearings. In 1940, the Agency issued a report summarizing the hearings as Accounting Series Release No. 19.[128] In that release, the SEC concluded that auditing procedures should require auditors to observe inventories and confirm receivables.[129] Because the accounting profession had already taken action to adopt such procedures,[130] the SEC refrained from establishing separate auditing procedures and decided to let the accounting profession develop auditing standards, thereby following the same path which the Commission had adopted regarding accounting principles.[131]

After a series of audit failures in the late 1980s and early 1990s, Congress included a provision in the Private Securities Litigation Re-

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127 Price, Waterhouse & Co. audited the financial statements for McKesson & Robbins and its subsidiaries for the year ended December 31, 1937. The consolidated financial statements reported total assets exceeding eighty-seven million dollars. This total, however, contained approximately nineteen million dollars in fictitious assets, including about ten million dollars in feigned inventories and approximately nine million dollars in fabricated receivables. For 1937, fictitious sales amounted to more than eighteen million dollars on which the consolidated income statement reported fictitious gross profit exceeding $1.8 million. HERWITZ & BARRETT, *supra* note 45, at 85.

To accomplish this fraud, Philip M. Musica, a previously convicted swindler who served as the corporation's president under the alias Frank Donald Coster, and his three brothers devised a clever scheme. McKesson & Robbins pretended to purchase merchandise from fictitious vendors that supposedly retained the goods for shipment directly to the corporation's customers. The perpetrators also prepared invoices to document fabricated sales to customers. Musica caused McKesson & Robbins to issue checks to the fictitious vendors, intercepted and cashed the checks, and used the proceeds for partial payments to the corporation on the fabricated sales to customers. Musica and his assistants, however, pocketed about $2.8 million in the scheme. Because the auditors did not observe the inventories or confirm the receivables, the audit did not detect the fraud. *Id.*

128 11 Fed. Reg. 10,918 (Dec. 5, 1940), *reprinted in* [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,020, at 62,104 (Dec. 5, 1940).

129 *Id.*, *reprinted in* [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,020, at 62,104 (Dec. 5, 1940).

130 Unfortunately, these procedures did not bind the profession. In addition, the failure to establish definitive accounting principles during this period hindered significant improvements in auditing.

131 Accounting Series Release No. 19, 11 Fed. Reg. at 10,918.

form Act of 1995 requiring that audits of issuers or registrants include, among other things, procedures designed to provide reasonable assurance that the audit will detect any illegal acts that would directly and materially affect the determination of financial statement amounts.[132] In addition, the legislation specifically gave the SEC authority to modify or supplement certain generally accepted auditing standards (GAAS) in at least three areas: illegal acts, related party transactions, and the registrant's ability to continue as a going concern.[133] In response to this legislation, the SEC adopted an amendment to Regulation S-X to define the term "[a]udit (or examination)" so that the Commission may modify or supplement GAAS.[134] The related financial reporting release expressed the SEC's desire to alert auditors and issuers to the possibility that, in certain circumstances, the Commission may require additional audit procedures beyond those necessary under GAAS. In addition, the SEC specifically rejected objections to the amendment that argued that the legislation limited the Commission's ability to set auditing standards to the three enumerated areas.[135]

Even after this legislation and the SEC's broad interpretation of its authority to establish GAAS for purposes of the federal securities laws, up until Sarbanes-Oxley, the SEC continued to show great deference to accountants. Periodically, the SEC forwarded suggestions and hints to the accounting profession. With the SEC's approval and support in 1997, for example, the AICPA created the Independence Standards Board (ISB) to establish independence standards for auditors of public companies, an effort labeled as a "new public-private sector partnership." This experiment lasted until July 31, 2001, when the ISB ceased operations. The ISB suffered from one fatal flaw: its eight members were equally divided between the accounting profession and so-called public members. As a result, and at least in appearance, if not in reality, the profession could effectively block any reforms.

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132 Pub. L. No. 104-67, § 301(a), 109 Stat. 737, 762–64 (adding section 10A to the 1934 Act, codified as amended at 15 U.S.C.A. § 78j–1 (West 1997 & Supp. 2004)).

133 *Id.*

134 Implementation of Section 10A of the Securities Exchange Act of 1934, Financial Reporting Release No. 49, 62 Fed. Reg. 12,743 (Mar. 18, 1997) (codified as amended at 17 C.F.R. § 210.1-02(d) (2004)), *available at* http://www.sec.gov/rules/final/34-38387.txt.

135 *Id.*; *see also* Shelene Clark, *Securities Litigation Reform Act's Impact Questionable; Struggle with Law's Interpretation Seen in Coming Years*, CORP. COUNS. WKLY., Apr. 10, 1996, at 8, 8 (outlining the legal issues that will be raised from the Private Litigation Reform Act of 1995).

That background brings us to Sarbanes-Oxley. Following the recent high profile financial frauds that raised questions about the audit process because auditors failed to detect seriously misstated financial statements, Sarbanes-Oxley created the PCAOB, a specialized body to oversee audits involving issuers and registrants.[136] Subject to SEC approval,[137] the legislation gives the PCAOB the authority to establish those auditing and related standards that registered public accounting firms use to prepare and issue audit reports for public companies subject to the SEC's jurisdiction.[138] Despite the relevance of auditing experience to these tasks, SOx stipulates that no more than two of the five members of the PCAOB be certified public accountants (CPAs), with the further limitation that the Chairman of the Board not have been a practicing CPA for at least two years prior to appointment.

Similar to the SEC's reliance on the FASB to establish GAAP for public companies, the PCAOB's creation enables, for the first time, a broad-based, private-sector organization to establish GAAS for audits of public companies. While reasonable minds can disagree as to whether the PCAOB falls into the "private-sector" category,[139] Congress imposed an organizational structure that attempts to protect the

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136 Sarbanes-Oxley Act of 2002 § 101, 15 U.S.C.A. § 7211 (West Supp. 2004).

137 After Sarbanes-Oxley, the SEC enjoys the power to approve any rules that PCAOB may adopt. *Id.* § 107(b)(2), 15 U.S.C.A. § 7217(b)(2). For example, the SEC recently approved a PCAOB auditing standard, effective May 14, 2004, that requires auditors' reports on financial statements for public companies to state that the auditor performed the audit in accordance with the PCAOB's standards rather than the previously required reference to GAAS. Order Approving Proposed Auditing Standard No. 1, References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board, Exchange Act Release No. 49,707, 69 Fed. Reg. 29,149 (May 20, 2004), *available at* http://www.sec.gov/rules/pcaob/34-49707.htm.

