GOVERNMENT REGULATION OF ACCOUNTANTS: THE PCAOB ENFORCEMENT PROCESS

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ABSTRACT

In 2002 the federal government altered the landscape of the accounting profession by creating, for the first time, a federal regulatory agency for this profession: the Public Company Accounting Oversight Board (PCAOB). Congress responded to the massive corporate failures of Enron, Tyco and others by enacting the Sarbanes-Oxley Act (SOA), to improve corporate governance and the reliability of financial information. Sarbanes-Oxley created the PCAOB to oversee the work of public accountants, the creators of corporate financial information.

The purpose of this paper is to provide insight and understanding into the PCAOB's enforcement process. This is important to public accounting students and practitioners. By gaining insight into how and why the PCAOB regulates as it does, needless conflict can be avoided and a constructive, mutually beneficial relationship will likely ensue.

This paper begins with an overview of government regulation, in order to show how the PCAOB fits into the general context of regulation. Then we review the Sarbanes-Oxley Act, which created the PCAOB. Next we consider the PCAOB, noting its unique features. The paper then describes and analyzes the PCAOB's enforcement mechanisms. Finally we conclude with recommendations as to how accountants can most constructively interact with the PCAOB.

INTRODUCTION

When President Bush signed the Sarbanes-Oxley Act (SOA)[1] in 2002 he stated that it created "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt"[2]. The SOA was a federal response to the massive corporate failures of Enron, Tyco and others. These failures were caused, in part, by accounting failures that had misrepresented the financial condition of some corporations. When the truth came out these corporations collapsed, causing losses to investors estimated at between $300 billion[3] and $500 billion[4]. Investor confidence in our capitol markets was shaken. In order to restore that confidence, and to make financial information more reliable, Congress passed the SOA by an overwhelming majority: 423 to 3 in the House of Representatives, and 99 to 0 in the Senate[5].

Accounting failures contributed to the recent crisis in investor confidence, but they were not the only cause of it. Some corporate managers contributed by "cooking the books" in order to

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increase stock prices so that they could collect inflated performance-based bonuses and profit from their stock options. Some securities analysts contributed by touting questionable securities because their broker-employers were selling them. And some public accounting firms contributed by performing substandard audits because they were not sufficiently independent and because they did not want to lose profitable non-audit business[6]. Add to this mix the bursting of the tech stock bubble, and a perfect storm of shaken investor confidence ensued.

Sarbanes-Oxley attempts to correct the various causes of this post-Enron crisis in confidence. To improve corporate governance, new independence requirements were established for corporate board audit committees; new internal control systems were mandated; corporate loans to management were prohibited; new attestation statements and signatures[7] by Chief Executive Officers (CEO)s and Chief Financial Officers (CFO)s were required for reports to the Securities Exchange Commission (SEC); and penalties for fraud were increased. Securities analysts' conflicts of interest were addressed by requiring a wall of separation between the sales staff of a brokerage firm and its analysts, and by prohibiting a brokerage firm from punishing an analyst who issued a negative report on a security. Analysts were also required to disclose their own holdings of the securities they were reporting on.

But the most sweeping changes wrought by Sarbanes-Oxley were reserved for public accountants. This profession performs the essential function of certifying that the financial information issued by public companies is accurate. Investors in our capitol markets rely on this financial information to make decisions. Without this reliance and trust our capitol markets could not function effectively. Our economy, which depends upon the health of our capital markets, would be significantly impaired.

In order to restore investor confidence by assuring more reliable certification of financial information, the SOA did two things: Title I of the Act created the Public Company Accounting Oversight Board (PCAOB or Board), a new government regulatory agency to oversee the work of public accountants; Title II enacted new auditor independence requirements to prevent conflicts of interest and undue influence by management in the auditors' work.

The PCAOB was a radical departure from past practice. Until the SOA, the accounting profession had been largely self-regulating[8]. The profession's national organization, the American Institute of Certified Public Accountants (AICPA) administered numerous self-regulatory organizations such as the Public Oversight Board (POB), whose task was to oversee the work of public accountants. But self-regulation by the profession was not entirely successful. The POB had no authority to sanction auditors for deficiencies or incompetence. In 2002 the POB voted unanimously to dissolve itself[9], feeling that it was unable to fulfill its mission with its limited authority[10]. Among other problems, the POB had been unable to get support for its plan to review the Big 5 accounting firms' compliance with auditor independence standards.

This paper focuses on Title I of Sarbanes-Oxley, the PCAOB, and more specifically on its enforcement process. As will be more fully described below, regulatory agencies operate by first

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promulgating rules or regulations and then by enforcing those rules. It is very useful for those being regulated to understand this regulatory process. Every public accountant will eventually come into contact with the PCAOB and its staff. With understanding, needless conflicts can be avoided and a smooth, mutually beneficial relationship can be maintained.

Unfortunately, as the business education publication BizEd[11] pointed out in August 2005, there is a shortage of useful educational material on the PCAOB and its enforcement process. The purpose of this paper is to help fill that need.

