Accounting, Auditing and Audit Committees After Enron, et al.: Governing Outside the Box Without Stepping Off the Edge in the Modern Economy*

Perry E. Wallace**

I. Introduction

The Enron corporate scandal, along with the ominous procession of similar debacles that followed it, inspired much commentary and discussion about the proper roles of accounting, auditing and the corporate audit committee.[1] Indeed, while other subjects also received well-deserved attention,[2] it was the massive and systemic breakdowns in these functions that pervaded the discourse and the processes leading to major corporate governance reforms.[3]

But how well will the reforms work? This article addresses the three functions from the perspective of key challenges in the post-Enron reform era. Part II explains how basic dynamics and dilemmas of the modern business environment contribute to problems in this area. Hence, as the article develops and explains the interrelationships among accounting, auditing and the audit committee in the larger business context, the discussion seizes upon the tensions involved when the pressures, temptations and opportunities placed before various actors in the business environment conflict with the effective performance of those functions. Against this background, the article then reflects on the much-discussed evolution of events leading to the Enron and other crises, during and after which a dance between pressures and processes led to the new reforms.

Part III of the article analyzes the impacts and the challenges of the reforms relative to the three functions. I conclude that, overall and notwithstanding their shortcomings, the reforms will prove to be an important step in the direction of responsible corporate govern-

---

* The mixing of metaphors here is intentional, to draw upon current—albeit somewhat hackneyed—usage and imagery in business and to emphasize the basic tension that is the central theme of the article. *See* William Strunk & E. B. White, The Elements of Style 80 (4th ed. 2000) ("When you use metaphor, do not mix it up."). Professor Strunk also observed, however, "the best writers sometimes disregard the rules of rhetoric," although usually there is in the writing "some compensating merit, attained at the cost of the violation." *Id.* at xvii-xviii.

** Professor of Law, Washington College of Law, American University. The author thanks the Washington College of Law for its support of the research that culminated in this article.

1. *See* discussion *infra* Part II.A-B (describing these functions and their roles in the corporate scandals).

2. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201-7266) (addressing numerous actors, including directors, officers, accountants, investment bankers, and attorneys).

3. *See* discussion *infra* Part II.B.

ance and financial market integrity in this area. At the same time, however, many of the most important questions remain unaddressed.

Among the challenges confronting businesses and managers of these functions in the future, some will derive from the very nature of the modern business environment. This is because success in modern enterprise will continue to demand great creativity and innovation—and thus incrementally greater risk-taking—with virtually immediate evidence of success (Outside the Box),[4] but it will also demand that businesses not run afoul of applicable legal norms (Off the Edge).[5] The latter point is especially true in view of the higher standards and more clearly-defined limits of post-Enron era reform.

II. Modern Business and the Dilemmas Posed to the Management of Accounting and Auditing Functions; Enron Against the World—and Against Itself

A. *Basic Dynamics and Dilemmas*

1. The Business Environment: Opportunities, Challenges, and the Importance of Results

The modern global business environment presents businesses with both vastly increased opportunities and vastly increased challenges.[6] To reap the benefits of these opportunities, however, a business must meet certain basic requirements.[7] Satisfying these requirements better positions the business to sustain itself against challenges such as global-sized volatility, risk and competition, and thereby increases its chances of achieving desired levels of market share and profitability.

Of course, however well-positioned the business may be, the ultimate requirement is *results*—results that paint the most attractive pic-

4. *See* Jim Tompkins, Think Outside the Box: The Most Trite, Generic, Hokey, Overused, Cliched or Unmotivating Motivational Slogans (2001).

5. *See, e.g.*, Mimi Swartz & Sherron Watkins, Power Failure: The Inside Story of the Collapse of Enron 192 (2003) ("The point of it all—the debating, the jockeying, the murderous politicking—was to prove that you were out there, dancing on the edge, where it was more exciting, more innovative, more *real*.").

6. Continuing integration of markets by virtue of trade and investment cooperation, virtually continuous technological advances, and increasingly shared economic cultural and social norms, among other elements, have appreciably expanded the scope of possibilities for business market-seeking, productivity and profit. *See generally* Daniel Yergin & Gardiner Morse, *What Makes Global Firms Resilient?*, Harv. Bus. Rev., July 2003, at 14; William J. Davey et al., Problems of International Economic Relations (4th ed. 2002); Ralph H. Folsom et al., International Business Transactions (6th ed. 2003).

7. Important elements include strategic and effective deployment of human resources and technology; acquisition and management of a sufficiently large size, reach or capacity of operations; substantial capital formation; and risk-taking. *See generally* Nitin Nohria et al., *What Really Works*, Harv. Bus. Rev., July 2003, at 42; James C. Collins & Jerry I. Porras, Built to Last: Successful Habits of Visionary Companies (1994); Jim Collins, Good to Great: Why Some Companies Make the Leap . . . and Others Don't (2001).

ture of the business to the world.[8] And at the core of these results is financial performance, which management will typically find it difficult *not* to present in a manner reflecting certain organizational pressures and "cognitive biases."[9] Some examples of these results are:

- substantial profits;
- substantial assets;
- low (or clearly manageable) debt levels;
- negligible (or at least manageable, and preferably strategic) losses;
- low expense levels; and
- substantial and continuing growth, based on the foregoing.[10]

This inclination to paint a pretty picture, however, may at times conflict with a fundamental constraint: the business must also present the facts and data in a manner that is true, fair, and complete and, therefore, useful to all interested parties. In other words, virtually every economic system possesses an underlying set of values and standards concerning the proper measurement and presentation of finan-

---

8. This description does not ignore the commonly known facts that (1) "expected earnings," as discerned by investment analysts and investors, is a major consideration in the setting of equity market valuations, and (2) during the high technology boom, many companies enjoyed high market valuations while showing losses. As to the first point, even predictions about earnings require an evaluation of past performance:

> Market value can be influenced by many factors, but in the main the value of equity securities is based upon the profitability of the enterprise. Value may be measured and predicted by: (a) consideration of past . . . performance; (b) assessment of current results of operations and financial condition; and (c) evaluation of likely future results. . . .
>
> . . . .
>
> . . . Thus one of the greatest risks to investors is the risk that the financial information upon which they rely is materially misstated.

Daniel V. Dooley, *Financial Fraud: Accounting Theory and Practice*, 8 FORDHAM J. CORP. & FIN. L. 53, 53-54 (2002). Mr. Dooley, a partner in the firm of PricewaterhouseCoopers, LLP, delivered the Second Annual Albert A. DeStefano Lecture on Corporate Securities & Financial Law at Fordham University School of Law on April 16, 2002. *Id.*

As to the second point, the bursting of the high tech bubble amply demonstrated the difficulties, if not the perils, associated with making valuations of companies without records of past performance. *See Federal Reserve Board's Semiannual Monetary Policy Report to the Congress Before the House Comm. on Financial Services*, 108th Cong. (2003) (testimony of Alan Greenspan, Chairman, Federal Reserve Bank), *available at* http://www.federalreserve.gov/boarddocs/hh/2003/july/testimony.htm.

9. *See* Dan Lovallo & Daniel Kahneman, *Delusions of Success: How Optimism Undermines Executives' Decisions*, HARV. BUS. REV., July 2003, at 56.

10. *See, e.g.*, 17 C.F.R. § 229.301 (2000). In promoting the major objectives of the securities laws to provide full and fair disclosure, many disclosures provided to the Securities and Exchange Commission (SEC), the public and the markets by public companies must display prominently certain "Selected Financial Data." These are in addition to the required presentation of complete financial statements. This disclosure occurs early in the document and seeks to capture, in brief, crucial, to-the-point financial data. Included are at least the "last five fiscal years" of the company's:

- net sales or operating revenues;
- income (loss) from continuing operations;
- income (loss) from continuing operations per common share;
- total assets;
- long-term obligations and redeemable preferred stock;
- cash dividends declared per common share; and
- additional items which . . . would enhance an understanding of and would highlight other trends in . . . [the company's] financial condition and results of operations.

cial performance, and these are typically expressed as "rules" or "principles." This obligation, insofar as financial information is concerned, directly implicates the science and art of accounting,[11] and it also anticipates the intervention of auditing professionals and the audit committee.

2. Accounting, Auditing and Audit Committees

a. *Accounting, Auditing and Their Discontents*

Notwithstanding the potential conflict posed for businesses, it is a fundamental precept of accounting in the United States that business management is responsible for the preparation and presentation of evidence of its financial status.[12] Thus, management *must* determine the accounting rules that are to be used, and it is responsible for its own interpretations and applications of those rules. For publicly-held companies, companies subject to certain comprehensive regulatory schemes and certain others,[13] the "rules" for identifying, compiling, recording and, ultimately, presenting accounting data are *generally accepted accounting principles,* or "GAAP."[14]

Actually, it is no surprise that in their financial reporting, some managers have at times been known to "enhance" unimpressive actual results, or even "create" impressive results where none exist. Moreover, the reasons for such manipulation derive from the confluence of several fundamental realities about the business environment and the reporting system:

(1) Management's duty and prerogative, as just described, to choose and interpret the rules;

11. *See* PATRICK R. DELANEY ET AL., GAAP 2003 (2002) (citing OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES, Statement of Financial Accounting Concepts No. 1 (Financial Accounting Standards Bd. 1998), *available at* http://www-biz.aum.edu/jheier/SFAC1.htm). Delaney describes SFAC 1 as setting out three objectives: "to provide useful information for economic decisions, to provide understandable information capable of predicting cash flows, and to provide relevant information about economic resources . . . and circumstances that change them." *Id.* at 18.

12. Circumstances Under Which Independent Public Accountants May Properly Express an Opinion, Exchange Act Release No. 62, 15 Fed. Reg. 9104 (June 27, 1947) ("The fundamental and primary responsibility for the accuracy of [accounting] information filed with the [Securities and Exchange] Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable.").

13. *See* DAVID R. HERWITZ & MATTHEW J. BARRETT, MATERIALS ON ACCOUNTING FOR LAWYERS 171-72 (3d ed. 2001) (discussing the fact that public companies and, in certain instances, some closely held companies must comply with GAAP, and that some regulatory schemes use GAAP while others use Regulatory Accounting Practices).

14. *See generally* DELANEY ET AL., *supra* note 11.