138 The PCAOB's rules apply only to accounting firms that audit public companies. The accounting profession, through the AICPA and its ASB, still establishes "generally accepted auditing standards in the United States," or "GAAS in the United States" or "U.S. GAAS," for audits involving private firms. Finally, remember that the General Accounting Office (GAO) establishes Government Auditing Standards, first published in 1972 and commonly referred to as the "Yellow Book," that apply to audits involving federal entities and other organizations that receive more than $300,000 in federal funds annually. Whether by law or contract, these standards apply to more than 30,000 domestic and international entities. HERWITZ & BARRETT, *supra* note 45, at 87.

139 *See* Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 973 (2005) (arguing that notwithstanding the PCAOB's designation as a nonprofit corporation in the private sector, various features render the Board a public body that can engage in state action for constitutional law purposes). Although technically speaking a private sector entity as a nonprofit corporation organized under the laws of the District of Columbia, the PCAOB enjoys, subject to SEC oversight, funding from congressionally-imposed fees on issu-

public interest by requiring a majority of non-CPAs as members.[140] With these structural features in place, the PCAOB stands poised to protect the investing public.

B. Management's Discussion and Analysis

In this discussion of the SEC's triumphs and travails regarding accounting and disclosure during the Agency's first seventy years, the various accounting rules and auditing standards are necessary characters. But the protagonist role goes to the MD&A requirements, a casting Pacioli himself would likely sanction. For like his accounting treatise, the MD&A requirements focus on a very practical consideration: the fact that the thrust of accounting disclosure in general should be to allow the investor to assess (1) not just the earnings figures but the *quality of earnings* and (2) the likelihood that past operating results fairly indicate future performance. Those overarching goals color not only the required disclosures, which must then encompass textual discussion to supplement the traditional numbers in the financial statements and the additional information in the related notes to those statements, but should also influence management's description of its assessment of the prospects for the future.

Item 303(a) of Regulation S-K, which the SEC promulgated in 1980, stands central to the MD&A requirements. This rule requires additional disclosures when the financial statements and accompanying notes do not indicate future operating results or financial condition.[141] In particular, the rule imposes additional disclosures, most specifically a textual discussion of any material events and uncertainties that would cause future operating results to deviate from reported financial information.[142] As the SEC neatly summarized in a 1999 consent order resolving public administrative proceedings against a registrant, its former chairman, and several affiliates, "Item 303(a) requires that management address any issues which impact the *quality of*

ers and statutory authority to establish GAAS for audits involving issuers and registrants and to investigate registered public accounting firms.

140 While the FASB's membership does not require a majority of non-CPAs, the Board of its parent organization, the FAF, includes five "at large" trustees, and constituencies other than the AICPA can submit nominees for eight of the remaining eleven slots on the FAF's Board. *See supra* note 115.

141 17 C.F.R. § 229.303(a) (2004). Item 303 of Regulation S-B imposes similar obligations on small business issuers. *Id.* § 228.303.

142 *Id.* § 229.303(a).

earnings."[143] Without descriptive information on issues such as liquidity, capital resources, past operating results, and predictions of future performance, an investor or reader cannot reasonably evaluate an existing or possible investment in the company.[144]

MD&A can require additional accounting-related information in at least two respects. First, the narrative explanation often provides details not found in the numerical presentation or footnotes accompanying the financial statements.[145] Second, the enhanced disclosure requirements seemingly establish a lower materiality threshold than found in financial statements under GAAP.[146] As a general rule, accountants and auditors usually treat any amount which does not exceed five percent of income before taxes as immaterial. On the other side, auditors usually consider any item which exceeds ten percent of income before taxes as material.[147] Although neither the SEC nor the courts have explicitly established a materiality standard for MD&A, they have rejected mathematical standards, preferring a facts and circumstances analysis.[148] Under the federal securities laws, the Supreme Court has concluded that an omitted fact qualifies as material

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143 *In re* Terex Corp., Accounting and Auditing Enforcement Release No. 1126, [1999–2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,633, at 63,106 (April 20, 1999) (emphasis added).

144 *Id.*; *see also In re* Bank of Boston Corp., Initial Decision Release No. 81, [1995–1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,719, at 87,304 (Dec. 22, 1995) (involving the failure to disclose known trends and uncertainties in the bank's real estate portfolio that would reasonably be expected to have a material unfavorable impact on the bank's financial condition).

145 *See* Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Financial Reporting Release No. 36, 54 Fed. Reg. 22,427, 22,428 (May 24, 1989), *available at* http://www.sec.gov/rules/interp/33.6835.htm.

146 *See* LuAnn Bean & Deborah W. Thomas, *The Development of the Judicial Definition of Materiality*, 17 ACCT. HISTORIANS J. 113, 120 (1990). To the extent that the "reasonably likely to have a material effect" standard in the MD&A requirements mandates disclosure in situations that do not qualify as "material" for accounting purposes, compliance with GAAP may not satisfy disclosure obligations under the federal securities laws.

147 *Id.*; *see also* Charles Jordan et al., *Materiality for Extraordinary Items*, 35 NAT'L PUB. ACCT., Dec. 1990, at 42, 43 (listing other mathematical guidelines for average net income, total revenues, total assets, and owners' equity).

148 *Compare* Ganino v. Citizens Utils. Co., 228 F.3d 154, 171 (2d Cir. 2000) (vacating in part, reversing in part, and remanding for further consideration a district court decision that granted the defendant's motion to dismiss after the district court held that the alleged misrepresentations of certain fees qualified as immaterial as a matter of law when the fees amounted to only 1.7% of the defendant company's total revenues), *with In re* Newell Rubbermaid, Inc. Sec. Litig., No. 99 C 6853, 2000 WL 1705279, at *8 (N.D. Ill. Nov. 14, 2000) (granting the defendants' motion to dismiss

when the alleged forty million dollars in undisclosed expenses constituted less than ten percent of the company's before-tax income during the relevant period).

One relatively recent example may illustrate how a quantitatively immaterial item might nevertheless qualify as material. An October 1998 *Wall Street Journal* article describes BankAmerica Corp.'s failure to disclose information about its $372 million write down of a loan to D.E. Shaw & Co., a New York investment firm. Even though bank officials knew about possible losses on the loan as early as August, the bank did not disclose the extent of the losses before shareholders voted in late September to approve a forty-three billion dollar merger with NationsBank, which created the nation's second-largest bank. The article quotes the merged bank's chief financial officer as saying that "'[$372 million is] a big number but it's not material to a company' that is as big as BankAmerica." Rick Brooks & Mitchell Pacelle, *BankAmerica Knew in August of Trading Woes*, WALL ST. J., Oct. 16, 1998, at A3. When the merged bank announced the write-down in mid-October, the stock price dropped eleven percent in a single day. Plaintiffs quickly filed multiple class action securities fraud actions related to the merger against new BankAmerica and other defendants. *See In re* BankAmerica Corp. Sec. Litig., 78 F. Supp. 2d 976, 982 (E.D. Mo. 1999) (discussing the facts and granting in part and denying in part the defendants' motion to dismiss); *see also* Brooks & Pacelle, *supra*.