We begin with an overview of government regulation, in order to show how the PCAOB fits into this context. Then we review the Sarbanes-Oxley Act, which created the PCAOB. Next we consider the PCAOB, noting its unique features. The paper then describes and analyzes the Board's inspection process, probably its most important enforcement mechanism. Separate sections follow, describing and analyzing the Board's investigative process and its disciplinary process. The legal rights of parties appearing before the Board are noted. Finally, conclusions are drawn regarding how accountants can best to interact with the PCAOB.

OVERVIEW OF GOVERNMENT REGULATION

The PCAOB is one of many regulatory agencies in the U.S. All agencies share a great many common features, so an understanding of regulation in general will help to understand the PCAOB in particular. Government regulation comes about as a legislative response to the electorate's demand that the government "fix" a serious public problem. For example, in 1929 the stock market crashed. The Dow Jones Industrial Average dropped from 381 in 1929 to 41 in 1932, losing 89% of its value[12]. Fortunes were lost and the crash ushered in the Great Depression. The stock market crash was caused in part by fraud and manipulation of securities. The federal government wanted to correct these problems, and to be seen as actively addressing the causes of the terrible economic depression gripping the nation.

Congress' response was to pass the Securities Acts of 1933[13] and 1934[14], which imposed new financial reporting and disclosure requirements and prohibited certain practices such as insider trading. But administering the provisions of these securities acts required collecting a vast amount of financial information from thousands of companies, reviewing it, and sometimes bringing enforcement actions in federal court. This work required a great deal of time and also the expertise of lawyers, accountants, securities professionals and administrators. Congress had neither the capacity nor the inclination to do this work itself, so it created an administrative agency to do it, the Securities Exchange Commission (SEC). This new agency first needed to take the general language of the securities acts and translate it into specific regulations that could be administered. Then it hired enforcement staff to ensure compliance with those regulations.

This is the pattern of all federal and state regulation: the public perceives a problem (sometimes a crisis); the legislature passes a new statute to remedy the problem and it also creates

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an agency to administer the remedial statute; the agency then translates the general provisions of the statute into specific rules or regulations and then enforces them. The agency is central and essential to regulation.

New government regulation is often controversial because it interferes with previously unrestricted private conduct. The antitrust laws might prevent a merger, or the Environmental Protection Agency (EPA) might require expensive waste water treatment. There is also a political aspect to people's response to regulation. Political conservatives generally disfavor regulation, at least in the economic or business sector. They point to compliance costs and diversion of management attention from central business issues. Conservatives prefer market solutions. Political liberals typically favor regulation, believing that improving society is a proper role of government. Liberals focus on the benefits of regulation and they have less confidence in market solutions.

This pattern of conservative opposition or liberal support for regulation was particularly evident in the 1930s with Franklin Delano Roosevelt's New Deal. At that time an alphabet soup of new federal regulatory agencies emerged to combat the great depression: the Securities Exchange Commission (SEC), Works Progress Administration (WPA), Tennessee Valley Authority (TVA), Social Security Administration (SSA) and many others. With the proliferation of these agencies in the 1930s many became concerned that regulatory agencies had become a "fourth branch of government". This new branch was thought by some to have excessive unchecked power and was therefore a threat to our system of limited government. U.S. Supreme Court Justice Robert Jackson stated, in the case of FTC v. Ruberoid[15], that agencies "have become a veritable fourth branch of government, which has deranged our three-branch legal theories".

This criticism is not without some basis. Our American constitutional system, which has admirably preserved our essential freedom for over 200 years, is based in part on the principle of separation of powers. This principle holds that if the executive authority of government is separate from the legislative authority, and the judicial authority is also separate, then each power of government will check and balance the others, preventing the emergence of a tyrant[16]. James Madison, one of the authors of our Constitution, makes this case in Federalist Number 47.

However, regulatory agencies combine the three powers of government. They violate the separation of powers principle. When regulatory agencies promulgate rules that have the force of law, they are performing what is essentially a legislative function. When regulatory agencies enforce their rules or regulations, they are performing what is essentially an executive function. And when they hold hearings and decide cases to determine whether their rules have been violated, agencies are performing what is essentially a judicial function.

This conflation of the powers of government by regulatory agencies has been troubling from the beginning. There is certainly the potential for abuse. Concern increased during the 1930s, with the proliferation of agencies under the New Deal.

By 1946 it became apparent that there was a need to limit the powers of agencies. Congress responded by passing the federal Administrative Procedure Act[17] of 1946. This Act discourages

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agency abuse by requiring them to follow certain procedures. For example, when making a new rule, the agency must first publish the proposed rule in the Federal Register and then wait during a comment period for public response. Hearings within an agency must provide a modicum of due process (although far less than in a civil or criminal trial). This includes providing a decision-maker called an administrative law judge who is kept separate from the prosecutorial arm of the agency. Appeals to the federal courts are provided for, but only after "final agency action" (APA Section 704). This allows the agency an opportunity to correct its mistakes before it is taken to court. All federal agencies must comply with the Administrative Procedures Act's requirements, just as private parties must comply with the agencies' rules.

In addition to the APA's curbs on agency abuse there is oversight by the three traditional branches of government. The President can remove directors of some agencies at his or her pleasure; Congress can enact new legislation that curbs the budget or authority of "rogue" agencies or it can even eliminate them entirely. The courts can overturn agency decisions that are arbitrary, that exceed statutory authority, or that violate proper procedure. Between oversight by the three traditional branches of government and the procedural guarantees of the APA, it is generally agreed[18] that abuse of power by regulatory agencies has been largely avoided. Nevertheless, and particularly with the emergence of a controversial new regulatory agency, the old criticisms and concerns sometimes re-emerge.