(2) The "flexibility" of GAAP rules themselves[15]—not to mention the much-criticized processes by which accounting rules are made and their applications verified (the audit process); and[16]
(3) The considerable pressures, temptations and opportunities—all linked to financial results—facing businesses and business actors.[17]

Thus, over the years, some companies have chosen approaches to "cooking the books" that typically include one or more of the following themes:

- Recognizing premature, questionable, extraordinary (but not so disclosed) or fictitious revenues;
- Shifting current expenses to a later or earlier period;
- Misreporting of assets and liabilities; or
- Improper cash flow reporting.[18]

Although the machinations and schemes described above have a long history, use of them in the Enron series of scandals was still breathtaking, much because of the sheer size of the monetary amounts involved, the consequent harm to investors and the market, certainly the audacity of the perpetrators—and the fact that they got caught.[19] Moreover, as commentators explored the growing number of subsequent revelations about accounting misdeeds, they made the connection to the complaints in past years—all too often ignored—about problems such as "managed earnings," improper uses of "pro forma" financial statements and the like. What emerged was a picture, not of several isolated abuses, but one of a system that had become troubled. The problem was the subject of a well-known speech entitled "The

---

15. *See* Herwitz & Barrett, *supra* note 13, at 173. The authors stated that:

> GAAP often sanctions alternative treatments for the same transaction.
> Given the various permissible choices, one academic calculated more than a million possible bottom lines . . . . Moreover, the fact that established accounting principles and other accounting literature do not, and indeed could not, address every conceivable situation leaves additional choices.

Id.

16. *See, e.g.*, Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants*, 63 Cal. L. Rev. 375, 417-19, 424-30 (1975); Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. Rev. 1151, 1176 (1970); George Mundstock, *The Trouble with FASB*, 28 N.C. J. Int'l L. & Com. Reg. 813, 814 (2003) (arguing that "current accounting principles are outmoded and fail to achieve their objectives. . . . [and that] problems with the current accounting principles arose in large part because the principles are policed by a private standard-setter").

17. *See generally* Lawrence E. Mitchell, Corporate Irresponsibility (2001). Mitchell observes that "[t]he modern American business corporation has been a subject of wonder and horror for much of the past century." *Id.* at 1. Professor Mitchell seizes upon the corporate drive to maximize short-term stock prices, as well as the underlying pressures and rewards related to that drive, as the main problem creating the horror. In his view, "[T]he main problem with American corporations — the main cause of their irresponsibility — is their drive to maximize short-term prices . . . ." *Id.* at 3. "What is remarkable is . . . how the legal and financial structures of the traditional American corporation create significant disadvantages for long-term management and strong competitive advantages for short-term management." *Id.* at 6.

18. *See* Charles W. Mulford & Eugene E. Comiskey, The Financial Numbers Game 8-15, 159-378 (2002); Howard Schilit, Financial Shenanigans 24-25, 63-175 (2d ed. 2002). The list herein is a composite of the descriptions of improper and fraudulent accounting practices that are the subject of these works. *See also* Dooley, *supra* note 8, at 57-82.

19. *See* discussion *infra* Part II.B.

Numbers Game" in which SEC Chairman Arthur Levitt explained his concern about, as well as his determination to combat, managed earnings:

> Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.[20]

b. *Who, or What, is to Blame?*

The search for a culprit reveals several possibilities, from the overall business environment, with its loopholes and its system of incentives and punishments that shape behavior in the markets, to the actors. In fact, commentators on the Enron scandals debated whether the problem was the system or the actors. Professor Coffee, for example, believes that reputational intermediary actors, or "gatekeepers,"[21] are the problem. "[T]he problem with viewing Enron as an indication of any systematic governance failure is that its core facts are maddeningly unique."[22] "Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified."[23] Dean Sargent, however, disagrees:

> It may be that Enron was unusual, but it had many successors in disaster, suggesting that something about the failure was systemic, and not idiosyncratic. The world of Enron and the others was a world swept by a perfect storm in which regulatory restraints, fiduciary obligation, market discipline, contractual incentives and professional gatekeepers all simultaneously failed to produce their intended beneficial effects.[24]

The approach taken in the reform process could be seen as responding to both views. Reform measures affect virtually the entire corporate governance system by placing considerable focus on various corporate and professional actors, including the internal corporate ac-

---

20. Chairman Arthur Levitt, The "Numbers Game," Address Before the NYU Center for Law and Business (Sept. 28, 1998), *available at* www.sec.gov/news/speech/speecharchive/1998/spch220.txt. Chairman Levitt set out five of the more popular types of "accounting hocus-pocus": (1) "Big Bath" Charges; (2) Creative Acquisition Accounting; (3) Miscellaneous "Cookie Jar Reserves"; (4) "Materiality" Abuses; and (5) Revenue Recognition Schemes. *Id. See also* Carol J. Loomis et al., *Lies, Damned Lies, and Managed Earnings*, FORTUNE, Aug. 2, 1999, at 74-76.

21. *See* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1403 (2002). Professor Coffee defines "gatekeepers" as "reputational intermediaries who provide verification and certification services to investors." *Id.* at 1405. This includes auditors, debt rating agencies, investment banks in fairness opinion engagements, and lawyers when they are serving less as "the transaction engineer, rather than the reputational intermediary." *Id.*

22. *Id.*

23. *Id.*

24. Mark A. Sargent, *Lawyers in the Perfect Storm*, 43 WASHBURN L.J. 1, 2-3 (2003).

tors and the gatekeepers.[25] The following discussion centers only on those characters directly involved in the management of accounting and auditing functions.

i. The Board of Directors and the Audit Committee

As to internal corporate actors, initial responsibility for choosing applicable rules, interpreting them in the context of actual transactions and preparing the financial statements and data, typically lies with staff employees under the direction of the chief financial officer (management). But the ultimate responsibility for their proper development and presentation rests with the board of directors. This is in keeping with the board's general duties in regard to the management of the corporation.[26] Importantly, the true picture of the board's participation in the life of corporate governance is complex indeed, and serious questions have emerged over the years about the actual, as well as the normative, role of the board.[27] Overall, however, corporate law and policy continue to invest in that body the ultimate responsibility for management of the corporation and to expect full compliance with this mandate.[28]

25. *See* discussion *infra* Part III.A.

26. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2003) ("The business and affairs of every corporation shall be managed by or under the direction of a board of directors . . . ."); MODEL BUS. CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors . . . .").

27. Although corporate legal codes expressly (but rather generally) set forth the role of the directors and place them at the top of the organizational chart with ultimate responsibility for management of the company, actual experience has frequently been rather different. In fact, historically, it has very often been the chief executive officer (CEO) who has made the definitive policy and strategic decisions for corporations, and these have typically gone unchallenged by the directors. Such was the conclusion of the first major empirical study of corporate decision-making, published in the book by Myles L. Mace. MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971). He reconfirmed the conclusion a decade later in his subsequent study. Myles L. Mace, *Directors: Myth and Reality — Ten Years Later*, 32 RUTGERS L. REV. 293 (1979).

28. It may well have been the criticisms of this inconsistency—not to mention the periodic shock of large-scale, systemic scandals—that inspired corporate boards to act more consistently with their legal and formal mandates. *See* JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS (1989).

Also, the emergence of more active (even activist) institutional investors and the (related) increases in pressures to include more "independent" directors, along with the "market for corporate control," seems to have accentuated the trend. *See* William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 263 (1992) ("The evolution of the junk bond market and takeover entrepreneurs, the growth of institutional investors, and the striking emergence of a global economy came together in the 1980s to force massive change in the private sector of our economy."); Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSPS. 121, 128 (2001) (stating that the "net effect of the leveraged buyout . . . [on corporate governance] was slightly positive"). At the same time, the complex and difficult challenge to arrive at effective and appropriate participation of the board continues. *See* JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY 576-80 (5th ed. 2003); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984).

Against this complicated backdrop, we have the corporate audit committee, the committee of the board with responsibility, at the board level, for accounting and auditing matters:

> An audit committee monitors and investigates a corporation's financial transactions and financial reports. One of its functions is to prevent financial improprieties. The audit committee also can serve as a direct link between the corporation's public accountants and the board of directors. Through its independent access to financial information and its contact with the public accountants, the audit committee also can better inform the board of the company's financial activities and improve the board's monitoring of management. Finally, the audit committee can shield the public accountants from undue management influence . . . .[29]

Arthur Levitt's "Numbers Game" speech in 1998 also expressed great concern that corporate audit committees were performing poorly. Levitt cited problems such as lack of expertise, infrequent meetings, conflicts of interest, lack of resources and a general lack of seriousness about their mandates.[30] In response to the speech, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) created the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which studied the matter and issued a report with recommendations.[31] Afterwards, the SEC ultimately approved proposed amendments to the listing standards of the NYSE, NASD and the American Stock Exchange (ASE),[32] which considerably raised the standards for qualification and performance of audit committees in listed companies.[33] With these improvements, it appeared that accounting and auditing oversight at public companies was beginning to improve.

ii. The Auditors

In addition to concerns about the unacceptable behavior of corporate audit committees, there was also concern about the performance of auditors. The Levitt speech expressed serious concerns about a series of well-publicized audit failures. Reminding auditors that "they are the public's watchdog in the financial reporting process,"[34]

---

29. BAUMAN ET AL., *supra* note 28, at 581.
30. Levitt, *supra* note 20.
31. *See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, *reprinted in* 54 BUS. LAW. 1067 (1999).
32. *See* Self-Regulatory Organizations, Exchange Act Release No. 34-42231, 64 Fed. Reg. 71523 (Dec. 14, 1999); Self-Regulatory Organizations, Exchange Act Release No. 34-42233, 64 Fed. Reg. 71529 (Dec. 14, 1999); Self-Regulatory Organizations, Exchange Act Release No. 34-42232, 64 Fed. Reg. 71518 (Dec. 14, 1999).
33. *See* Joseph I. Goldstein & Jeffrey F. Robertson, *Modifications to Audit Committee Requirements May Increase Director Liability*, 32 Sec. Reg. & L. Rep. (BNA) 1104 (2000).
34. Levitt, *supra* note 20 ("We rely on auditors to put something like the good housekeeping seal of approval on the information investors receive."). HERWITZ & BARRETT, *supra* note 13, at 180:

Chairman Levitt proposed that the Public Oversight Board create a group "to review the way audits are performed and assess the impact of recent trends on the public interest."[35] Again, there were improvements,[36] but Chairman Levitt had continuing concerns about the integrity of the audit function.