In Staff Accounting Bulletin No. 99, the SEC's staff explicitly rejected the automatic classification of financial statement misstatements or omissions that fall under a five percent threshold as immaterial, absent particularly egregious circumstances, such as misappropriation by senior management. The staff emphasized that registrants and their auditors must consider qualitative factors in materiality determinations. For example, a quantitatively small misstatement or omission could nevertheless qualify as material when it:

- arises from an item capable of precise measurement;
- masks a change in earnings or other trends;
- hides a failure to meet analysts' consensus expectations for the enterprise;
- changes a loss into income or vice versa;
- concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- determines the registrant's compliance with regulatory requirements;
- affects the registrant's compliance with loan covenants or other contractual requirements;
- increases management's compensation—for example, by satisfying a requirement for the award of bonuses or other forms of incentive compensation; or
- involves concealment of an unlawful transaction.

In assessing multiple misstatements, the bulletin reminds registrants and auditors that they must consider all misstatements or omissions both separately and in the aggregate to determine whether, in relation to the individual line item amounts, subtotals, or totals in the financial statements, the misstatements or omissions materially misstate the financial statements taken as a whole. Finally, the SAB reminds registrants that immaterial but intentional misstatements can violate the federal securities laws. Materiality, Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,153–54 (Aug. 19, 1999), *available at* http://www.sec.gov/interps/account/sab99.htm; *see also* if a substantial likelihood exists that a reasonable investor would have considered the omitted fact important because disclosure would have significantly altered the "total mix" of available information.[149] To the extent that the "reasonably likely to have a material effect" standard in the MD&A requirements mandates disclosure in situations which would not qualify as "material" for accounting purposes, compliance with GAAP may not satisfy disclosure obligations under the federal securities laws.

In January 2002, the SEC indicated its view that the words "reasonably likely" express a lower disclosure threshold than "more likely than not."[150] Unfortunately, the SEC did not compare "reasonably likely" to the "reasonably possible" standard that typically requires disclosure under GAAP.[151] In the years ahead, we can expect lawyers and the courts to face this potentially important issue.[152] At this time,

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Kenneth C. Fang & Brad Jacobs, *Clarifying and Protecting Materiality Standards in Financial Statements: A Review of SEC Staff Accounting Bulletin 99*, 55 BUS. LAW. 1039 (2000) (tracing the development of materiality standards, examining the purpose and reasoning behind SAB No. 99's release, and concluding that the bulletin creates an ambiguous standard that opens the door to liability for innocent mistakes in judgment).

149 Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (interpreting Rule 10b-5); TSC Indus., Inc. v. Northway, 426 U.S. 438, 448–49 (1976) (discussing the proxy rules); *see also* 17 C.F.R. §§ 230.405, 240.12b-2 (2004) ("The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.").

150 Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Financial Reporting Release No. 61, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002), *available at* http://www.sec.gov/rules/other/33-8056.htm.

151 *See* ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5, §§ 3, 10 (Financial Accounting Standards Bd. 1975); *see also* HERWITZ & BARRETT, *supra* note 45, at 181.

152 In *Greenstone v. Cambex Corp.*, 975 F.2d 22 (1st Cir. 1992), the First Circuit—in an opinion authored by then Chief Judge, now Justice, Breyer—explicitly recognized, but did not decide, the issue. In that case, the First Circuit affirmed the district court's decision dismissing a securities fraud claim because the investor did not plead "with particularity" any specific factual allegations supporting the conclusion that Cambex or its officers knew that the company faced a significant possibility of loss arising from certain IBM Credit leases prior to the time that IBM Credit filed the lawsuit. In the opinion's last paragraph, the court observed:

> We need not . . . decide whether the appropriate standard is knowledge (1) that an IBM Credit lawsuit was "probable" or (2) that the lawsuit (or some similar loss) was "reasonably likely[."] Whether the standard is one or the other or yet some third similar standard (such as "reasonably expects"), we should reach the same result.

Id. at 28.

we can simply assume that the MD&A rules impose a lower standard for disclosure, which translates to more helpful information for investors.[153]

Apart from lowering the materiality threshold, the SEC has also sought to bolster the substance of required MD&A disclosures. In 2003, the SEC issued guidance indicating that the Agency wants to elicit more meaningful disclosure in several areas, including (1) material trends and uncertainties, and (2) liquidity and capital resources. As to material trends and uncertainties, the SEC stated that the MD&A requirements seek "to provide information about the quality and potential variability of a company's earnings and cash flow, so that readers can ascertain the likelihood that past performance is indicative of future performance."[154]

If you have not already so surmised, the MD&A requirements contain abundant, inherent wiggle room. Thus, SEC enforcement of the requirements remains crucial to their interpretation—and ultimate success. For that reason, the 1992 SEC enforcement action against Caterpillar, Inc. represented a landmark event in the Agency's MD&A policy.[155] In that administrative action, everyone agreed that Caterpillar's financial statements complied with GAAP,[156] which did not require separate reporting of a foreign operation unless its revenues or assets amounted to at least ten percent of consolidated revenues or total assets.[157] Everyone also agreed that as a result of "an exceptionally profitable year" and various non-operating items, Caterpillar's wholly-owned Brazilian subsidiary, Caterpillar Brasil, S.A. (CBSA), contributed some twenty-three percent of Caterpillar's consolidated 1989 net profits even though neither CBSA's revenues nor assets represented ten percent or more of consolidated revenues or total assets. Early in 1990, Caterpillar's top management realized that the inauguration of Fernando Collor de Mello as the new President of Brazil would bring sweeping economic and monetary changes designed to bring the country's hyperinflation under control, and that

153 *See, e.g.*, *In re* Caterpillar, Inc., Accounting and Auditing Enforcement Release No. 363, [1991–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,830, at 63,055 (Mar. 31, 1992).

154 Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Financial Reporting Release No. 72, 68 Fed. Reg. 75,056, 75,062 (Dec. 29, 2003), *available at* http://www.sec.gov/rules/interp/33-8350.htm.

155 *See In re* Caterpillar, Inc., [1991–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 63,050.