THE SARBANES-OXLEY ACT (SOA)

The SOA fits squarely into the pattern of government regulation described above. It was a legislative response to a crisis in public confidence that threatened to undermine our capital markets and our economy. The public demanded reform, and Sarbanes-Oxley was enacted with almost unanimous support from Congress. This Act contains nine Titles. Title I established the Public Company Accounting Oversight Board (PCAOB or Board). This will be described in greater detail in the next section. Title II strengthens auditor independence, prohibiting acts that may lead to conflicts of interest, for example simultaneously performing audits and lucrative non-audit work such as consulting. SOA Section 201 provides a list of prohibited activities including bookkeeping, appraisal, management of human resources, legal services and "any other service that the Board determines, by regulation, is impermissible". SOA Section 203 requires that the lead audit partner can not remain in that position for more than five years, for fear of a too-close relationship developing between the lead auditor and corporate management.

Title III seeks to improve corporate management responsibility. SOA Section 301 requires that corporate boards of directors establish audit committees composed of independent directors – those not otherwise connected to the corporation or who receive fees from the corporation. SOA Section 302 requires that corporate chief executive officers (CEO)s and chief financial officers (CFO)s sign their companies' annual and quarterly reports to the SEC. They must certify that they

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have reviewed the report and that, "…based on the officer's knowledge, the report does not contain any untrue statement of a material fact…"

Title IV continues to strive to improve management responsibility. To avoid conflicts of interest between executive officers or directors and the corporation, SOA Section 402 prohibits personal loans from the corporation to those individuals. SOA Section 404 requires that each annual report required by the Securities Exchange Act of 1934 must include an internal control report. This is a new requirement, and has probably attracted more criticism and complaint than any other single section of the SOA. This may be because Section 404 causes companies to incur significant additional compliance costs[19].

Title V addresses securities analyst conflicts of interest. SOA Section 501 requires that analysts disclose their own investments in corporations they are reporting on. This Section also requires brokerage firms to "establish structural and institutional safeguards" to separate their securities dealers from their analysts. Brokerage firms are prohibited from retaliating against an analyst who issues "an adverse, negative, or otherwise unfavorable research report" on securities the firm is selling.

Title VIII increases the penalties for corporate fraud. SOA Section 802 makes intentional destruction or falsification of records a federal felony when done "with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States…". The maximum penalty is imprisonment for 20 years. SOA Section 806 provides whistleblower protection. SOA Section 1107, in Title IX, makes retaliation against whistleblowers a federal felony, punishable by imprisonment for up to 10 years.

THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)

As PCAOB Board Member Daniel Goelzer stated[20] "the Sarbanes-Oxley Act ended the profession's long tradition of self-regulation and peer review. In its place, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board." The Board consists of a Chair and four other Board Members, selected by the Securities Exchange Commission. This new regulatory agency was created to administer the accounting provisions of the SOA. The PCAOB follows the general pattern of agency action described earlier: hiring experts, promulgating rules, and setting up an enforcement mechanism for those rules.

Several features of the PCAOB are note-worthy. It is an "independent" agency, in that its board members are appointed for fixed terms as opposed to serving at the pleasure of the President. SOA Section 101(e) provides that the five Board members shall be selected by the SEC in consultation with the "Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury". PCAOB Board Members may not be removed before the expiration of their terms except for "good cause shown".

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The PCAOB is more independent than most other independent agencies in that its funding comes from an independent source and not from Congress. SOA Section 109 provides that the funding of the Board shall come from "annual accounting support fees" levied on corporate issuers in proportion to their "equity market capitalization". We observed earlier in the section titled "An Overview of Government Regulation" that oversight by Congress is one traditional means of controlling agencies and preventing abuse. Congress controls the purse-strings, and sets the budget of each agency annually. If an agency has aroused the ire of Congress, it can cut back that agency's budget. Agencies, being bureaucracies, strenuously try to avoid this. However, if an agency has independent funding, it is immune from such cutbacks. Very few agencies enjoy this privileged status, but the PCAOB is one that does. Greater independence makes the agency less responsive to political pressures.

Another note-worthy feature of the PCAOB is that its status is somewhat unclear. SOA Section 101(b) provides that the Board shall be a private "non-profit corporation" not "an agency or establishment of the United States Government". This is not a mere academic distinction. The Administrative Procedure Act (APA), which requires that agencies follow procedures that assure certain rights of affected parties, only applies to federal government agencies. If the PCAOB is not such an agency, then the APA does not apply. In addition, the Constitutional protections of the Fourth Amendment, which prohibit unreasonable searches and seizures, apply to government agencies but not to private corporations. This could be important in future litigation.