At the heart of these concerns was the fact that, in Levitt's view,

> the accounting profession stands at a pivotal moment in its history . . . [in which] broad reorganizations of the largest and most prestigious . . . firms . . . have the potential to advance the public interest . . . [but] must be accomplished without creating conflicts of interest through long-term financial relationships.[37]

"Independence is at the core of the profession,"[38] observed the Chairman, as he identified current practices in the profession that threatened this value. Maintaining financial interests in their audit clients, engaging in various non-audit services—often providing them for audit clients,[39] performing both the internal and the external audits for the same client,[40] taking assignments where the size of the fee depends on the answer given and, more broadly, the questionable effectiveness of the self-regulatory structure of auditing,[41] all raise the possibility of compromises in the quality of the audit.

As the preceding discussion explains, the concerns raised by the Enron scandals were not new. In fact, the issues, the problems, the solutions, and the problems with the solutions have long been a part

---

> An audit involves a process whereby an independent accountant examines an enterprise's financial statements and expresses an opinion regarding whether the financial statements fairly present, in all material respects, the enterprise's financial position, results of operations and cash flows in conformity with GAAP. In that way, auditors serve to enhance the reliability and credibility of financial statements for the investing public.

35. Levitt, *supra* note 20.

36. *See* Audit Committee Communications, Statement of Auditing Standards No. 90 (American Inst. of Certified Pub. Accountants 1999). The AICPA responded to Levitt's speech and the Blue Ribbon Committee Report and Recommendations with a requirement that the auditor must discuss the quality of a public company's accounting principles with the audit committee. *Id.*

37. SEC Chairman Arthur Levitt, Renewing the Covenant with Investors, Address at the NYU Center for Law and Business (May 10, 2000), *available at* www.sec.gov/news/speech/spch370.htm.

38. *Id.*

39. *Id.*

> In fact, today, auditing no longer dominates the practices of the largest firms. It accounts for just 30 percent of total revenues—down from 70 percent in 1977. Consulting and other management advisory services now represent over half—up from 12 percent in 1977. Since 1993, auditing revenues have been growing by 9 percent per year on average—while consulting and similar services have been growing at a rate of 27 percent each year . . . .
>
> . . . Among the expanded menu of services the major firms provide today are corporate finance, risk management, actuarial work, merger and acquisition analysis, network and database architecture, and asset management . . . .

Id.

40. *Id.*

41. *Id. See also* Mike Brewster, Unaccountable (2003) (describing the transformation, and, at times, the corruption, of the accounting profession up to the present, including the effect of competition, globalization and other features of the business environment on the profession).

of the life of the business environment. But it would take scandals of the magnitude and impact of the Enron series of failures to capture the world's attention and to provide the impetus for larger-scale reform.

B. *Accounting for Enron, et al.*[42]

The Enron scandal commenced a series of fateful events that left stakeholders in American corporate governance with a profound sense of concern: Had the global reputation of American capitalism, with its vaunted stability, transparency and integrity, been irreparably damaged? Were the capital markets safe for investment? Could corporate directors and officers and other professionals be trusted? And had the American corporate governance model been shown to be unworthy of imitation around the world?[43]

1. Enron

From its November 2001 announcement that it would drastically restate its financial reports for the years 1997-2000 and the first two quarters of 2001,[44] to its bankruptcy filing a month later,[45] and afterwards, the world watched the Enron drama in horror. Significantly, at the core of the now-famous Enron misdeeds lay a pattern of questionable accounting decisions and audit failures. Using—in fact, abusing—certain "related-party" business partnerships (often called "special purpose entities" or "special purpose vehicles"), the company sought to create an image of phenomenal financial success, with all the associated benefits for the company, its directors, officers and employees.[46]

42. An adaptation/version of this section was used in Perry E. Wallace, *The Globalization of Corporate Governance: Shareholder Protection, Hostile Takeovers and the Evolving Corporate Environment in France*, 18 CONN. J. INT'L L. 1 (2002). At the time of the adaptation, the intended title of this article, then a work in progress, was *Accounting for Enron, Arthur Andersen, et al.; Outside the Box, On the Edge, and Not Alone*. *See id.* at 43, n.196.

43. *See, e.g.*, Caroline Atkinson, *America's Crony Capitalism*, FIN. TIMES, Feb. 6, 2002, *available at* http://search.ft.com/search/articles.html ("The sorry tale that is emerging of special deals and dishonest dealing hits squarely at the reputation of the US capital markets.").

44. Press Release, Enron Corp., Enron Provides Additional Information About Related Party and Off-Balance Sheet Transactions; Company to Restate Earnings for 1997-2001 (Nov. 8, 2001), *available at* http://www.enron.com/corp/pressroom/releases/2001/ene/78-SECReleaseLtr.html. The company thus reduced past reported income by approximately $96 million in 1997, $113 million in 1998, $250 million in 1999, and $132 million in 2000, as well as increases of $17 million for the first quarter of 2001 and $5 million for the second quarter of 2001. Additionally, Enron's debt was increased in the restatement by $711 million in 1997, $561 million in 1998, $685 million in 1999 and $628 million in 2000. Overall, shareholders' equity would be reduced by $1.2 billion. *See* SWARTZ & WATKINS, *supra* note 5.

45. *See* Report from the Special Investigative Committee of the Board of Directors of Enron Corp., to the Members of the Board of Directors 148-77 (Feb. 1, 2002), *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport020102.pdf [hereinafter Powers Report].

46. *Id.* at 36-40. The benefits included the usual enhancement of the company's reputation and its attractiveness in the product and capital markets. Also, typically, in earnings-based incentive compensation arrangements, managers and others benefit directly from high earnings

More particularly, by engaging in various special business transactions with these entities, the company had been able to report high levels of earnings in its consolidated financial statements while keeping reports of large portions of its *total* debts and losses "off the books."[47] Further, the decisions to proceed in this manner were made in the upper ranks of the company at the officer-director level, and those decisions had also been approved by prestigious law and accounting firms who clearly saw the company as a valued client.[48]

The damage caused by the Enron frauds was as massive and wide-ranging as it was shocking.[49] And as matters moved to the investigatory stage,[50] the initial focus naturally turned to the Enron board of directors, whose gross failures of duty seemed obvious.[51] But events, and crises, had only just begun.

and related increases in company stock prices. Moreover, in Enron's energy trading business, a good credit rating (low debt, high earnings) was crucial to continued operations. *Id.* at 36-37. *See also* SCHILIT, *supra* note 18, at 6-8 (discussing the "rewards" derived from financial manipulation and fraud).

47. Although the term "off-balance-sheet" is the one typically used in this context, the term "off-the-books" is more accurate. This is because, often, as in the Enron matter, companies are not only attempting to avoid making entry of certain *debts* on their balance sheets, but they are also seeking to avoid entering certain *expenses* and *losses* on their income statements.

48. *See* Steven Pearlstein, *In Blossoming Scandal, Culprits Are Countless*, WASH. POST, June 28, 2002, at A01, *available at* http://www.washingtonpost.com/wp-dyn/articles/A58584-2002Jun27.html. The author quoted Jeffrey Garten, dean of the Yale University School of Management, when he said, "I think it is fair to say that there was nobody in the business community who is not implicated in this in some way." *Id*.

49. *See* PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE, 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE (Comm. Print 2002) [hereinafter ROLE OF THE BOARD REPORT].

> [The Enron] bankruptcy sent shock waves throughout the country, on both Wall Street and Main Street where over half of American families now invest directly or indirectly in the stock market. Thousands of Enron employees lost not only their jobs but a significant part of their retirement savings; Enron shareholders saw the value of their investments plummet; and hundreds, if not thousands of businesses around the world, were turned into Enron creditors in bankruptcy court likely to receive only pennies on the dollars owed to them.

Id. at 1.

50. In the wake of the Enron debacle, numerous congressional committees and several federal agencies, including the SEC, began investigations of all aspects of the company that could have contributed to its downfall. *See, e.g.*, Chairman Harvey L. Pitt, *Public Statement by SEC Chairman: How to Prevent Future Enrons* (Dec. 11, 2001), *at* http://www.sec.gov/news/speech/spch530.htm; Kurt Eichenwald with Jonathan D. Glater, *Justice Dept. to Form Task Force to Investigate Collapse of Enron*, N.Y. TIMES, Jan. 10, 2002, at A1; Letter from W.J. "Billy" Tauzin, Chairman, and Other Members of the Committee on Energy and Commerce, U.S. House of Representatives, to Joseph F. Berardino, Managing Partner and Chief Executive Officer, Arthur Andersen (Jan. 17, 2002) (on file with author) (requesting certain documents related to Andersen's audit work for Enron).

51. *See* ROLE OF THE BOARD REPORT, *supra* note 49, at 2-3. The committee found that the Enron board (1) failed to perform its fiduciary duties owed to shareholders and the corporation; (2) "knowingly allowed Enron to engage in high risk accounting practices"; (3) approved "inappropriate conflicts of interest"; (4) knowingly allowed Enron to engage in "billions of dollars in off-the-books activity to make its financial condition appear better than it was"; (5) "approved excessive compensation for company executives"; and (6) failed to maintain proper standards of independence not only with respect to certain board members and the company but also with respect to the company's relationship with its auditor. *Id.*

2. The Parade of Horrors

As the Enron matter shook the public, a procession of corporate giants stepped—or stumbled—forward, announcing their own failures in the proper reporting of past financial information. Also, venerable professional financial and accounting firms came under a cloud of suspicion regarding the integrity of their performance and of their relations with corporate clients. In fact, next in the news was Arthur Andersen, which, despite its many years as a much-revered accounting and auditing firm, came under fire in connection with its role as auditor to Enron.[52] The firm was indicted,[53] prosecuted and convicted,[54] which "in effect killed one of the world's largest audit firms."[55]

The now-well-known parade of horrors continued, and enterprises and firms such as Global Crossing, Ltd.;[56] Tyco International, Ltd.;[57] Merrill Lynch & Co., Inc.;[58] Adelphia Communica-

52. Criticisms of Arthur Andersen's performance in the Enron and other matters caused considerable attention to be directed at the accounting profession. The issues centered on the apparent lack of true independence, whether in the making of accounting and auditing rules (where the accounting profession has been said to have abused its self-regulatory prerogative) or in the actual conduct of audit engagements (where the profession has been said to be vulnerable to pressures (1) to maintain valued clients and (2) to obtain lucrative contracts to perform non-auditing consulting work for those clients). *See, e.g.*, Press Release, Remarks by the President on Corporate Responsibility, President Announces Tough New Enforcement Initiatives for Reform (July 9, 2002), *available at* http://www.whitehouse.gov/news/releases/202/07/print/20020709-4.html (announcing a "10-point Accountability Plan for American Business" including four points directed at the audit system); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 78d-3, 78o-6, 7201, 7202, 7211-7219, 7231-7234, 7241-7246, 7261-7266, 18 U.S.C. §§ 1348-1350, 1514A, 1519, 1520). "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes," which includes significant new reforms for accounting and auditing, including the creation of a new "Public Company Accounting Oversight Board." *Id.*

53. *See* Deputy Attorney General Larry Thompson, Remarks at News Conference, Arthur Andersen Indictment (Mar. 14, 2002), *available at* http://www.usdoj.gov/dag/speech/2002/031402newsconferencearthurandersen.htm.