156 *See* HERWITZ & BARRETT, *supra* note 9, at 359, 365.

157 *Id.* at 365.

those new economic policies would cause CBSA to suffer significant losses during 1990. Nothing in Caterpillar's MD&As suggested either the disproportionate effect of CBSA's profits to Caterpillar's overall profitability during 1989 or management's uncertainty about CBSA's 1990 performance. That silence was exactly the kind of sin of omission that the MD&A requirements sought to prevent. By instituting the enforcement action against Caterpillar, the SEC signaled that GAAP would no longer shield registrants from the MD&A rules.

The SEC also quickly proved that the enforcement action against Caterpillar would not stand as an isolated example. Subsequent to Caterpillar, the SEC has increasingly brought enforcement actions against registrants for inadequate disclosures regarding their financial statements, even though those financial statements complied with GAAP. In 1994, for example, the SEC instituted administrative proceedings against a registrant for failing to disclose a material slowdown in sales in its periodic filings even though the corporation had disclosed the information in a press release.[158] The SEC concluded that a registrant must disclose known trends in the MD&A section even though the registrant has previously announced the trends to the public elsewhere.[159]

In 1998, Sony Corporation ("Sony") settled administrative charges arising from the company's failure to disclose properly losses in its Sony Pictures Entertainment Inc. subsidiary ("Pictures") in the MD&A sections of its annual reports for the fiscal year ended March 31, 1994.[160] The enforcement action also involved two other current reports that the company filed on Form 6-K, the document that foreign issuers use to file reports of material information with the SEC. These inadequate disclosures occurred during the several months before Sony wrote down about $2.7 billion in goodwill related to its acquisition of Pictures. Despite the expressed preference of its outside auditors and own financial officers, Sony did not report the results of Pictures as a separate industry segment. Instead, the company reported the combined results of Pictures and Sony's profitable music business as a single "entertainment" segment. This treatment obscured the approximately $967 million in net losses that Pictures had incurred—which the SEC described as a "known trend"—after the acquisition and before the close of the fiscal year ended March 31,

158 *In re* Shared Med. Sys. Corp., Exchange Act Release No. 33,632, 56 S.E.C. Dock. 199 (Feb. 17, 1994).

159 *Id.*

160 *See In re* Sony Corp., Accounting and Auditing Enforcement Release No. 1061, [1995–1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,574, at 63,816 (Aug. 5, 1998).

1994. Additionally, Sony's filings failed to disclose that the company had been considering the possible need to write down a substantial part of the goodwill attributable to Pictures for more than a year. As part of the settlement, Sony agreed to engage an independent auditor to examine its MD&A presentation for the fiscal year ending March 31, 1999, and to adopt procedures to ensure that its new chief financial officer assumes primary responsibility for ensuring that the company's disclosures comply with legal and accounting requirements. In a related civil action, Sony also agreed, without admitting or denying wrongdoing, to pay a one million dollar civil penalty, an amount equal to the largest sum the SEC has ever received for a non-antifraud violation.

More recently, in 2002, the SEC initiated cease-and-desist proceedings against Edison Schools, Inc. ("Edison") because the company failed to disclose that a substantial portion of its reported revenues included payments that never reached Edison.[161] Even though Edison's revenue recognition practices did not violate GAAP, the company did not disclose the amount of the expenses that certain school districts paid directly to teachers, who remained school district employees, or other vendors to operate the schools that Edison managed. This omission distorted the realities of Edison's operations and financial results. Edison consented to a cease-and-desist order to resolve the proceedings.[162]

Separately and collectively, these administrative proceedings document the importance that the SEC places on MD&A and highlight the types of prospective information that a reader should expect to find in future MD&As. According to the statement the SEC issued shortly after Enron filed its bankruptcy petition in December 2001, public companies should use their MD&As to explain in plain English their "critical accounting policies;" the assumptions, estimates, and other judgments or uncertainties affecting the application of those policies; and the likelihood that the company would report different amounts under different conditions or using different objectives.[163] Less than six months later, the SEC issued proposed rules that would require issuers and registrants to include a separately captioned section regarding the application of critical accounting policies in the

161 *See In re* Edison Schools, Inc., Accounting and Auditing Enforcement Release No. 1555, [2001–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 75,070, at 63,367 (May 14, 2002).

162 *Id.* at 63,367–72.

163 Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Financial Reporting Release No. 60, 66 Fed. Reg. 65,013 (Dec. 17, 2001), *available at* http://www.sec.gov/rules/other/33-8040.htm.

MD&A section of various securities filings.[164] The rules would require disclosures about both the critical accounting estimates used to apply the company's accounting policies and the initial adoption of certain accounting policies.[165] Although those proposed rules remain under consideration, late in 2003 the SEC did publish additional interpretive guidance regarding MD&A.[166] The release offered a chronology of prior SEC actions regarding MD&A and sought to elicit more meaningful disclosure about, among other things, critical accounting estimates.[167]

As mentioned in this Article's opening paragraph, the MD&A requirements hold the distinction as perhaps the most significant administrative initiative involving the intersection between accounting and disclosure in the SEC's first seventy years. I do not expect the prominence of the MD&A requirements to fade anytime soon. What the SEC does, whether via rules, interpretation, or enforcement, remains crucial to full disclosure and vital to the reliability and stability of our national securities markets. I urge the SEC to continue to

164 Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, Securities Act Release No. 8098, Exchange Act Release No. 45,907, 67 Fed. Reg. 35,620 (proposed May 20, 2002), *available at* http://www.sec.gov/rules/proposed/33-8098.htm.

165 *Id.*

166 Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Financial Reporting Release No. 72, 68 Fed. Reg. 75,056 (Dec. 29, 2003), *available at* http://www.sec.gov/rules/interp/33-8350.htm.

167 *Id.* In early 2003, the SEC's Division of Corporation Finance issued a report summarizing the significant issues that its staff raised with companies in the Fortune 500 in its review of the annual reports those companies filed during 2002. The report listed inadequate discussions in MD&A as the staff's top concern and emphasized that review efforts would continue to focus on this section in disclosure documents. The report encouraged all companies to present useful and meaningful disclosures about financial condition, operating results, and liquidity. Div. of Corp. Fin., Sec. & Exch. Comm'n, *Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies, at* http://www.sec.gov/divisions/corpfin/fortune500rep.htm (last modified Feb. 27, 2003). The SEC's most recent guidance regarding MD&A expressed the Commission's belief that less convoluted language and better presentation would improve the clarity and understandability of MD&A; stressed the need for analysis (the "A" in MD&A), as well as discussion of required information; and urged companies to focus their disclosures regarding key indicators of financial condition and operating performance, liquidity and capital resources, material events and uncertainties that would cause reported financial information to fail to predict future operating performance or financial condition, and critical accounting estimates. Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, 68 Fed. Reg. 75,056.

stress and enforce the MD&A requirements, which I view as the Agency's biggest accomplishment in the accounting arena.