In deciding whether the PCAOB is an agency within the contemplation of federal law we may examine its authority and operation. If it looks like an agency and acts like an agency, then a federal court will likely rule that it is an agency. It is beyond dispute that the PCAOB was established by the federal government, specifically by the Sarbanes-Oxley Act. Moreover, the Board is controlled by and reports to the SEC, indisputably a federal agency. Its members are appointed by the SEC, with consultation from other federal agencies. SOA Section 104(a) authorized the Board to establish rules for inspections and to "conduct a continuing program of inspections" to assure compliance with the Act. SOA Section 105 authorizes the Board to establish rules for investigations and to conduct investigations. This Section also provides that the Board may request issuance of a subpoena from the SEC. SOA Section 105(c)4 gives the PCAOB authority to "impose such disciplinary or remedial sanctions as it determines appropriate", including suspension or revocation of registration, without which a public accounting firm can not do public company audit work. Sanctions can also include fines of up to $15 million. SOA Section 107 provides for SEC review of disciplinary action taken by the Board. In effect the PCAOB reports to the SEC. The decisions of the SEC with regard to Board actions constitute final agency action from which an adversely affected party can appeal to federal court.

Even though Sarbanes-Oxley describes the PCAOB as a private "non-profit corporation", we see that it was created by the federal government and it has the same authority, and behaves in the same manner as does a typical government regulatory agency. It is therefore reasonable to

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conclude that a future federal court will probably regard it as such, and require that it comply with the provisions of the Administrative Procedure Act and other federal law.

PCAOB ENFORCEMENT

As noted earlier, the PCAOB uses three separate enforcement mechanisms: inspections, investigations and disciplinary actions. Inspections are usually routine and do not indicate the presence of any problem. However, if irregularities are discovered by the inspection, then the next mechanism, an investigation, will ensue. The investigation will focus on perceived problem areas, and may include requesting or subpoenaing witnesses or documents. If the investigation leads the PCAOB to conclude that a violation has occurred, and the accounting firm has not corrected or undertaken a plan to correct the violation, then the next mechanism, disciplinary action, follows. Disciplinary action takes the form of a hearing followed by the possible imposition of sanctions which can include suspension or revocation of the accounting firm's registration and substantial fines.

The PCAOB appears to be mindful of its ground-breaking role as the first federal government agency to regulate the accounting profession. It has adopted a "soft" approach to enforcement, preferring to guide public accounting firms and to assist them towards compliance rather than by wielding its sanctions in an aggressive manner. This was described as a "supervisory approach" in the PCAOB Release of March 21, 2006. This releases states[21]:

> The Board takes a supervisory approach to oversight and seeks through constructive dialogue to encourage firms to improve their practices and procedures.

The Release goes on to state "Overall, both the effectiveness and efficiency of the Board's programs are enhanced when firms opt for constructive engagement rather than an adversarial approach." The PCAOB Annual Report for 2005, released August 2006 confirms[22] this approach.

This "soft" supervisory approach to regulation was more fully described by PCAOB Board Member Daniel Goelzer in a speech on December 12, 2005. He stated[23]:

> That brings me to the fundamental point I would like to make regarding our enforcement program. The Board's enforcement philosophy is modeled on what we have called the "supervisory approach" to regulatory oversight. As long as we believe that an auditing firm is acting in good faith and is capable of and willing to conduct audits in accordance with the PCAOB's standards, we will generally use our authority to make non-public recommendations, rather than our authority to bring disciplinary actions.

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The supervisory approach taken by the Board is remarkably conciliatory and non-confrontational. Time and again, as will be seen below, accountants are given a second chance, even a third chance to avoid sanctions or even public criticism by indicating a good-faith effort to comply. Sometimes merely undertaking additional training or education is all that the Board requires.

This soft approach by the PCAOB might be due to several factors. First, the Board is regulating members of a learned profession, one that has a proud history. The Accounting profession understands its key role in American society. This is evidenced by the remarks of former Chairman of the AICPA Board of Directors Bob Bunting, who stated in his acceptance speech[24] in October 2004:

> Fundamentally, great professions play a vital role in the health of our economy and society. Each of you—whether you work in academia or government, for a corporation or in a public accounting firm—is involved in the process of providing understandable, reliable and transparent information for decision-makers. This role is vital to our society and its economy. It is in our interest as a profession to ensure this function's integrity, fairness and relevance.

Another reason for the soft enforcement approach taken by the PCAOB may be that it appreciates the drastic nature of the step taken by Sarbanes-Oxley in instituting, for the first time, federal government regulation of a profession that had, until then, been largely self-regulating. It is natural to expect push-back from some accountants who resent the federal intrusion. For the PCAOB to be successful it needs the cooperation of the profession. Likewise, for the profession to be successful and to regain public confidence following the Enron debacle, it is helpful to be seen as partnering with a federal agency closely associated with the Securities Exchange Commission. There is every reason to view the relationship as symbiotic. Let us now take a closer look at the PCAOB's enforcement mechanisms. Inspections, investigations and disciplinary actions are described and discussed in separate sections.

THE PCAOB INSPECTION PROCESS

Of the PCAOB's three enforcement mechanisms, inspections are probably the most important. All public accounting firms will be inspected, once each year for larger firms and at least once every three years for smaller firms. The Board recognizes the importance of its inspection program. PCAOB Board Member Charles Niemeier stated[25] in 2006 that "our inspection program is the core of our supervision of registered firms". Board Member Daniel Goelzer stated[26] in 2006 that "the Board is fundamentally an inspection body". The largest single group of employees of the PCAOB is in the inspections division[27]. In 2005 the Board conducted inspections of 281 registered accounting firms[28].