54. *See* Press Release, Deputy Attorney General Larry Thompson, Arthur Andersen Verdict (June 15, 2002), *available at* http://www.usdoj.gov/opa/pr/2002/June/02_dag_356.htm; Press Release, SEC, Statement Regarding Andersen Case Conviction (June 15, 2002), *available at* http://www.sec.gov/news/press/2002-89.htm.

55. *Trial and Error*, ECONOMIST, June 22, 2002, at 63.

56. *See* Jim Wagner, *Global Crossing Files for Chapter 11*, Jan. 28, 2002, *at* http://www.opticallynetworked.com/news/print.php/962491 (stating that CEO John Legere claims the bankruptcy filing was necessary, not because the company had operational problems, but because the company merely has some "balance sheet issue[s]"); Thor Olavsrud, *SEC Opens Global Crossing Probe*, Feb. 8, 2002, *at* http://www.internetnews.com/infra/print.php/971341 (stating that U.S. Securities and Exchange Commission opens investigation of the company, amidst allegations that the company, along with its auditor Arthur Andersen, had been reporting fraudulently-inflated income).

57. *See* Harry R. Weber, *Tyco Financial Chief to Resign*, Aug. 1, 2002, *at* http://www.philly.com/mld/philly/business/3781048.htm (referring to the questions that were being investigated regarding the company's complex accounting and fraudulent self-dealing by insiders and stating that CEO Dennis Kozlowski was indicted on charges of tax evasion).

58. *See* Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, *In re* Spitzer v. Merrill Lynch & Co., Inc. (No. 02-401522) (Apr. 8, 2002), *available at* http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf. Attorney General Spitzer petitioned the Supreme Court of the State of New York, County of New York, for an order, based on accusations that Merrill Lynch disseminated biased and distorted stock ratings, often misleading individual investors, in order to secure and maintain lucrative contracts for investment banking services from corporate clients. *See also* Press Release, Attorney General of the State of New

tions;[59] Qwest Communications, International, Inc.;[60] ImClone Systems, Inc.;[61] Xerox Corporation;[62] WorldCom, Inc.;[63] and AOL Time Warner;[64] among others, joined the "rogues' gallery"[65] of suspected bad corporate actors. The troubles within the corporate and financial sectors were so great that a substantial reform process was unavoidable.

III. The Reforms and Their Challenges

A. *The Reforms*

The core reform process yielded changes in the corporate governance regulatory structure at the congressional level through enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley); at the agency level primarily through promulgation of rules by the SEC; and

---

York Eliot Spitzer, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (May 21, 2002), *available at* http://www.oag.state.ny.us/press/2002/may/may21a_02.html (announcing a settlement agreement "that should bolster the integrity of stock analyst research at the nation's largest securities firm").

59. *See* SEC Litigation Release No. 17627 (July 24, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17627.htm. Defendants were charged with fraudulent exclusion of company liabilities through the use of "off-balance sheet, unconsolidated affiliates"; falsification of operations statistics and inflating company earnings to meet Wall Street's expectations; and "concealed extensive self-dealing by the Rigas family." *Id.* "John Rigas, the former head of Adelphia Communications, and two of his sons were arrested Wednesday and charged with looting the cable TV company of hundreds of millions of dollars to pay for luxury condos and a golf course, and to cover personal investment losses." *Rigas and Sons Arrested*, July 25, 2002, *at* http://money.cnn.com/2002/07/24/news/rigas.

60. *See* Anitha Reddy, *Qwest Move Puts Focus on Trades*, Wash. Post, July 30, 2002, at E1 (reporting that Qwest "announced it had incorrectly booked as much as $1.16 billion" based on widespread industry practice of "trading communications capacity to build worldwide networks"); Press Release, Qwest Communications International, Inc., Qwest Communications Notified of Criminal Investigation by the U.S. Attorney's Office in Denver (July 10, 2002), *available at* http://www.qwest.com/about/media/pressroom/1,1720,1055_archive,00.html.

61. *See ImClone Ex-CEO Nabbed*, June 13, 2002, *at* http://money.cnn.com/2002/06/12/news/waksal ("Samuel Waksal, the former CEO of ImClone Systems Inc. who hobnobbed with Mick Jagger and Martha Stewart, was charged Wednesday with tipping off people to sell their ImClone stock right before regulators rejected the company's application for a new cancer drug.").

62. *See* Press Release, SEC, Xerox Settles SEC Enforcement Action Charging Company with Fraud (Apr. 11, 2002), *available at* http://www.sec.gov/news/headlines/xeroxsettles.htm (reporting that Xerox agreed to pay the largest financial fraud penalty ever against a public company, to restate its past financial results, and to submit to a special review of its accounting controls).

63. *See* Press Release, WorldCom Inc., WorldCom Announces Intention to Restate 2001 and First Quarter 2002 Financial Statements (June 25, 2002), *available at* http://www.worldcom.com/about_the_company/press_releases/display.phtml (reporting that erroneous accounting of current expenses as capital expenses amounted to improper inflation of earnings (EBITDA) of $3.055 billion for 2001 and $797 million for the first quarter of 2002); Carrie Johnson & Ben White, *WorldCom Arrests Made*, Wash. Post, Aug. 2, 2002, at A01 ("In an increasingly familiar sight, FBI agents handcuffed Scott D. Sullivan, WorldCom's former chief financial officer, and David F. Myers, its onetime controller, and led the grim-faced accountants past a horde of cameras to the U.S. District Court in Manhattan, where they were released on multimillion-dollar bonds.").

64. *See* David D. Kirkpatrick & Saul Hansell, *U.S. Initiates Investigation of Accounting at AOL Unit*, N.Y. Times, Aug. 1, 2002, at C1.

65. *See WorldCom: Another Cowboy Bites the Dust*, Economist, June 29, 2002, at 57 (presenting a list of American corporate actors deserving of membership in its "Rogues' gallery").

at the level of the Self Regulatory Organizations through changes in listing standards and the like.

Sarbanes-Oxley was characterized by President Bush as "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[66] And indeed the changes are significant, as this listing and summary of its principal provisions indicates:[67]

- CEO and CFO Certification Requirements;[68]
- Audit Committees for Listed Companies;[69]
- Disgorgement of CEO and CFO Compensation Following Restatement of Financial Statements;[70]
- Prohibition on Insider Trades During Individual Account Plan Blackout Periods;[71]
- Prohibition of Insider Loans;[72]
- Real Time Disclosure Requirements;[73]
- Mandated Periodic SEC Review of Public Company Filings;[74]
- Accelerated § 16 Reporting;[75]
- Newly Created Accounting Oversight Board Under SEC Supervision;[76]
- Auditor Independence; Auditor Relationship with Audit Committee;[77]

66. Press Release, Remarks by the President at Signing of H.R. 3763, the Sarbanes-Oxley Act of 2002 (July 30, 2002), *available at* http://www.whitehouse.gov/news/releases/2002/07/20020730-1.html.

67. Cleary, Gottlieb, Steen & Hamilton, *Memorandum No. 1, Sarbanes-Oxley Act of 2002 Ushers in Sweeping Changes for Public Companies in the United States*, *in* Greene et al., U.S. Regulation of the International Securities and Derivatives Markets M1-2 to M1-4 (6th ed. Special Supp. 2003).

68. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 78d-3, 78o-6, 7201, 7202, 7211-7219, 7231-7234, 7241-7246, 18 U.S.C. §§ 1348-1350, 1514A, 1519, 1520). Section 302 requires the SEC, through rulemaking, to require chief executive officers and chief financial officers of public companies to sign certifications of the accuracy and truthfulness of company annual and quarterly reports filed with the SEC. Sarbanes-Oxley Act § 302. The section also imposes significant responsibilities regarding internal controls and certain related disclosures. *Id.* Section 906 imposes a somewhat similar—but not identical— certification requirement and imposes criminal penalties. Sarbanes-Oxley Act § 906.

69. Sarbanes-Oxley Act §§ 301, 407. Section 301 requires the SEC to adopt rules establishing minimum listing standards regarding the function and responsibilities of audit committees. Sarbanes-Oxley Act § 301. Section 407 requires the SEC to adopt rules defining the term "financial expert" on the audit committee and requires company disclosures regarding that expert. Sarbanes-Oxley Act § 407.

70. Sarbanes-Oxley Act § 304.

71. Sarbanes-Oxley Act § 306.

72. Sarbanes-Oxley Act § 402.

73. Sarbanes-Oxley Act § 409 (requiring disclosure, in plain English, "on a rapid and current basis" of information concerning material changes in a company's financial conditions or operations).

74. Sarbanes-Oxley Act § 408 (requiring enhanced SEC review, on a "regular and systematic" basis).

75. Sarbanes-Oxley Act § 403.

76. Sarbanes-Oxley Act §§ 101-107 (creating five-member Public Company Accounting Oversight Board (PCAOB) to oversee public company auditing).

77. Sarbanes-Oxley Act §§ 201-209, 401 (restricting or prohibiting certain non-audit services to audit clients; making the audit committee a central point of contact within the company; requiring increased communication).

- Enhanced Criminal and Civil Provisions;[78] and
- Notable Other Provisions: Lawyers' Professional Responsibility Rules;[79] SEC Resources;[80] Whistle blower Protection.[81]

In addition, the SEC issued a flurry of rules and other guidance, both before and after (pursuant to) Sarbanes-Oxley. Moreover, the SROs, pursuant to Sarbanes-Oxley and SEC mandates, submitted proposed changes to their corporate governance rules. Among these changes is the guidance regarding audit committees of public (listed) companies.