C. *Auditor Independence*

To my mind, the one area involving accounting and auditing where the SEC has sometimes neglected the need to protect the investing public involves auditor independence. Although we may never learn exactly what caused the audit failures at Enron and other companies in recent years, the SEC's failure to insist upon auditor independence certainly did not help, and we can trace that failure back at least twenty years. This section of the Article recounts in some detail the SEC's missed opportunities and the scandals that arose, at least in part, from the Agency's failures to act. In my opinion, however, Congress must now also shoulder some blame; the recent Sarbanes-Oxley reforms, while they definitely alleviate longstanding ills adversely affecting auditor independence, do not go far enough to remedy the problem completely. Independence remains the cornerstone for the auditing process and the auditing profession. The SEC should further solidify that essential independence.

Before describing how the SEC has failed to preserve inviolable auditor independence and my views as to better enhance it in the future, as a preliminary matter, I should distinguish the roles and responsibilities of auditors and attorneys. Basically, lawyers act as advocates for their clients, while auditors serve as independent attestators. In essence, an auditor must treat the financial markets, rather than the enterprise undergoing the audit or its management, as the real client. In the words of Professor Calvin H. Johnson, "[auditors] owe no duty to the firm: In the game of auditing, the accountants are the cops and managers are the robbers."[168]

In *United States v. Arthur Young & Co.*,[169] the Supreme Court contrasted the roles of attorneys and independent auditors in holding that an auditor must disclose audit workpapers in response to a subpoena issued by the Internal Revenue Service. As lawyers generally appreciate, they serve as confidential advisors and advocates for clients. The lawyer's duty of loyalty requires a lawyer to present the client's case in the most favorable possible light. By comparison, an auditor assumes a different role which the Supreme Court described

168 Calvin H. Johnson, *Accounting in Favor of Investors*, 19 CARDOZO L. REV. 637, 638 (1997).

169 465 U.S. 805 (1984).

as "a disinterested analyst charged with public obligations."[170] The Supreme Court wrote:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. 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.[171]

The SEC, fortunately, has endorsed the Supreme Court's view of the accounting profession's role as the auditor. In that regard, the Agency requires an independent auditor's report to accompany all financial statements that issuers and registrants file.[172] But what standards determine independence? As starters, SEC rules and professional standards prohibit auditing firms, their owners, and audit employees from owning any direct financial interest or material indirect financial interest in an audit client, its parent, any subsidiaries, or other affiliates, or from holding a close connection with the issuer or registrant as a director, officer, or employee.[173]

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170 *Id.* at 817.

171 *Id.* at 817–18; *see also* KPMG Peat Marwick v. Nat'l Union Fire Ins. Co., 765 So. 2d 36, 38–39 (Fla. 2000) (using the reasoning in *United States v. Arthur Young & Co.* to conclude that certain public policy reasons that prevent an insurer or assignee from asserting a professional malpractice claim against an attorney do not apply to such claims against an independent auditor). *But see* Daniel R. Fischel, *Lawyers and Confidentiality*, 65 U. CHI. L. REV. 1, 19–21, 33 (1998) (disagreeing with the Supreme Court's distinction between the roles of attorneys and independent auditors; arguing that, as reputational intermediaries, lawyers and auditors perform far more similar economic functions than the Court's analysis suggests; and ultimately concluding that "[a]bsent some more compelling justification for [attorney confidentiality rules, such as the ethical duty of confidentiality, the attorney-client privilege, and the work product doctrine,] than has been advanced to date, these doctrines should be abolished").

172 For enterprises subject to the SEC's jurisdiction, the Commission requires the auditor's report to state (1) whether the accountant performed the audit in accordance with GAAS and (2) the auditor's opinion regarding the accompanying financial statements and the accounting principles and practices that the registrant used to prepare those financial statements. HERWITZ & BARRETT, *supra* note 45, at 58.

173 17 C.F.R. § 210.2-01(b)–(c) (2004); *see also In re* Rider, Accounting and Auditing Enforcement Release No. 555, [1991–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,015, at 63,389-55 (Apr. 29, 1994) (permanently denying an auditor who owned 2000 shares of common stock in an audit client the privilege of appearing or practicing before the SEC as an accountant).

The SEC's rules on independence also require intellectual honesty in both fact and appearance. The Agency will not recognize an auditor as independent if "a reasonable investor with knowledge of all relevant facts and circumstances" would conclude that the auditor cannot exercise objective and impartial judgment on all issues encompassed within the engagement involving the particular audit client. To determine whether an auditor qualifies as independent, the SEC will consider all relevant circumstances, including evidence bearing on all relationships between an accountant and any audit client or affiliate.[174] In that regard, the SEC will look to whether the relationship between the auditor and the audit client or the provision of any nonaudit service (1) creates a mutual or conflicting interest between the auditor and the audit client, (2) places the auditor in the position of auditing the auditor's own work, (3) results in the auditor acting as management or as an employee of the audit client, or (4) makes the auditor an advocate for the audit client.[175]

While those principles flow from the SEC's Codification of Financial Reporting Policies,[176] the Agency has not always enforced those standards stringently. During the late 1990s, the largest public accounting firms—first the Big Six and then the Big Five (now the Final Four)—increasingly provided nonaudit services, such as consulting, internal auditing, and tax advising, often to the very enterprises they audited. From 1988 to 1999, the percentage of average revenue at the then-Big Five accounting firms arising from accounting and auditing services fell from fifty-five to thirty-one percent. By comparison, during that same period the percentage of average revenue coming from management consulting services increased from twenty-two to fifty percent. On average, public accounting firms charged $2.69 in nonaudit fees for every dollar in audit fees.[177] In essence, auditing became a "loss leader" to more profitable consulting services.[178]

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174 17 C.F.R. § 210.2-01(b).

175 *Id.* § 210.2-01(1)–(2).

176 Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7870, Exchange Act Release No. 42,994, 65 Fed. Reg. 43,148, 43,158 (proposed July 12, 2000) (articulating four governing principles found in the Codification, *see supra* note 50 and accompanying text), *available at* http://www.sec.gov/rules/proposed/34-42994.htm; *see also* Revision of the Commission's Auditor Independence Requirements, Financial Reporting Release No. 56, 65 Fed. Reg. 76,008, 76,030 (Dec. 5, 2000) (explaining the rationale underlying the preliminary note that explains the SEC's approach to independence issues), *available at* http://www.sec.gov/rules/final/33-7919.htm.