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Before discussing the specific provisions of Sarbanes-Oxley and the PCAOB's Rules promulgated to administer those provisions, it is useful to consider the general approach taken by the PCAOB in its inspection process. An inspection of a public accounting firm usually starts with an assessment of that firm's "tone at the top".

Tone at the top refers to top management's attitudes and behavior regarding regulatory compliance and ethics. It would be hard to overestimate the importance the PCAOB inspectors place on positive tone at the top. If the inspection team determines that the tone at the top is positive, it will feel a reduced need to make in-depth inspections of specific audits.

The accounting profession recognized the importance of determining tone at the top long before passage of the Sarbanes-Oxley Act[29]. In 1987, the National Commission on Fraudulent Financial Reporting (the Treadway Commission) issued a report that concluded that the tone set by top management was critically important in creating a healthy financial reporting environment[30].

In a 2004 speech[31] given by Director of the Division of Enforcement of the SEC Stephen Cutler, he emphasized the importance of a healthy tone at the top. He suggested several ways in which top management could act to provide it. These include complying with the "letter and spirit of the rules", taking "good moral character" into account when hiring new employees and making "integrity, ethics and compliance part of the promotion, compensation and evaluation process". Mr. Cutler pointed out that

> It speaks volumes when a company fires or suspends a rainmaker or other important employee for an ethical breach; and just as importantly, it speaks volumes when a company doesn't.

Mr. Cutler also gave useful examples of firms which had failed to provide healthy tone at the top. He reported that at Enron, senior managers conducted a skit in which one of the themes was deceiving the SEC. At Hollinger, CEO Conrad Black wrote an email in which he referred to his company's shareholders as "a bunch of self-righteous hypocrites and ingrates."

Another aspect of the PCAOB's general approach is that inspectors conduct what has been described as a "risk-based" inspection. Inspectors do not focus their attention equally on all areas of a public accounting firm's work. They focus on those areas which seem to carry the most risk. As the PCAOB Annual Report for 2005[32] explains:

> The PCAOB uses a risk-based approach to performing its oversight programs. For example, the PCAOB's inspections teams identify audits for review based on an evaluation of the risks of misstatements or omissions in financial reporting, and they further maximize the effectiveness of their reviews by selecting the portions of those audits that are likely to pose the most challenging audit issues.

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Using this risk-based approach, inspectors would not randomly select audits to review. Instead they would look for high-risk audits. An example of a high-risk audit might be an audit of a company that had a troubled history of SEC compliance. Another example might be an audit of a company that other public accounting firms had declined to work for.

We now turn to specific provisions of the Sarbanes-Oxley Act and the PCAOB Rules. Section 104 of the SOA authorizes the PCAOB to conduct inspections and describes the Board's inspection procedures. As noted earlier, regulatory agencies take the general language of a statute and translate it into specific rules or regulations that can be administered. The PCAOB has accordingly promulgated PCAOB Rules 4000-4012 to define and apply the provisions of SOA Sec. 104. The SOA statutory provisions and PCAOB Rules are conveniently available online at the PCAOB's website, www.pcaobus.org.

SOA Sections 104(a) and 104(b), and PCAOB Rules 4000-4004 describe "regular inspections" and "special inspections" by the Division of Registration and Inspections of the PCAOB. Regular inspections are routine inspections required of all registered accounting firms doing audits of public companies regulated by the Securities Exchange Commission (SEC or Commission). Large accounting firms, auditing "more than 100 issuers" (corporations that issue securities) must be inspected annually, while smaller accounting firms need only be inspected at least once every three years. However, in addition to the Rule 4001"regular inspections", the Board may also conduct Rule 4002 "special inspections". SOA Section 104(b)2 states that the PCAOB may conduct these special investigations "at the request of the Commission or upon its own motion". The Rules do not elaborate on what the proper basis for a special inspection should be. Rule 4002 does emphasize however that "the Board may authorize a special inspection on its own initiative". An appropriate basis for a special inspection might be a "tip" that an auditor is in violation of a PCAOB rule or standard. The Board has actively sought such tips by setting up a tip hotline[33] with which informants can transmit information anonymously if they wish. They can email the Board at tips@pcaobus.org or telephone the confidential tip line at (800) 741-3158.

SOA Sections 104(c) and 104(d) and PCAOB Rule 4004 describe the procedure to be followed during a PCAOB inspection. Inspectors are given exceptional latitude to inspect for "any act or practice or omission … that may be in violation of this Act, the rules of the Board, the rules of the Commission, the firm's own quality control policies, or professional standards". Note that an accounting firm's own policies, as expressed in a handbook or manual, could be used against an accountant working for that firm, even if the violation or omission is not prohibited by Generally Accepted Accounting Principles (GAAP) or Generally Accepted Auditing Standards (GAAS). Moreover, the Board can enforce "professional standards" which also might not be specifically addressed by GAAP or GAAS. However, as noted above, the Board has taken a "soft" approach and is unlikely to use this broad discretionary authority in an aggressive manner.