1. Audit Committees

Section 301 of Sarbanes-Oxley amended section 10A of the Securities Exchange Act of 1934[82] (Exchange Act) to require that the SEC adopt rules addressing essentially the long-standing criticisms of audit committees that the Enron scandals had demonstrably proven were well-founded.[83] New section 10A(m)(2) of the Exchange Act sets out in definitive fashion the responsibilities of the audit committee:

> The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.[84]

Section 301 also imposes the requirement, with certain limited exceptions, that *all* audit committee members be "independent" and sets out guidance on the meaning of that term;[85] requires establishment of

78. Sarbanes-Oxley Act §§ 802-807, 902-906 (enhancing existing criminal penalties and creating new crimes).

79. Sarbanes-Oxley Act § 307 (requiring the SEC to adopt rules setting forth minimum professional conduct for attorneys to report "evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof").

80. Sarbanes-Oxley Act § 601 (authorizing additional funding of $776 million to the SEC for 2003).

81. Sarbanes-Oxley Act § 806 (prohibiting retaliation against employees who assist in investigations of certain alleged misconduct and creating a process for employee recourse against such retaliation).

82. 15 U.S.C. § 78(f) (2000).

83. Securities Exchange Act of 1934 § 10A(m)(1), Pub. L. No. 107-204, 116 Stat. 775 (codified at 15 U.S.C. § 78(j)(1)(m)(1)).

84. Sarbanes-Oxley Act § 301(2); Securities Exchange Act § 10A(m)(2), 15 U.S.C. § 78j-1(m)(2); *see also* Sarbanes-Oxley Act § 205, *amending* section 3(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a) (defining the audit committee as "a committee . . . established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer").

Significantly, the section continues, setting forth that "(B) if no such committee exists with respects to an issuer, the entire board of directors of the issuer" shall be the audit committee. *Id.* The identical wording also appears in section 2(a) of the Sarbanes-Oxley Act.

85. Sarbanes-Oxley Act § 301(3) (stating that unless exempted by the SEC, audit committee members are not independent if they "accept any consulting, advisory, or other compensatory fee from the issuer . . . or . . . [are] an affiliated person of the issuer or any subsidiary thereof"). Sarbanes-Oxley Act § 301(3)(b)(i)-(ii).

procedures to address complaints about the company's accounting or auditing matters;[86] authorizes audit committees to engage advisers;[87] and requires companies to provide appropriate funding for payment of auditors and advisers.[88] A related provision, section 407, requires the SEC to issue rules "to require each issuer . . . to disclose whether or not . . . the audit committee of that issuer is comprised of at least [one] member who is a financial expert," and if there is no such member, to explain why not.[89]

Pursuant to these mandates, the SEC adopted, on April 9, 2003, new Rule 10A-3 under the Exchange Act, whose primary purpose was "to direct, by rule, the national securities exchanges and national securities associations (or "SROs") to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees."[90] Exchange Act Rule 10A-3 sets out minimum standards for audit committee compliance.[91]

Based on this guidance, the SROs have developed and submitted proposed amendments to their rules on corporate governance.[92] Thus, the proposed rules endorse, at a minimum, or enhance in various instances, Rule 10A-3 requirements such as the ones that audit

86. Sarbanes-Oxley Act § 301(4).

87. Sarbanes-Oxley Act § 301(5).

88. Sarbanes-Oxley Act § 301(6).

89. Sarbanes-Oxley Act § 407(a). Section 407(b) sets forth considerations for the SEC to take into account in defining the term "financial expert." Essentially, the section makes it clear that this person must have substantial education and experience, such as one who has served in actual or similar capacities as "a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer." Sarbanes-Oxley Act § 407(b).

See Disclosure Required by sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release Nos. 33-8177, 34-47235, 17 C.F.R. pts. 228, 229, 249 (Jan. 23, 2003), *available at* http://www.sec.gov/rules/final/33-8177.htm. In this release, the SEC creates the term "audit committee financial expert," to be used in lieu of the term "financial expert" in Sarbanes-Oxley Act section 407 and imposes related disclosure requirements:

> This term suggests more pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee, such as: a thorough understanding of the audit committee's oversight role, expertise in accounting matters as well as understanding of financial statements, and the ability to ask the right questions to determine whether the company's financial statements are complete and accurate.

Id.

90. Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, 17 C.F.R. pts. 228, 229, 240, 249, 274 (Apr. 9, 2003), *available at* http://www.sec.gov/rules/final/33-8220.htm.

91. Generally, the rule does the following: "clarifies the audit committee requirements, particularly the independence requirements, specified in Section 301," that apply to each audit committee member; "provides certain exemptions, in particular for foreign private issuers, from certain of the audit committee requirements"; "updates disclosure requirements regarding audit committees"; and "sets out the timing of implementation of the Rule by the SROs and compliance with the Rule's requirements by issuers." Memorandum from Cleary, Gottlieb, Steen & Hamilton, SEC Adopts Audit Committee Standards Under Sarbanes-Oxley Act Section 301 (Apr. 18, 2003) (on file with author).

92. *See, e.g.*, NYSE Rulemaking, Exchange Act Release No. 34-47672 (Apr. 11, 2003), *available at* http://www.sec.gov/rules/sro/34-47672.htm [hereinafter NYSE Proposed Rule]; NASD Rulemaking, Exchange Act Release No. 34-47516 (Mar. 17, 2003), *available at* http://www.sec.gov/rules/sro/34-47516.htm [hereinafter NASD Proposed Rule].

committees may only be composed of independent directors;[93] that its members must be financially literate;[94] that listed companies must have an "audit committee charter" setting forth the committee's responsibilities and authorities;[95] that it is the audit committee's responsibility to "appoint, retain, compensate, evaluate and terminate the company's independent auditors";[96] that it is the audit committee's responsibility to approve all non-audit services;[97] that independent directors must conduct regularly-scheduled meetings alone and not in the presence of management;[98] and that audit committees must follow the procedures for handling complaints about accounting and auditing matters set forth in Rule 10A-3.[99]

Of particular significance is the independence of the audit committee members. For example, the NYSE and Nasdaq proposals set out specific requirements and criteria that are more strict than the minimums established in SEC Rule 10A-3, and they do so by enhancing the definition of "independence" as applies to directors generally, including audit committee members. The following are more significant features of the proposals:

- The board of directors must determine, and disclose the basis for such determination, that no material relationship exists between a director and the company so as to compromise that director's independence;[100]
- Prohibit certain payments or compensation to the director;[101]

---

93. *See* discussion *infra* notes 99-104 and accompanying text.

94. *See* NYSE Proposed Rule 303A(6); NASD Proposed Rule 4350(d)(2)(A)(ii), *as amended by* NASD Amendment 2; Letter from Sara Nelson Bloom, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC (July 15, 2003) (transmitting SR-NASD-2002-141: Amendment No. 2, Director Independence and Independent Committees under Rules 4200 and 4350) (copy on file with the author).

95. NYSE Proposed Rule 303A(7)(b); NASD Proposed Rule 4350(d), *as amended by* Amendment 2; *see also* Letter from Sara Nelson Bloom, *supra* note 94, at 1-2.

96. NYSE Proposed Rule 303A(7)(c), (d); NASD Proposed Rule 4350(d)(1)(D), *as amended by* Amendment 2; *see also* Letter from Sara Nelson Bloom, *supra* note 94, at 1-2.

97. NYSE Proposed Rule 303A(7)(c)(i); NASD Proposed Rule 4350(d)(1)(D), *as amended by* Amendment 2; *see also* Letter from Sara Nelson Bloom, *supra* note 94, at 1-2.

98. NYSE Proposed Rule 303A(3); NASD Proposed Rule 4350(c)(2).

99. NYSE Proposed Rule 303A(7)(c)(ii); NASD Proposed Rule 4350(d)(1)(D), *as amended by* Amendment 2; *see also* Letter from Sara Nelson Bloom, *supra* note 94, at 1-2.

100. *See* NYSE Proposed Rule 303A(2)(a); NASD Proposed Rule 4200(a)(15), Interpretive Material (IM) 4200.

101. *See* NYSE Proposed Rule 303A(2)(b)(i) (prohibiting determination of independence where director or immediate family member is receiving more than $100,000 yearly from the listed company, other than director-related fees and certain deferred compensation payments; five-year hiatus required before persons receiving more than $100,000 can be deemed independent); NASD Proposed Rule 4200(a)(15)(A)-(C) (mandating a three-year hiatus from employment with listed company or its subsidiaries for director and immediate family members for independence; neither director nor immediate family are independent who accept payments in excess of $60,000 during the past three fiscal years, except director-related fees, payments from investments in the listed company, payments to a non-executive family member working for the company or a subsidiary, tax-qualified retirement plan benefits, or non-discretionary compensation).

- Place restrictions on directors with regard to employment with the company's accountant;[102]
- Prohibit certain business relationships between the director and the company;[103]
- Prohibit cross compensation committee links; and[104]
- Address the role of a director's ownership of a company's securities in determining independence.[105]

To whatever extent the foregoing provisions do not make clear the centrality—if not the substantially increased workload—of the audit committee in corporate governance reform, then Title IV (Enhanced Financial Disclosures) settles the point. Title IV imposes an assortment of enhanced disclosure requirements and prohibitions designed to address problems uncovered during the Enron scandals. The provisions of that title address the accuracy of financial reports, off-balance sheet transactions, pro forma reports,[106] "personal loans to executives,"[107] certain interested transactions,[108] "management assessment of internal controls,"[109] "code of ethics for senior financial officers,"[110] "enhanced review of periodic disclosures"[111] and "real

102. *See* NYSE Proposed Rule 303A(2)(b)(ii) (establishing a five-year hiatus before director can be deemed independent where director or immediate family member was affiliated with or employed by the listed company's present or former internal or external auditor); NASD Proposed Rule 4200(a)(15)(F) (requiring that a director may not serve who is or was a partner or employee of the listed company's outside auditor and worked on the listed company's audit during the past three years).