177 S. Rep. No. 107-205, at 15 (2002).

178 *See generally* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 Bus. Law. 1403, 1410–12 (2002) (discussing how the major accounting

As only one illustration, Enron's auditor, Arthur Andersen, lacked independence in both fact and appearance. During 2000, the year before Enron's bankruptcy, the company paid fifty-two million dollars to Andersen—twenty-five million dollars for auditing services and an additional twenty-seven million dollars for nonauditing services—and ranked as Andersen's second largest client. Perhaps more significantly, an internal Andersen memo from February 2001 discussing the retention of Enron as an audit client refers to one hundred million dollars a year in potential revenues from Enron. Even if Andersen could absorb the loss of Enron as a client, individual careers and the Houston office depended upon retaining the Enron engagement. As the audit partner for the firm's second largest client, David B. Duncan enjoyed clout not only in the Houston office, but throughout Andersen. Indeed, one commentator has accurately described a fifty million-dollar client as a "meal ticket" for a forty-two year-old audit partner.[179]

To exacerbate the problem, the Big Five typically encouraged their employees, especially those not likely to become partners, to take jobs with clients or potential clients when they left the firm. The resulting "revolving door" between Andersen and Enron only weakened the auditor's appearance of independence. Between 1989 and 2001, eighty-six people left Andersen to work for Enron. Andersen alumni at Enron included Richard A. Causey, its chief accounting officer and a former Andersen audit manager; Jeff McMahon, Enron's treasurer; and Sherron Smith Watkins, the vice president who unsuccessfully tried to blow the whistle on Enron's aggressive accounting. Employees at Enron often referred to Andersen as "Enron Prep." In the "up or out" environment at Andersen, everyone who worked on the Enron account had subtle incentives to keep both their bosses and the people at Enron happy.

Finally, the so-called "integrated audit" Andersen employed at Enron and then sought to market more widely to other clients impaired the firm's independence. Under this model, Andersen attempted to combine its role as external auditor with the process of internal auditing, whereby an enterprise checks its own books. Paralleling and sometimes overlapping outside or independent audits, internal audits seek to ensure that an enterprise follows its procedures, safeguards its assets, and operates efficiently. Under a five-year, eigh-

firms used auditing services to attract clients, to whom they then sold more lucrative consulting services).

179 *See* Kip Dellinger, *Critique of Tax Bar Clarified*, 99 TAX NOTES 155, 155 n.2 (2003).

teen million dollar contract that looked to create an "integrated audit," Andersen took over Enron's internal auditing in 1994, transforming dozens of Enron staffers into Andersen employees. The *Wall Street Journal* reported that before Enron's collapse more than one hundred Andersen employees worked in leased space inside Enron's headquarters in Houston. In videotapes Andersen filmed to market the "integrated audit," people at both Andersen and Enron described how intertwined their operations had become. In one segment, Jeffrey Skilling, then Enron's president, commented: "I think over time we and Arthur Andersen will probably mesh our systems and processes even more so that they are more seamless between the two organizations."[180]

1. Another Missed Opportunity

While Sarbanes-Oxley and its implementing rules do strengthen auditor independence, these reforms were late arriving. The SEC initially had the opportunity to strengthen auditor independence in the late 1970s when the success of the consulting practices in public accounting firms under the rubric of "management advisory services," or MAS, attracted the Agency's attention. Accordingly, the SEC issued two administrative releases, Accounting Series Release Nos. 250 and 264, to address the heightened concern that providing such services to audit clients could, or could appear to, impair the auditor's independence.

In Accounting Series Release No. 250,[181] effective for proxy statements filed after September 30, 1978, the SEC required registrants to (1) describe each service the independent accountant provided to the registrant during the most recent fiscal year, (2) disclose the percentage relationships that (a) the fees for individual nonaudit services bear to the audit fee if that percentage exceeds three percent and (b) the fees for the aggregate nonaudit services bear to the audit fee, and (3) state whether the registrant's audit or similar committee or its board of directors approved in advance each service that the independent auditor provided and considered the possible effect of the performance of each such service on the auditor's independence.[182]

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180 *See* Ianthe Jeanne Dugan et al., *On Camera, People at Andersen, Enron Tell How Close They Were*, WALL ST. J., Apr. 15, 2002, at A1.

181 Disclosure of Relationship with Independent Public Accountant, Accounting Series Release No. 250, 43 Fed. Reg. 29,110 (July 6, 1978).

182 *Id.*

About a year later, the SEC issued Accounting Series Release No. 264,[183] which stated the Commission's views regarding various factors auditors should consider in assessing whether performing nonaudit services for publicly traded audit clients impairs independence.[184] In addition, the release set forth certain factors that audit committees, boards of directors, and managements should consider in determining whether to retain their independent auditors to perform nonaudit services.[185]

Ironically, in response to those developments and similar regulatory initiatives in other parts of the world, Harvey Kapnick, then Arthur Andersen's chief executive, proposed to spin-off the firm's consulting practice from the audit and tax practices in an effort to deal with the issue. When the firm's partners rejected that proposal in favor of an alternative that would drastically reduce the size of the consulting practice and consulting work performed for SEC audit clients, Kapnick resigned as the firm's chief executive and left Arthur Andersen.

After the 1980 election, the SEC moved into a deregulatory phase.[186] In 1981, the SEC proposed to withdraw the rule that required disclosures about nonaudit services in proxy statements.[187]

183 Interpretative Release Relating to Accounting Matters; Scope of Services by Independent Accountants, Accounting Series Release No. 264, 44 Fed. Reg. 36,156 (June 20, 1979).

184 In particular, the auditor should consider its dependence on revenues from MAS, both from the standpoint of MAS revenues to total firm revenues and the relationship between the audit fee and the proposed MAS fee. In addition, auditors must exercise care to (1) serve only in an advisory capacity and ensure that they do not supplant management, (2) avoid engagements that will require self-review, (3) consider whether the nonaudit services may actually enhance audit quality, and (4) identify the relationship of the engagement to audit skills to prevent the auditing firm from essentially becoming a MAS business. *Id.* at 36,157–59.

185 In the first instance, the SEC encouraged audit committees, boards of directors, and management to weigh the economic benefits that the engagement would offer against the potential adverse effects of having the auditor perform nonaudit services in an effort to assess whether the engagement offers real advantage to the client. Like the auditor, the audit committee, the board, and management should consider whether the nonaudit services would supplant management or create self-review, and assess whether the engagement unwisely increases the auditor's dependence on MAS. *Id.* at 36,159–60.