A problem arises however, because PCAOB Rule 4006 titled "Duty to Cooperate With Inspectors" requires registered public accounting firms and "every associated person of a registered

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public accounting firm" to cooperate with the inspection. This cooperation includes providing "information by oral interviews, written responses, or otherwise" and also providing access to any records in the "possession, custody or control" of the firm or person. Non-cooperation can result in suspension or revocation of the firm's registration.

This is not a small matter, and it raises a Constitutional issue[34]. What if a PCAOB inspection reveals evidence of criminal activity, such as embezzlement or bribery, to which the accountant has been a party? Does the Constitutional privilege against self-incrimination, contained in the Fifth Amendment, protect an accountant who refuses to give self-incriminating testimony? The Board has anticipated this problem, and addressed it in its September 29, 2003 Release[35]:

> We note, however, that we do not intend to invade the province of any legitimately asserted privilege … including valid assertions of the privilege against self-incrimination under the Fifth Amendment to the United States Constitution. We fully intend, however, that assertions of the Fifth Amendment privilege may be used as … the basis for evidentiary inferences against the person asserting the privilege.

An accountant who believes that her testimony could implicate her in a crime can therefore refuse to provide that testimony, but the Board can then use her refusal to infer that a Sarbanes-Oxley violation has occurred. This places the accountant in a difficult position, especially considering the broad sanction powers of the Board. The Courts will have to define the exact outlines of the Fifth Amendment's protection in these situations.

After the inspection is complete, the PCAOB investigating team prepares a report. This report is described in SOA Sections 104(f) and 104(g), and also PCAOB Rules 4007-4009. Here we see the first of several remarkable provisions evidencing the "soft" approach of the Board. First a "draft inspection report" is prepared and shared with the accounting firm that has been inspected. That firm has 30 days to submit a written response to the draft report. The Board may provide an extension of that time.

The firm can submit its response, which might disagree with the inspectors' findings. The firm can also request "confidential treatment" for any portion of the firm's response, but the firm must "supply any supporting authority or other justification for according confidential treatment to the information". Justification might take the form of evidence that certain information is a trade secret or that it is protected by the attorney-client privilege. If the PCAOB agrees with the firm's response it could modify its draft inspection report, or it could merely attach the firm's response to its draft report. Note that these confidentiality provisions are different from the confidentiality provisions regarding the final inspection report, discussed below.

PCAOB Rules 4008 and 4009 deal with the Board's "final inspection report". The Board will review the draft inspection report and may respond to it by modifying it, or perhaps by sending inspectors back to collect more information. The Board will then issue a final inspection report.

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The Board will share the final report with the accounting firm, which can attach its letter or comments to that final report. If the Board thinks it appropriate, it can also attach a letter or comment by the inspectors. This final inspection report, with attached letters and comments, is then transmitted to the SEC.

PCAOB Rule 4009 and SOA Sec. 104(g)2 provide additional evidence of the "soft" approach taken by the Board and by the SOA. The final inspection report will be made public, but in almost all cases the accounting firm will be spared the embarrassment of criticisms or exposure of defects in its quality control systems. Those criticisms and defects will *not* be disclosed to the public for twelve months following the Board's issuance of its final inspection report. During that time the firm may submit evidence that it has addressed the defects. Rule 4009 provides that if the accounting firm merely *addresses* (not cures) the defects, then the criticisms contained in the final inspection report will remain confidential. The SEC and other agencies that received a copy of the original report will then be notified that "the firm has satisfactorily addressed the criticisms or defects in the quality control system." PCAOB Rule 4009 infers that if an accounting firm falls short and receives a negative inspection report but that firm shows good faith in attempting to deal with its shortcomings, no sanctions or public criticism will follow.

In taking this "soft" supervisory approach, the Board is mindful of the need to maintain the viability of existing public accounting firms. With the demise of Arthur Anderson, the "Big 5" public accounting firms shrank to the "Big 4". If another major public accounting firm were to succumb we would be down to the "Big 3". With three or fewer large public accounting firms it would be extremely difficult for large companies to satisfy their accounting needs. The accountant independence provisions of Sarbanes-Oxley prohibit an accounting firm that is already providing other services to public companies from also undertaking audit work. This limits the potential universe of public accounting firms available to those large companies. A large multinational corporation such as General Electric has such vast accounting needs that only one of the "Big 4" can satisfy those needs. It is logical that the PCAOB will seek to preserve and rehabilitate a firm with shortcomings rather than contribute to its demise. All the PCAOB asks is a good faith effort to improve, and evidence that the firm is capable of work that meets PCAOB standards.

PCAOB INVESTIGATIONS

In most cases PCAOB enforcement will end with the final inspection report issued by the Board. However, if evidence of a violation is discovered during the inspection (or otherwise, for example by an informant) then the Board can initiate the next mechanism in the enforcement process, an investigation. The PCAOB's authority to conduct investigations is found in SOA Sections 105(a) and 105 (b), and in PCAOB Rules 5000-5113.

When the Board undertakes an investigation, the process shifts gears. The Board, in its Release of March 21, 2006[36], stated that "unlike the Board's inspection process, the Board's

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disciplinary process is adversarial in nature". The matter shifts to a new department within the PCAOB, the Department of Enforcement and Investigations. It is to be expected that the investigators of this department will have a more prosecutorial attitude than the inspectors who performed routine inspections.

