Creating Accountability: Increased Legal Status of Accounting and Auditing Authorities in the Global Capital Markets (U.S. and EU)

Thomas C. Pearson

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Cover Page Footnote
International Law; Commercial Law; Law
Creating Accountability: Increased Legal Status of Accounting and Auditing Authorities in the Global Capital Markets (U.S. and EU)

Thomas C. Pearson†

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I. Introduction

Financial markets are increasingly integrated into the expanding global capital markets. The global financial stock market, which at the end of 2003 exceeded more than $118 trillion and is expected to grow to $200 trillion by 2010, is increasing dramatically faster than the world’s gross domestic product.\(^1\) The United States (U.S.) and European Union (EU) provide about eighty percent of the value of the world’s financial stocks.\(^2\) International capital flows across borders have more than tripled since 1995, totaling four trillion U.S. dollars annually,\(^3\) despite

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\(^2\) See Klaus C. Engelen, Preventing European “Enritis,” The Int’l Econ. 40, 46 (Summer 2004). Older information on the capital markets adds Japan to comprise over 80% of the global capital market. However, with the EU’s creation of the Euro, European financial markets are integrating and gaining share. Whereas, Japan’s financial markets are becoming less important in the global financial system. Japan’s financial stocks are relatively stagnant and have relied upon the expansion of government debt. McKinsey, supra note 1, at links “Different Profile in Different Regions” and “The US Remains the World’s Capital Hub.”

\(^3\) As an example of cross-border flows, foreigners hold 12% of U.S. stocks, 25%
various financial crises during the past decade. The interdependence should continue to intensify as technology expands the possibility for overseas trading and exchange of services.  

The global capital markets rely upon accounting as the international language of business. Paul Volker, former Chairman of the U.S. Federal Reserve, has explained that high quality financial reporting “is essential to the effective functioning of capital markets and the productive allocation of economic resources.” Trustworthy financial reporting for investors and creditors requires enforceable high quality accounting and auditing authorities. Accounting and auditing have become especially important in the last two decades with the substantial increase in the number of people worldwide who have an ownership interest in public companies, either directly through stocks, or indirectly through mutual funds and pension plans.

This article focuses on the creation of greater accountability in the last few years due to more accounting and auditing authorities having acquired legal status. The increased legalization arises primarily after the enormous financial reporting and audit failures in the early 2000s including Enron, WorldCom, Parmalat, and of U.S. corporate bonds, and 44% of U.S. Treasury bonds. See McKinsey, supra note 1, at link “Growing Cross-Border Capital Flows.” Similarly, at least 250 Japanese security issuers have their stocks and bonds listed in the EU Japan’s Ministry of Economy, Trade & Industry, Study Group on the Internationalization of Business Accounting, Report on the Internationalization of Business Accounting in Japan, 7 (June 2004), http://www.iasplus.com/resource/0406ifrjsapangaap.pdf [hereinafter Japan’s Report]. The EU and the United States are each other’s biggest trading partners.

See Japan’s Report, supra note 3, at 9.


See id.

See generally id. (stating that good accounting needs to be strengthened due to its importance).

other multinational companies in the United States, Europe, and other industrialized areas of the world.¹¹

Having professional accounting and auditing standards as legal authorities is a response to a combination of factors, most importantly from increased globalization in the securities markets.² This is also leading to the convergence project to harmonize U.S. and international accounting standards.³ However, the desire is to retain some political control for accountability over the determination of acceptable accounting


¹² See, e.g., Volcker, supra note 5 (emphasizing the importance of auditing standards in the international realm).