186 Stephen A. Zeff, *How the U.S. Accounting Profession Got Where It Is Today* (pt. 1), 17 ACCT. HORIZONS 189, 204 (2003).

187 Relationships Between Registrants and Independent Accountants, Accounting Series Release No. 296, 46 Fed. Reg. 43,181 (Aug. 27, 1981). The proposing release stated that "[a]lthough specific information about nonaudit services is important, it may not be of sufficient utility to investors to justify continuation of the disclosure requirement." *Id.* at 43,181. In addition, the SEC expressed its belief that the ac-

Concurrently, the SEC rescinded ASR No. 264,[188] opining that the Commission "has achieved its objective in issuing ASR 264."[189] In essence, the SEC embraced an approach that allowed the accounting profession to regulate itself, stating:

> Accountants and their self-regulatory structure, audit committees, boards of directors, and management are aware of the Commission's views on accountant's independence and should be sensitive to the possible impact on independence of nonaudit services performed by accountants. The Commission believes it should be able to rely on these persons to ensure adequate consideration of the impact on accountants' independence of nonaudit services because they share the responsibility to assure that the public maintains confidence in the independence of accountants.[190]

Less than six months later, the SEC issued a final rule that rescinded ASR No. 250, eliminating the rule requiring disclosure in proxy statements about the nonaudit services that the independent auditor provided for the registrant.[191]

Although the SEC eventually strengthened its auditor independence rules in 2000 after a bitter dispute with the accounting profession, the damage had already been done.[192]

2. Sarbanes-Oxley and Its Failure to Ensure Auditor Independence

Among its most critical provisions, Sarbanes-Oxley sought to strengthen auditor independence. Unfortunately, the reforms in Sarbanes-Oxley, by focusing exclusively on independence issues arising from conflicts of interests, overlook the probability that unconscious bias, and more specifically an auditor's propensity to interpret data in accordance with her desires, typically causes audit failures. As long as financial or other incentives tempt auditing firms and their

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counting profession's self-regulatory mechanism could "generate appropriate information about nonaudit services to enable adequate continued oversight." *Id.*

188 Rescission of Certain Accounting Series Releases and Adoption of Amendments to Certain Rule of Regulation S-X Relating to Disclosure of Maturities of Long-Term Obligations, Accounting Series Release No. 297, 46 Fed. Reg. 43,411 (Aug. 28, 1981).

189 Relationships Between Registrants and Independent Accountants, 46 Fed. Reg. at 43,185.

190 *Id.*

191 Relationships Between Registrants and Independent Accountants, Accounting Series Release No. 304, 47 Fed. Reg. 5404 (Feb. 5, 1982).

192 *See* Revision of the Commission's Auditor Independence Requirements, Financial Reporting Release No. 56, 65 Fed. Reg. 76,008 (Dec. 5, 2000) (codified at 17 C.F.R. § 210.2-01(c)(4) (2001)), *available at* http://www.sec.gov/rules/final/33-7919.htm.

executives and employees to try to retain an audit engagement, unconscious bias will plague auditing. Accordingly, unconscious bias suggests the need to require mandatory rotation of audit firms after fixed terms for present fees. Such a reform would eliminate the threat that a public company could fire or otherwise punish its auditor for failing to approve questionable accounting practices.[193]

In an effort to reduce conflicts of interest, Sarbanes-Oxley contains at least six different provisions designed to strengthen various requirements regarding auditor independence for public companies.[194] These provisions address audit committees, prohibited services, pre-approval requirements, audit partner rotation, conflicts of interest, and implementing regulations.[195]

Most relevant to this discussion, SOx section 201 prohibits auditors from providing certain services to audit clients subject to the SEC's jurisdiction.[196] In essence, the legislation codifies a list contained in the regulations on auditor independence that the SEC adopted in 2000.[197] The "prohibited activities" for auditors include bookkeeping or other services related to the audit client's accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing; management functions; human resources; broker-dealer, investment adviser or investment banking services; legal services; expert services unrelated to the audit; and, subject to the SEC's approval, any other service that the PCAOB decides to prohibit via regulation.[198] If

193 Matthew J. Barrett, *Enron and Andersen—What Went Wrong and Why Similar Audit Failures Could Happen Again*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 155, 166–67 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

194 *See* Matthew J. Barrett, *"Tax Services" as a Trojan Horse in the Auditor Independence Provisions of Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 463, 470–73.

195 *Id.* In addition, the Act directed the Comptroller General to study the potential effects arising from requiring mandatory audit firm rotation. *See* Sarbanes-Oxley Act of 2002 § 207, 15 U.S.C.A. § 7232 (West Supp. 2004). In late 2003, the General Accounting Office subsequently submitted a report concluding that costs from increased audit fees and the loss of institutional knowledge acquired by a public company's previous auditor under mandatory audit firm rotation likely outweighed any benefits from enhanced auditor independence. *See* GEN. ACCOUNTING OFFICE, GAO-04-216, PUBLIC ACCOUNTING FIRMS: REQUIRED STUDY ON THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION 3, 4, 8 (2003), *available at* http://www.gao.gov/new.items/d04216.pdf.

196 15 U.S.C.A. §§ 78j-1, 7231.

197 *See* Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008.

198 15 U.S.C.A. §§ 78j-1(g), 7231. Pursuant to a directive in SOx section 208(a), in early 2003 the SEC issued final regulations designed to strengthen auditor indepen-

a registered public accounting firm provides any of the listed services to an audit client who is also an issuer or registrant, the audit firm likely would not only jeopardize its independence from the audit client, but also violate federal securities laws, SEC regulations, and PCAOB rules. As described more fully in the next paragraph, an auditor may perform services not included on the prohibited list, such as tax services, for an audit client only if the client's audit committee approves those services in advance.

In that regard, Sarbanes-Oxley generally requires an issuer's audit committee to pre-approve all services, both audit and nonaudit, that a registered public accounting firm provides to an audit client.[199] This requirement specifically applies to any non-prohibited services. In addition to satisfying the pre-approval requirement, issuers must disclose the amounts paid to auditors for various types of services.[200]

To enable investors to evaluate the auditor's independence, the final rules expanded previously required disclosures regarding fees paid to the auditor for both audit and nonaudit services. These disclosures must cover the last two fiscal years and four distinct categories: "Audit Fees," "Audit-Related Fees," "Tax Fees," and "All Other Fees." In the future, such disclosures will appear in both a public company's annual report and proxy statement.[201]

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dence. Strengthening the Commission's Requirements Regarding Auditor Independence, Financial Reporting Release No. 68, 68 Fed. Reg. 6006 (Feb. 5, 2003) (codified in scattered sections of 17 C.F.R.), *available at* http://www.sec.gov/rules/final/33-8183.htm. These regulations, which generally became effective on May 6, 2003, amended the Code of Federal Regulations to reflect SOx's new rules on prohibited services. *See* 17 C.F.R. § 210.2-01(c)(4) (2004).