In order to engage in a formal investigation, the Director of Enforcement must first obtain an "Order of Formal Investigation" from the Board. The Board will issue that order "when it appears that an act or practice, or omission to act … may violate any provision of the Act." It therefore appears that a formal investigation should not be ordered unless the Director of Enforcement first has evidence of a questionable act or omission. Presumably this is to discourage "fishing expeditions" in which over-eager regulators go hunting for evidence of non-compliance. Such conduct is highly unlikely today, with the PCAOB understaffed and barely able to keep up with its workload.

SOA Sec. 105(b)2 and PCAOB Rules 5102-5109 and 5111 deal with the important issue of the powers of the Board to collect or compel the production of evidence from accountants and accounting firms being investigated. The Board may require the testimony of any registered public accounting firm or "person associated with a registered public accounting firm, with respect to any matter that the Board considers relevant or material to an investigation." Testimony is to be given under oath, with a reporter preparing a transcript, in a non-public proceeding. This again raises the issue of the Constitution's Fifth Amendment privilege against self-incrimination, discussed earlier. SOA Section 105(b)5 and PCAOB Rule 5108 deal with the important issue of the confidentiality of investigative records. SOA Section 105(b)5 states that all "documents and information" prepared or received by the Board are "confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process)". Moreover, this privileged information is not subject to discovery under the Freedom of Information Act[37]. These provisions provide effective confidentiality protection with respect to civil liability and civil litigation.

PCAOB DISCIPLINARY PROCEEDINGS

Unlike its predecessor the Public Oversight Board (POB), which was a self-regulatory organization under the supervision of the American Institute of Certified Public Accountants (AICPA), the PCAOB has very potent sanctions at its disposal. SOA Section 105(b)4 gives the Board the authority to impose "disciplinary or remedial sanctions" including temporary suspension or permanent revocation of an accounting firm's registration. Without registration a firm may not audit public companies. Revocation of registration would probably lead to the demise of a public accounting firm. The Board can also temporarily suspend or permanently bar an individual accountant from association with any registered public accounting firm. The Board has authority to impose heavy fines on violators. For unintentional (probably negligent) acts, the Board can impose a fine of up to $100,000 for an individual, and up to $2,000,000 for a firm. These limits

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increase substantially if an intentional act is involved. The limits then go to $750,000 and $15,000,000. Intentional acts include reckless conduct and even "repeated instances of negligent conduct" that violate the SOA. Other sections of the SOA authorize the imposition of jail sentences for failure to maintain required records or willful destruction of records.

Perhaps the most interesting sanction available to the PCAOB is described in SOA Section 105(b)4(F). This section authorizes the Board to require "additional professional education or training." Once again we see the "soft" side of PCAOB enforcement. If a situation seems salvageable, the Board will probably act to preserve the public accounting firm.

As with most regulatory agencies, there is an opportunity for a party charged with a violation to challenge it. These challenges are decided in administrative hearings within the agency. As noted earlier, regulatory agencies were criticized because they combine the three powers of government: they act in an executive capacity, investigating and enforcing; they act in a legislative capacity, promulgating rules that have the force of law; and they act in a judicial capacity by hearing and deciding cases which contest allegations of regulatory violations. In the case of the PCAOB, regulatory violations can result in significant sanctions, as just noted.

Agency hearings are efficient because agency personnel having the necessary expertise are already on hand as salaried employees. The decision-maker is not a judge from the judicial branch of government, but rather another employee of the agency who serves as the hearing officer. Due process at agency hearings typically is reduced so that less time is spent on each hearing. These factors enable the agency to resolve disputes with greater efficiency; they are all present in the specific case of PCAOB hearings. In order to avoid abuse, parties are accorded procedural rights including several opportunities for appeal.

The SOA's description of the hearing process within the PCAOB is remarkably brief: only a few paragraphs contained in Section 105(c). From this brief statement of authority the Board had promulgated 49 rules that occupy 44 pages of text. This is a good example of how agencies take general statutory language and then promulgate many specific rules necessary to implement the intent of the legislation. Many of these rules are purely procedural and of interest only to lawyers engaged in administrative hearings. For example, Rule 5408 limits page lengths of briefs. Rule 5463 limits the time for oral argument before the Board. However, other rules define substantive rights of parties appearing before the Board and are of interest to practitioners and students. These more significant rules are discussed below.

One of the early complaints about abuse by agencies was that the quasi-judicial officer deciding cases within the agency was an employee of the agency and therefore biased in favor of it. The first requirement of anyone deciding cases is an open, unbiased mind. In order to meet this objective, the federal Administrative Procedure Act (APA) requires that this function be performed by an "administrative law judge" who may be an employee of the agency but who is insulated by a high wall of separation from the enforcement or policy arms of the agency[38]. PCAOB Rule 5200 conforms to this requirement. The decision-maker is called a "hearing officer" who "may not be

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responsible to or subject to the supervision or direction of an employee or agent engaged in the performance of investigative or prosecuting functions for the Board". As a result, the hearing officer does not have to fear career retaliation for decisions adverse to the agency. Any employee or agent of the Board engaged in investigative or prosecutorial functions may not "participate or advise in the decision … except as a witness or counsel".