103. *See* NYSE Proposed Rule 303A(2)(b)(iv) (stating that director is not independent where director or immediate family member is executive officer or employee of another company where (A) that other company accounts for the greater of 2% or $1 million, or more, of the subject listed company's consolidated gross revenues or (B) the subject listed company accounts for the greater of 2% or $1 million, or more, of that other company's consolidated gross revenues); NASD Proposed Rule 4200(a)(15)(D) (stating that a director is not independent where he/she is a partner, controlling shareholder or executive officer of the organization to which the listed company made, or received, payments (with certain exceptions) that exceed the greater of 5% of the recipient's consolidated gross revenues or $200,000 during the current fiscal year or any of the past three fiscal years).

104. *See* NYSE Proposed Rule 303A(2)(b)(iii) (stating that a director is not independent where the director, or "immediate family member, is employed as an executive officer of another company where any of the listed company's present executives serves on that other company's compensation committee" until five years after the end of such service or relationship); NASD Proposed Rule 4200(a)(15)(E) (duplicating the NYSE proposal, except the hiatus period is three years).

105. *See* NASD Proposed Rule 4350(d)(2) (establishing qualitative listing requirements for Nasdaq National Market and Nasdaq SmallCap Market issuers and audit committee composition). In the first amended proposal, directors could not be deemed independent if they owned more than 20% of the issuer's voting securities, or such lower measurement as may be established by the SEC. Significantly, the "Commentary" to NYSE Proposed Rule 303A(2)(a) states that "the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding." The NASD, in Amendment No. 2 to its proposal, deleted the 20% ownership prohibition; *see* Letter from Sara Nelson Bloom, *supra* note 94, at 2.

106. Sarbanes-Oxley Act § 401(a)(i), (ii) and (b). *See* Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Exchange Act Release Nos. 33-8182, 34-47264, 17 C.F.R. pts. 228, 229, 249 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/33-8182.htm.

107. Sarbanes-Oxley Act § 402.

108. Sarbanes-Oxley Act § 403.

109. Sarbanes-Oxley Act § 404.

110. Sarbanes-Oxley Act § 406.

111. Sarbanes-Oxley Act § 408.

time issuer disclosures."[112] Each of these measures suggests significant involvement—and in fact, leadership—on the part of the audit committee.

In addition to the foregoing reforms to corporate governance, centering on the audit committee, significant measures were adopted affecting the accounting profession and the audit function.

2. Auditing and Auditors

a. *The Public Company Accounting Oversight Board*

Section 101 of Sarbanes-Oxley establishes a five-member[113] Public Company Accounting Oversight Board (PCAOB or Board) "to oversee the audit of public companies . . . in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[114] Section 102(a) prohibits the preparation or issuance of any audit report for a public company, or any participation in these acts, by any person "not a registered public accounting firm."[115] This mandatory registration requirement sets the stage for the takeover from the accounting profession, by the Board, of the regulation of auditing by public accounting firms. The initial application is the first step in a periodic reporting process,[116] and it is itself a rather comprehensive and inquiring disclosure document. Thus, information about an accounting firm's clients, fees (audit and non-audit), financial status, quality control policies, associated persons, pending legal proceedings, disagreements with clients, and the like, must be provided.[117] Further, the applicant firm must execute a specific consent relative to cooperation and compliance with Board inquiries relative to the firm and its associated persons.[118]

As a congressionally created non-profit corporation under District of Columbia law, and "not . . . an agency or establishment of the

---

112. Sarbanes-Oxley Act § 409.

113. Sarbanes-Oxley Act § 101. Section 101(e)(1) provides for a Board of five members "appointed from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures . . . [of companies] and the obligations of accountants." Sarbanes-Oxley Act § 101(e)(1). Only two members may be certified public accountants (CPA) and if one of those persons is the chairperson then that person may not have been a practicing CPA for at least five years prior to appointment. Sarbanes-Oxley Act § 101(e)(2).

114. Sarbanes-Oxley Act § 101(a). Because the Board is not a federal agency, neither its members nor its employees or agents "shall be deemed to be an officer or employee of or agent for the Federal Government." Sarbanes-Oxley Act § 101(b).

115. Sarbanes-Oxley Act § 102(a).

116. Sarbanes-Oxley Act § 102(d) provides, "Each registered public accounting firm shall submit an annual report to the Board, and may be required to report more frequently, as necessary . . . ."

117. Sarbanes-Oxley Act § 102(b)(2).

118. Sarbanes-Oxley Act § 102(b)(3).

United States Government,"[119] the Board has been granted certain duties and authorities that are generally "subject to action of the [Securities and Exchange] Commission under section 107."[120] These include registration of public accounting firms that audit public companies and establishment or adoption (in some instances mandatory) of relevant "auditing, quality control, ethics, independence, and other standards" applicable to those firms.[121]

The Board may also "conduct inspections of registered public accounting firms,"[122] "conduct investigations and disciplinary proceedings" and "impose appropriate sanctions . . . upon registered public accounting firms and associated persons of such firms."[123] Its enforcement authority extends to its rules or the securities laws relating to "the preparation and issuance of audit reports and the obligations and liabilities of accountants" as regards registered public accounting firms and their associated persons.[124]

b. *Auditors and the Audit Process*

Title II of Sarbanes-Oxley is devoted to the subject of auditor independence. As a direct reflection of the concerns about the role of non-audit services in potentially compromising audit firm independence in contemporaneous audit engagements, section 201(a) amends section 10A of the Securities Exchange Act of 1934[125] to impose a flat prohibition on the performance of certain non-audit services for audit

119. Sarbanes-Oxley Act § 101(b).

120. Sarbanes-Oxley Act § 101(c). Section 107 confers upon the SEC "oversight and enforcement authority over the Board." Sarbanes-Oxley Act § 107(a).

121. Sarbanes-Oxley Act § 101(c)(2). Section 103 deals extensively with this duty to establish standards, including the mandate to set rules on preparation and retention of sufficiently detailed audit work papers; concurring or second partner review of an audit report and approval by a qualified person other than the supervising partner; substantive description, relative to audit report, of auditor's testing of the client's internal control processes; and quality controls with respect to ethics and independence. Sarbanes-Oxley Act § 103.

122. Sarbanes-Oxley Act § 101(c)(4). Section 104(a) requires that the Board "conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with [applicable standards and law]." Sarbanes-Oxley Act § 104(a). Inspections would be conducted annually for larger firms and at least every three years for smaller firms. Inspections would cover "selected audit and review engagements" (including controversial ones), would also be concerned with the accounting firm's quality control system, and firms that disagree with any final inspection report may seek review by the SEC. Sarbanes-Oxley Act § 104(d)(1).

123. Sarbanes-Oxley Act § 101(c)(4). Section 105 requires the Board to adopt rules establishing "fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms." Sarbanes-Oxley Act § 105(a). Sanctions could include temporary or permanent (1) revocation of firm registration; (2) suspension or bar of an associated person; (3) limitation on activities, functions or operation of a firm or associated person; (4) censure; (5) additional education or training; (6) civil penalty; or (7) other appropriate sanction. Sarbanes-Oxley Act § 105(c)(4). Procedures for review before the SEC are to be established. Sarbanes-Oxley Act § 105.

124. Sarbanes-Oxley Act § 101(c)(6). Also, section 101(c)(7) authorizes the Board to "set the budget and manage the operations of the Board . . . ." Sarbanes-Oxley Act § 107(c)(7). A related provision, section 101(f) confers powers to sue and be sued, to conduct operations, to make contracts, and the like. Sarbanes-Oxley Act § 101(f).

125. Pub. L. No. 107-204, 116 Stat. 775 (codified at 15 U.S.C. § 78(j)-(1)).

clients. The list set forth includes well-known problem areas, such as bookkeeping and accounting-related services; "financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services;"[126] internal audits; management services; investment services; legal and other "expert services unrelated to the audit; and any other service that the Board determines . . . is permissible."[127]

The Board may exempt a firm, an issuer, any person or a transaction from the prohibition where the Board determines such an exemption is "in the public interest and is consistent with the protection of investors, and subject to review by the [Securities and Exchange] Commission."[128] Additional measures meant to ensure independence and avoid conflicts of interest are in section 203, requiring rotation of a lead and supervising audit partner after five years,[129] and section 206, precluding audits for a company whose chief executive, financial or accounting officers participated in an audit of the company within the preceding year.[130]

Title II also emphasizes the prominent and central role envisioned for the audit committee. Section 201(b), for example, requires that even where certain non-audit services, including tax services, are not prohibited under section 201(a), a firm may perform such services "only if the activity is approved in advance by the audit committee of the issuer."[131] Further, section 202 amends section 10A of the Securities Exchange Act of 1934[132] (Pre-approval Requirements) to provide that all auditing and non-auditing services—to the extent they are not *de minimus*—shall be pre-approved by the audit committee.[133] Additionally, section 204 further amends section 10A to require each registered public accounting firm to report to the audit committee regarding "all critical accounting policies . . . to be used; all alternative treatments of financial information" and a preferred treatment and "other material written communications between the . . . firm and the management."[134]

Finally, buttressing these obligations are several titles at the end of Sarbanes-Oxley that in effect create weighty deterrents for any and

126. Sarbanes-Oxley Act § 201(a)(2)-(4).
127. Sarbanes-Oxley Act § 201(a)(8)-(9).
128. Sarbanes-Oxley Act § 201(b).
129. Sarbanes-Oxley Act § 203.
130. Sarbanes-Oxley Act § 206.
131. Sarbanes-Oxley Act § 201(h).
132. Pub. L. No. 107-204, 116 Stat. 775 (codified at 15 U.S.C. § 78(j)-(1)).
133. Sarbanes-Oxley Act § 202.
134. Sarbanes-Oxley Act § 204. *See generally* Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release Nos. 33-8183A, 34-47265A, 35-27642A, 17 C.F.R. pt. 249 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/33-8183a.htm.

all participants in corporate wrongdoing, including accountants. These include Title VIII (Corporate and Criminal Fraud Accountability), providing criminal penalties for altering documents, protection for whistleblowers and criminal penalties for defrauding shareholders of public companies;[135] Title IX (White-Collar Crime Penalty Enhancements);[136] Title X (Corporate Tax Returns);[137] and Title XI (Corporate Fraud Accountability), including penalties for impeding an official proceeding and authority of the SEC to prohibit persons from serving as officers or directors.[138]

B. *The Challenges*

Even though the reforms are important and are very likely to improve the level of corporate governance in companies, significant challenges remain. One key theme in these challenges is that of independence, including that of professionals such as accountants and directors serving on audit committees.