199 15 U.S.C.A. §§ 78j-1, 7231. SOx section 202 allows the audit committee to delegate the authority to grant pre-approvals to one or more designated members, as long as any designee also qualifies as an independent director and any resulting approvals come before the full audit committee at each of its scheduled meetings. In addition, the statute allows a de minimis exception to the pre-approval requirement when an auditor provides services which the issuer did not recognize at the time of the engagement as nonaudit services, and the aggregate amount of all such nonaudit services that the auditor provided to the issuer did not exceed five percent of the total amount that the issuer paid to its auditor during the fiscal year in which the auditor provided the nonaudit services. After either the issuer or the auditor promptly brings such services to the audit committee's attention, the audit committee can approve these services before the auditor completes the audit. Once again, if the audit committee delegates such approval authority to one or more of its members, those members may grant the approval necessary for the de minimis exception. *Id.*

200 *Id.* § 78j-1(i).

201 Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6006, 6030, 6048 (codified in scattered sections of 17 C.F.R., including 17 C.F.R. § 240.14a-101 (Item 9(e)(1))).

So far, so good. But did Congress cover all the bases? A recent *Harvard Business Review* article entitled *Why Good Accountants Do Bad Audits* argues that unconsciously biased judgments, or what lawyers often refer to as cognitive bias, rather than criminal collusion between auditors and management, often cause audit failures.[202] Two recent experiments, one with business students and the other with professional auditors, demonstrated that even the suggestion of a hypothetical relationship with a client distorts an auditor's judgments. As the audit failure at Enron vividly illustrates, long-standing relationships involving millions of dollars in ongoing revenues can only magnify these results. The article posits that three structural aspects of the accounting industry—ambiguity, attachment, and approval—create significant opportunities for bias to influence auditing judgments. In addition, the article highlights three aspects of human nature—familiarity, discounting, and escalation—that amplify auditors' unconscious biases.[203] If unconscious bias explains most audit failures, the auditor independence provisions in SOx largely miss the mark. As long as financial or other incentives tempt auditing firms and their executives and employees to try to retain an audit engagement, unconscious bias will remain present.[204] Thus, unconscious bias suggests the need for the SEC to require mandatory rotation of audit firms after fixed terms for preset fees. The preset fees and fixed terms would eliminate the threat that a public company could fire or otherwise punish its auditor for failing to approve questionable accounting practices.

Another related congressional blunder on this issue involves tax services that auditors might perform for audit clients. During the hearings which ultimately led to Sarbanes-Oxley, Congress considered a ban that would have prevented auditing firms from providing any nonaudit services, including so-called "tax services," to publicly traded audit clients. These tax services range from tax compliance work, such as preparing tax returns, to sophisticated tax minimization strategies, or "tax shelters," that aggressively seek to use quirks in the Internal Revenue Code to avoid taxes. Ultimately, Congress decided against an absolute bar on nonaudit services and instead developed a list of prohibited services. Unfortunately, Congress omitted tax services from that list, although Congress did give the PCAOB the power to add to the list, subject to SEC approval. Sadly, when the SEC issued its final rules on auditor independence to implement the reforms in

202 Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, HARV. BUS. REV., Nov. 2002, at 96.

203 *See id.* at 102.

204 Barrett, *supra* note 193, at 166.

Sarbanes-Oxley, the accompanying administrative release specifically reiterated the Agency's "long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence."[205] Various commentators, including myself, continue to argue that various conflicts of interest arise anytime an auditor offers significant tax advice to an audit client or promotes a tax shelter to anyone.[206] As the studies underlying the *Harvard Business Review* article demonstrate, financial and other incentives can potentially influence an auditor's decision to acquiesce in a questionable accounting practice. Under one Sarbanes-Oxley reform, the national securities exchanges and national securities associations have adopted rules that require listed companies to give their audit committees direct responsibility to hire, compensate, oversee, and fire the independent auditor.[207] While management can no longer hire or fire the auditor, under the guise of increasing auditor independence, management can use "enhanced independence" to support a recommendation to the audit committee to hire another firm to provide tax services, other permissible nonaudit services, or future audit services. Thus, if the auditor does not approve, or at least acquiesce in, certain accounting treatments or disclosures that management prefers, the auditor conceivably jeopardizes potentially significant future professional fees.

CONCLUSION

As I have personally reflected through Pacioli's eyes on the SEC's record on accounting and auditing issues during the past seventy years, I would list as especially high points the Commission's reliance on the private sector to set accounting principles; the numerous accounting authorities that the Commission and its staff have promulgated; the Agency's efforts to design, improve, and enforce the MD&A requirements; the focus on internal controls; and its leadership on accounting issues. In addition to often inadequate resources, which I really cannot blame on the SEC, the two glaring weaknesses are the belated and still incomplete efforts to safeguard auditor indepen-

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

206 *See, e.g.*, Barrett, *supra* note 194, at 466–67 (arguing that auditors for public companies should also not provide tax compliance services to audit clients or their executives); Bernard Wolfman, *SEC Let Investors Down*, 98 TAX NOTES 1019 (2003) (opining that the SEC "has left the investing public in the lurch" and urging the SEC and Congress to prohibit auditors for public companies from promoting tax shelters or providing tax planning and consulting services).

207 HERWITZ & BARRETT, *supra* note 45, at 52–53.

dence and the failure to complete the initiative that would have required management to report annually on the effectiveness of the company's internal controls at least two decades before Sarbanes-Oxley.

This Article has looked at the distant past, where we saw one man struggling on his own to explain the mechanics of bookkeeping—and the responsibilities of those who practice it. We have examined the more recent past, where events have forced regulators, legislators, and the accounting profession to reflect on their responsibilities to the investing public and to fashion some inbuilt checks that will safeguard the public's trust. Pausing now to look ahead, I view one issue as absolutely essential to retaining the U.S. securities markets' leading place in the world: a still further enhanced commitment to auditor independence.

Finally, in an effort to give a final salute to our dear friar, I revise my earlier mnemonic list to highlight the SEC's accomplishments and challenges as follows:

P Private sector
A Accessibility
C Caterpillar
I Internal controls
O Officer certification
L Liquidity
I Independence