In order to preserve impartiality (and equally important, the appearance of impartiality) it is important that agency personnel not influence the hearing officer through informal, private contacts. PCAOB Rule 5403(b) therefore prohibits ex parte (one party only) communications. Enforcement personnel may not "communicate with the person presiding over an evidentiary hearing on a fact in issue, unless on notice and with opportunity for all parties to participate."

Hearings before the Board are generally private. Rule 5203 provides that the Board has the power to hold public hearings but only "for good cause shown and with the consent of the parties". The burden of proof is on the Board to prove the alleged violation "by a preponderance of the evidence". This is the same burden of proof in the ordinary civil trial (Rule 5204). Alleged violators may represent themselves or be represented by an attorney (Rule 5401). If an alleged violator reasonably believes that a particular hearing officer is biased against her, she can challenge that hearing officer by making a motion for withdrawal (Rule 5402). However, that motion is made directly to the challenged hearing officer, who must decide if he or she is biased. If the hearing officer decides that he or she is biased, a replacement will be appointed. But if the hearing officer decides that he or she is not biased, then that hearing officer "shall continue to preside over the proceeding." There is no provision in the rules for an interlocutory appeal from a hearing officer's decision not to withdraw. One possible improvement to these rules would be to provide alleged violators with one peremptory challenge to a hearing officer. This would enhance confidence in the fairness of the proceedings.

At the hearing before the PCAOB, either party may request a PCAOB demand for testimony or production of documents. The Board has discretion to seek an SEC subpoena that would compel testimony or production of documents from "any person, including any client of a registered public accounting firm" (Rule 5424).

PCAOB Rule 5441 deals with the admissibility of evidence. Here we see the typical contraction of due process in the interests of administrative efficiency. This rule provides that "the hearing officer may receive *relevant* evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious." This standard of "relevance" is a liberalization of the far more restrictive rules of admissibility that exist in a civil or criminal trial. For example, hearsay evidence is normally excluded at trial, but it could be admissible under the relevance standard of Rule 5441. By adopting a less formal standard of evidence admissibility, technical wrangling over specific admissibility rules is avoided and the hearing officer can focus on the basic merits of the agency's allegations. This is a common trade-off found in agency hearings.

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If the hearing officer's decision is adverse to the accountant, he or she can appeal that decision to the Board (Rule 5460). The Board has wide discretion to affirm, reverse or modify the hearing officer's decision, or the Board can send the matter back to the hearing officer for additional proceedings. The accountant can file briefs with the Board (Rule 5462) and seek oral argument before the Board (Rule 5463).

If an accounting firms meets with an adverse decision by the Board, the firm can appeal to the Securities Exchange Commission (Rule 5467). The SEC's decision is the final one within the regulatory agency system. At this point the firm can bring a legal challenge against the PCAOB in federal court.

When challenging agency action before the federal courts it is useful to remember that courts typically give great deference to agency expertise.[39] If an appellant accounting firm is arguing, for example, that the financial information it provided to the SEC is correct using accounting method A, but the PCAOB or the SEC insist that accounting method B must be used to provide accurate financial information, it is highly unlikely that the court will overturn the agency's finding. Judicial review is most likely to succeed if a procedural requirement has been violated, or perhaps upon a convincing showing that the agency has exceeded the authority granted to it by the legislature.

CONCLUSION

The Public Company Accounting Oversight Board is the first federal regulatory agency for the accounting profession. It has substantial sanction powers, including revocation of a public accounting firm's registration, which would probably result in the demise of that firm. The Board has strong inspection and investigation authority, including subpoena power for testimony or documents. These powers are exercised by an agency that is extremely independent. PCAOB independence comes from the fact that Board Members are appointed for fixed terms and can only be removed for good cause. The Board is largely independent of political pressure because the Board's funding comes from a fee levied on regulated companies.

Even though the PCAOB is an extremely powerful government regulatory agency it has chosen to exercise its power with great restraint. It has adopted a soft, "supervisory approach" to enforcement. Criticisms of accounting firms contained in final inspection reports remain confidential for twelve months. If during that time the accounting firm addresses its shortcomings, these criticisms will never become public. The Board will try to work with an accounting firm to improve that firm's performance, so long as the firm demonstrates good faith and a capacity to perform audit work that meets the Board's standards.

Parties coming before the Board have important procedural rights. If the PCAOB charges an accounting firm with a violation, the firm can challenge that in an administrative hearing held within the PCAOB. The hearing officer will be a PCAOB staff member who is kept separate from the enforcement staff of the Board. There are opportunities for appeal from an adverse hearing

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decision, first to the Board, then to the Securities Exchange Commission and finally to the federal courts.

While parties coming before the PCAOB can assert their legal rights in the enforcement process, they should be mindful that the Board's "supervisory approach" affords them an opportunity to work constructively with the Board. The Board much prefers to preserve public accounting firms rather than to see them fail. In almost all cases a firm will be better off taking advantage of the Board's supervisory approach rather than by aggressively contesting the Board's determinations. After all, both the Board and the profession share the common goal of providing the best possible financial information to decision-makers.

By working constructively with the PCAOB, public accounting firms can best serve their clients and themselves and attain the high standards to which their profession aspires.

ENDNOTES

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