1. Director and Auditor Independence; Related Issues

Notwithstanding the admirable enhancement of the standards for independence, certain basic questions—structural ones—remain in place. Consider, for example, the dynamics surrounding the fact that notwithstanding the clear legal mandate regarding directors' duties, common practice has been that the company's CEO and others actually make the truly important decisions, including those about nominees for directorships and about potential auditing firms. Further, even where authority is formally vested in the directors or a committee to choose the accounting firm, or in the directors and shareholders to choose new directors, it has often been true that management made the initial choice and promoted that choice to the formal decisionmakers.[139]

---

135. Sarbanes-Oxley Act §§ 801-807.
136. Sarbanes-Oxley Act §§ 901-906.
137. Sarbanes-Oxley Act § 1001.
138. Sarbanes-Oxley Act §§ 1101-1107.
139. *See* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1483 (1984) ("[M]any lawyers without personal boardroom experience have a total misconception of the decisional process as it actually functions in the boardroom."). For more information, see the works by Myles L. Mace, *supra* note 27.

Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 812 (2001) (discussing the "temptation to manipulate the information given to the board"); *see also* Floyd Norris, *More Changes in Store for the Big Board*, N.Y. TIMES, Sept. 18, 2003, at C1. Disclosure that Richard A. Grasso, Chairman and Chief Executive Officer of the New York Stock Exchange (NYSE) would be paid $139.5 million in deferred compensation, along with potentially another $48 million, generated outrage on both Wall Street and main street. In addition to the fact that the NYSE was one of the regulators that failed as a "gatekeeper" in the Enron scandals, it was then seen as not having met the high corporate governance standards it had recently been seeking to impose on regulated companies. Important here, it became known that Grasso, as an

Some commentators have concluded that the tendency of directors, and possibly others such as attorneys and auditors, to agree with the positions and recommendations of management derives, in part, from a "polarization" of group decision-making based on certain "homogeneities."[140] That is, managers, auditing professionals and directors often know one another, personally and professionally, and even if they do not, they will probably share the same values, educational and social backgrounds, and thus think similarly. And these homogeneities, particularly in the context of substantive board and committee discussions and especially in times of danger for the corporation, can tend both to reflect and to affirm the underlying values and ethos of the typically management-dominated corporate cultures in which these actors serve.[141] Moreover, and importantly, director nominees may well see a board membership as a much-valued source of status and business contacts, as well as actual and potential income.[142] A similar dynamic pertains in the instance of the accountant.[143] Hence, the temptation to "go with the flow" may be quite strong. In this re-

officer, had essentially chosen the members of the board compensation committee that approved his compensation. *See id.*

140. *See* Erica Beecher-Monas, *Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud*, 55 ADMIN. L. REV. 357, 380 (2003) (drawing upon the behavioral theory of groups to explain the homogeneity of corporate boards and committees and its concomitant effect on decision-making). Professor Beecher-Monas stated,

> [t]hese polarization effects are more acute when the group is homogeneous, as it tends to be at the upper echelon of corporate management . . . because if group members share a particular bias, polarization may magnify its impact. Certainly at Enron, where top managers were drawn primarily from elite business schools . . . homogeneity might have contributed to the extreme views toward the propriety of creating the special purpose entities, approving the conflicted transactions, and opting for risky disclosure practices.

Id. (citing Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 536 (2002)).

141. *See, e.g.*, *id.* at 378-80. She stated,

> [a]pparently, this polarization phenomenon is a function of group discussion. . . . [possibly because] groups have an internal culture that prefers some values to others. . . . [or possibly because]
>
> . . . .
>
> . . . there are a disproportionately large number of persuasive arguments in the direction the group is leaning.

Id. (citing Robert Steven Baron & Gard Roper, *Reaffirmation of Social Comparison Views of Choice Shifts: Averaging and Extremity Effects in an Autokinetic Situation*, 33 J. PERSONALITY & SOC. PSYCHOL. 521, 528-30 (1976); JOHN C. TURNER ET AL., REDISCOVERING THE SOCIAL GROUP (1987); Eugene Burnstein & Amiram Vinokur, *What a Person Thinks Upon Learning He Has Chosen Differently from Others*, 11 J. EXPERIMENTAL SOC. PSYCHOL. 412 (1975) (stating that shifts in choice occur even without discussion, upon learning of others' views); Eugene Burnstein & Amiram Vinokur, *Persuasive Argumentation and Social Comparison as Determinants of Attitude Polarization*, 13 J. EXPERIMENTAL SOC. PSYCHOL. 315 (1977).

142. *See, e.g.*, Beecher-Monas, *supra* note 140, at 381 ("People have been shown to manipulate statistical inferences in ways consistent with the self-serving bias and shareholders are the quintessential 'statistical others' in this regard.").

143. *Id.* at 382 (quoting MAX BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 2 (4th ed. 1998), for the proposition that "'it is psychologically impossible for auditors to maintain their objectivity; cases of audit failure are inevitable, even from the most honest of firms' because auditors are hired by those that they audit").

gard, one could ask whether, as a practical matter, any of the people typically chosen could ever be truly "independent."

Of course, there are important countervailing considerations to this structural bias concern. Managements, accountants and potential director nominees know one another because they typically are persons who have had extensive—usually successful—involvement with business and other important institutions. Indeed, this involvement—not to mention their achievement and success—was probably what brought them to the attention of management in the first place. In other words, talented, successful people often encounter—and relate to—other talented, successful people. Further, on the question of shared values, even where business actors start out with different values, the business environment is itself a powerful force in shaping certain values—and rejecting others.[144] Obviously, where the values are positive and helpful, this is not a problem. To the degree the effect of these potential biases can in fact be managed, the corporation stands a chance of reaping the potential benefits of independent directors. Professor Richard Epstein explains these benefits:

> Ideally, independent directors are not blinded by the conflicts of interest that sometimes cloud the judgments of insiders. Their presence on boards can signal to outside passive investors that the corporation will not become a fiefdom of the CEO and a claque of greedy insiders. So, independent directors are a good thing.[145]

Nevertheless, some commentators express skepticism about the promise of the independent director as a panacea for virtually whatever ails today's body corporate, and they focus not only on bias as an impediment to independence but also on other related subjects. Professor Epstein, for example, asserts that the use of independent directors, while acceptable "[i]n principle," has always been subject to certain "limits":

> Independent directors do not have a full-time stake in the fortunes of the business. Often they . . . know little of the technical side of the business and are immersed in their own businesses and lack sufficient time for the board and company in a time of crisis.[146]

In the Sarbanes-Oxley reform era, Professor Epstein's doubts have intensified. Grounding his observations in the general concern that government-imposed solutions such as these reforms are inferior to market-based cures, he fears the reforms could be ironically counterproductive. He believes that in the new regime directors' duties, especially those placed on nomination and audit committees, will

144. *See generally* SWARTZ & WATKINS, *supra* note 5 (describing, among other things, the way the Enron corporate culture shaped the professional and personal values of most people who had any significant contact with it).
145. Richard A. Epstein, *Sarbanes Overdose*, NAT'L L.J., Jan. 27, 2003, at A17.
146. *Id.*

become increasingly more onerous, given the enhancements in their responsibilities imposed by various reform measures.[147] More particularly, he asserts, the new reforms will increase overall costs to the company, including director fees, fees of attorneys, consultants and the like, as well as director and officer liability insurance; increase the directors' potential liabilities; increase their time requirements; and thus discourage their interest in participation.[148] Moreover, when they do participate, he fears, the significantly augmented compensation could (ironically) be "so high that directors will find it harder to speak truth to power when corporate wrongdoing surfaces."[149]

Similarly, Professor (and former SEC Commissioner) Roberta Karmel notes that the reforms have created "a radical departure from previous legal theories regarding the divide between federal and state law. . . . [and through their 'financial expert' requirement] also will result in the restructuring of public company audit committees."[150] Rather than give a clear approval of the reforms, however, she simply observes that whether they will result in enhanced accountability, transparency, integrity and investor confidence "is an open question."[151]

Like Professor Epstein, she notes the question "whether the added responsibilities being placed on audit committee members . . . will require such directors to spend so much time on issuer business that because of their increased fees and added work they will no longer be functioning as truly outside, independent directors."[152] Finally, in another criticism going to the heart of the reforms, Professor Karmel questions the SEC's motives in its choices regarding the structure of the reforms:

> Despite these denials, the SEC is restructuring audit committees to its liking, creating differentiations between board members, and attempting to change the board from a collegial to an adversarial body, with little analysis as to the justification for doing so. . . . [W]hile an adversarial model may be useful in the courtroom it may not be such a good model for the boardroom.[153]

Finally, as if the aforementioned criticisms are not enough, some commentators and researchers even assert that to whatever extent and degree the much-touted independent, or outside, director does exist

147. *Id.*
148. *Id.*
149. *Id.*
150. Roberta S. Karmel, *Federalization of the Law Regarding Audit Committees*, N.Y. L.J., Feb. 20, 2003, at 3.
151. *Id.*
152. *Id.*
153. *Id.*

and can be retained, there is no guarantee that his or her participation will give rise to improved decisions.[154]

When one adds to this phenomenon the many other great pressures, temptations and opportunities of the modern business environment, we have nothing less than the larger background against which the reform measures must produce results. In the worst case, the rationale supporting the independent director concept is seriously flawed (or perhaps even inoperative), and thus corporate governance at the board level is essentially compromised per se. Moreover, this would be true whether or not directors, accountants and managements continue their game of nods and winks, all the while presenting the appearance of conformity with the letter and spirit of the new corporate governance structure. Fortunately, however, the new environment contains numerous promising features, which, if put to work properly, could hold corporate and professional actors to higher levels of quality in their performance.

Admittedly, heightened scrutiny of the type that helped produce the reforms, though it obviously serves an important purpose, usually diminishes with time. Therefore, it is the residual scrutiny and resolve to correct the problem that matters, and this is where the conjunction of the reform structures provisions and certain major actors become important. Notable in this regard is the institutional investor community,[155] but business and consumer organizations, along with a more enlightened public (including many investors who were stunned by re-

154. *See, e.g.*, Symposium, *Panel 2: Corporate Governance Issues*, 8 FORDHAM J. CORP. & FIN. L. 49, 61-62 (2003). Panelist Professor Colon notes that "studies have actually found to the contrary; they have found that there is no relationship between independence and shareholder returns." *Id.*; *see also* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921-22 (1999); James P. Walsh & James K. Seward, *On the Efficiency of Internal and External Corporate Control Mechanisms*, 15 ACAD. MGMT. REV. 421, 434 (1990).

155. For contrasting views on the potential of institutional investors to influence proper corporate governance, see Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 821-22 (1992); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 449 (1991); Susanne Craig & Kate Kelly, *Large Investors Call for Grasso to Leave NYSE*, WALL ST. J., Sept. 17, 2003, at C1.

> Calls for the resignation of New York Stock Exchange Chairman Dick Grasso got a whole lot louder yesterday. The heads of four of America's largest public pension funds—two in California, one in New York and one in North Carolina, representing combined assets of $401 billion—asked Mr. Grasso to step down.
>
> . . . .
>
> . . . [T]he criticism from these powerful investor groups could lead the NYSE board to take action . . . .

Id. Not long thereafter, Mr. Grasso, under attack for having engineered a compensation package deemed excessive, resigned. *See* Press Release, NYSE, NYSE Statement (Sept. 17, 2003), *available at* http://www.nyse.com/press/1063796433687.html; Press Release, SEC, SEC Statement in Response to NYSE Announcement of Chairman Grasso's Resignation (Sept. 17, 2003), *available at* http://www.sec.gov/news/press/2003-119.htm (acknowledging the resignation and pledging to "continue its review of [NYSE] governance standards and . . . work closely with the new leadership").

cent market events and shocks), and continuing expressions of political will by the regulators,[156] will also be important.

2. Auditing and Accounting: PCAOB and FASB

a. *Public Company Accounting Oversight Board (PCAOB)*

The PCAOB (Board) has been vested with significant authority, and, at least structurally, it holds the promise of alleviating concerns expressed over the years about the accounting profession's virtually exclusive role in regulating itself and in setting accounting and auditing standards. Section 103 of Sarbanes-Oxley requires the Board to adopt standards governing auditing, quality control and independence. Importantly, however, section 103(a)(1) provides that the standards adopted be "proposed by [one] or more professional groups of accountants designated [by the Board] . . . or advisory groups convened [by the Board or its staff]."[157] Further, section 103(c)(1) provides that the "Board shall cooperate on an ongoing basis" with the professional groups of accountants and advisory groups in the standard-setting process.[158]

Certainly, the opportunity to receive input from the accounting profession and others is an entirely logical, and potentially quite useful, feature. What will be important, of course, is that the Board not allow this avenue for valuable guidance and expertise to become an opening for attempts at undue influence by the accounting profession. This point of potential vulnerability is key, and it joins such other points as the political will of the Board and the SEC and the actual composition of the Board as the decisive issues in the success of this new regime of regulation. Unfortunately, from the very beginning, there has been controversy that has raised concerns over the new scheme for regulating auditing.[159]

---

156. *See* Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Exchange Act Release No. 34-48301, 17 C.F.R. pt. 240 (Aug. 6, 2003), *available at* http://www.sec.gov/rules/proposed/34-48301.htm. In an effort to address concerns about the process leading to the election of directors, this proposed rule seeks to "make more transparent to security holders the operation of the boards of directors of the companies in which they invest." *Id.* Notably, the proposal includes a measure providing for nominations of directors by holders of three percent or more of the company's stock, along with a transparent process by which such nominations are considered. *Id.*; *see also* Press Release, Council of Institutional Investors, Shareholders Urged to Write SEC in Support of Proxy Rule Reform of Shareholder Nominations of Corporate Directors (May 22, 2003), *available at* http://www.cii.org/pressreleases/pressrelease6.asp.

157. Sarbanes-Oxley Act § 103(a)(1).

158. Sarbanes-Oxley Act § 103(c)(1).

159. *See* William Baue, *SRI Firms Caution Against a Wimpy Accounting Oversight Board*, Nov. 22, 2002, *at* http://www.socialfunds.com/news/print.cgi?sfArticleId=974 (discussing the controversy over an attempt by SEC Chairman Harvey Pitt to appoint William Webster to chair the Board, while hiding the fact that Webster had served on the board of a large corporation during a time in which the company had serious accounting troubles).

Integrity in the regulatory process is fundamental, and many commentators have recognized that without it, the reforms will not work. Notes one critic, "Companies are already looking for loopholes in the Sarbanes-Oxley Act . . . . For example, they are defining a wide variety of consulting services as 'audit-related.'"[160]

In this area, and generally, transparency in regard to the Board's activities could provide a significant deterrent to compromises in its standards. For this reason, there should be serious consideration of the Board's policies regarding public participation and public awareness. One commentator, considering the topic of Board investigations and sanctions, makes the following observation:

> The Act goes to considerable length to assure that investigations conducted by the PCAOB and its proceedings to impose disciplinary sanctions on a registered firm or associated persons are non-public. All documents or information received by or for the Board . . . or staff in connection with an investigation are "confidential and privileged"; are not subject to "civil discovery or other legal process . . . ."[161]

Finally, Sarbanes-Oxley, whether or not intentionally, left a number of historical concerns and criticisms about the auditing function largely to the Board for specific treatment. Notable here is the extensive work that will be necessary to close the "expectations gap," a term referring to the "[d]iffering perceptions [that] exist between the assurance investors and other users of financial statements expect and that which auditors provide."[162]

After its inauspicious beginning, the Board will obviously be the subject of considerable scrutiny. On the other hand, it could turn that scrutiny into a positive benefit by performing well.

b. *Financial Accounting Standards Board (FASB)*

On the subject of accounting (as opposed to auditing) standards, although the mechanism for establishing GAAP has historically been the subject of great criticism,[163] Sarbanes-Oxley does relatively little to address its many problems. Section 108 amends section 19 of the Securities Act of 1933[164] to reaffirm the SEC's original authority to

160. *Id.* (quoting Diane Tod South, Director of Social Research at Citizens Funds).

161. HAROLD S. BLOOMENTHAL, SARBANES OXLEY ACT IN PERSPECTIVE 36 (2002).

162. HERWITZ & BARRETT, *supra* note 13, at 227-33 ("In reality, an audit does not guarantee that error or fraud has not affected the financial statements. Similarly, an audit does not offer any assurance about the safety of an investment in the enterprise."); James McLaughlin & Michael Smith, *What Does "Present Fairly" Mean?*, INSIGHTS, June 2002, at 2 ("If financial statements prepared in accordance with GAAP can nevertheless be misleading, it raises the question, 'What does the phrase 'present fairly,' as used in audit reports and in the standard representation and warranty regarding financial statements, mean?'").

163. *See, e.g.*, HERWITZ & BARRETT, *supra* note 13, at 152-59 (discussing the developments leading to the creation of the Financial Accounting Standards Board and the criticisms of the standard-setting mechanism over the years).

164. Pub. L. No. 107-204, 116 Stat. 768 (codified at 15 U.S.C. § 77(s)).

make accounting standards and to state formally what it has always done: "recognize, as 'generally accepted' for purposes of the securities laws, any accounting principles established by a standard setting body."[165] Without specifically naming the Financial Accounting Standards Board (FASB), that organization is clearly the one intended.[166] Optimistically, the description could be read as a mandate (albeit strangely indirect) as to the level of quality and integrity at which FASB is expected to perform. Thus, the standard-setting body must be one that

> (i) is organized as a private entity;
> (ii) has, for administrative and operational purposes, a board of trustees . . . serving in the public interest, the majority of whom are not, concurrent with their service on such board, and have not been during the 2-year period preceding such service, associated persons of any registered public accounting firm;
> (iii) is funded as provided in section 109 . . . ;
> (iv) has adopted procedures to ensure prompt consideration, by majority vote of its members . . . [necessary accounting rules];
> (v) considers . . . the need to keep standards current . . . .[167]

Section 109(e) provides for funding of FASB through support fees generated from public companies. This feature, along with its description of the organization in a manner that sets high standards for its operation, essentially composes the reforms of that standard-setting body. As noted in a senate report:

> The bill seeks to formalize the SEC's [historic] reliance on the FASB and . . . to strengthen the independence of the FASB by assuring its funding and eliminating any need for it to seek contributions from accounting firms or companies whose financial statements must conform to FASB's rules.[168]

No doubt, many will conclude that, in effect, FASB has received a "pass" in Sarbanes-Oxley reform.[169] Only its subsequent performance will show whether the relative lack of action in this regard was warranted.[170]

165. Sarbanes-Oxley Act § 108(b)(1).

166. Sarbanes-Oxley Act § 108(b)(1)(A), both describing FASB without naming and at the same time, significantly, prescribing standards to encourage independence, integrity and efficiency.

167. Sarbanes-Oxley Act §108(a).

168. S. Rep. No. 107-205, at 13 (2002).

169. *See generally* Mundstock, *supra* note 16.

170. While it is only speculation, one possibility is that Congress envisions the emerging regulatory combination of the SEC and the PCAOB as a sufficient oversight mechanism for FASB such that no drastic action is required at this point. The PCAOB, after all, was denominated an "accounting" oversight board. Perhaps related to this point, it is interesting that in section 108(d) of the act, Congress assigned one of the more important issues in accounting (whether to adopt principles-based accounting, which essentially raises the question of the adoption of International Accounting Standards) to the SEC for study and not to FASB. Sarbanes-Oxley Act § 108(d).

IV. Conclusion

The Enron series of scandals provoked, first, shock and distress, and then, debate and process, leading to reform. Those reforms are important, but in light of their limitations and inadequacies in some areas, they should perhaps best be seen as a first step. Such a view is realistic, given that the period of debate and commentary leading to the reforms revealed that, maybe other than the size of the Enron failures, there was nothing new under the sun. That is, problems of corporate fraud, independence of major actors, and the like, had always existed. They also have usually been ignored—until there was a crisis.

And although it is distressing that these crises seem to recur periodically, each time catching many within the investing public, the regulators, the corporate and professional communities off guard, certain features of this most recent reform are encouraging and affirming about the American corporate governance system. Though problems existed, they were uncovered and made public. Further, the debates and discussions that followed were free and open, reflecting the values of a truly democratic society. Finally, bad actors were condemned and punished, and there has been a substantial—albeit imperfect—enhancement of the corporate governance system that will make future crises less likely, less frequent, less injurious, or perhaps all of the above.