¹³ See FASB and IASB, FASB and IASB Agree to Work Together toward Convergence of Global Accounting Standard IP02/1576 (10/29/02), at http://www.fasb.org/news/nr102902.shtml. Four reasons support convergence into harmonized international accounting standards. They are (1) the interconnected markets creating greater financial risk; (2) international standards are derived after rigorous debate and sometimes fine-tuning; (3) common standards facilitate consistent treatment of cross-border markets and activities; and (4) international standards helps to align the regulatory practices in the different jurisdictions. See Koh Yong Guan, Managing Dir. of the Monetary Auth. of Singapore, Keynote Address of the MAS Capital Markets Seminar (2002), http://www.bis.org/review/r920515f.pdf.
standards. For auditing authorities, legalization arises primarily from the securities market and the regulatory push by the Securities and Exchange Commission (SEC) for more similar financial reporting enforcement through auditing oversight by a governmental entity.

The change in worldwide legalization of accounting authorities is most readily apparent in the European Union’s momentous adoption of the International Accounting Standards Regulation 2005, as well as related auditing and securities law enforcement. The dramatic international action taken by those European countries and others is prompted in part by the extraterritorial effect of the U.S. Sarbanes-Oxley Act of 2002 (SOX) and its requirement that any accounting firms auditing public companies must register with the Public Company Accounting Oversight Board (PCAOB).

SOX has legalized auditing standards in the United States by requiring that the PCAOB’s auditing standards obtain approval through the SEC. Therefore, SOX has also indirectly, and probably unintentionally, enabled courts to apply the Administrative Procedures Act (APA) and inevitably create legal

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14 For example, “[t]he establishment of an endorsement mechanism at EU level is necessary because it is not possible politically, nor legally, to delegate accounting standard setting unconditionally and irrevocably to a private organization over which the EU has no influence [IASB].” Financial Reporting: The IAS Regulation – Frequently Asked Questions, Memo 01/40 (Feb. 13 2001), http://europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/01/40&format=HTML&aged=1&language=EN&guiLanguage=en.

15 See id.

16 See generally Financial Reporting, supra note 14 (describing International Accounting Standards and what changes they are likely to produce).

17 See Sarbanes-Oxley Act of 2002, (Public Company Accounting Reforms and Investor Protection Act), Pub. L. No. 107-204, 116 Stat. 745 (codified primarily in chapters 15 and 18 U.S.C.). See generally, William S. Duffey, Jr., Corporate Fraud and Accountability: A Primer on the Sarbanes-Oxley Act of 2002, 54 S.C. L. REV. 405 (2002) (explaining that “[t]he SEC’s proposals would also require companies filing annual and quarterly reports ‘to maintain procedures [aimed at providing] reasonable assurance that the company is able to collect, process and disclose the information required’ in its Exchange Act reports, as well as require ‘periodic review and evaluation of these procedures’ and certification by the issuer’s CEO and CFO as to the adequacy of the issuer’s information gathering capabilities.”). Id. at 410.

18 See Sarbanes-Oxley Act § 107(b)(2).

accounting authorities. Others have not discussed this probable new legal status for higher level U.S. accounting authorities. Therefore, this article explains in-depth the basis for the legal argument, as well as the legalized auditing authorities significantly influencing the law in the EU and affecting the accounting profession.

The potential consequences of the new legal status of accounting and auditing are enormously important, particularly for securities litigation. Moreover, the new legal status furthers the unstated policy concerns to harmonize accounting authorities in other major capital markets, as part of an effort towards global convergence of financial standards and greater transparency in financial reporting.

In Part II, this article examines the preliminary question in the U.S. of when the APA applies to an "agency," so as to create more accountability to the public. The analysis in Part III considers whether the APA applies to the Financial Accounting Standards Board (FASB); the result effecting a more refined legal analysis for the body of accounting rules and conventions known as Generally Accepted Accounting Principles (U.S. GAAP), creating a hierarchy of authorities similar to a regulation, interpretive releases, and a part that is merely just influential. Part IV examines the legal status of the PCAOB to determine the legal status of its new "auditing and related professional practice standards" for verifying that the accounting is in accordance with the relevant accounting standards.

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20 See generally id. (establishing procedures for creating authorities for legal accounting).

21 The desire to harmonize accounting standards was discussed over two decades ago. See generally Barbara S. Thomas, International Accounting and Reporting - Developments Leading to the Harmonization of Standards, 15 N.Y.U. J. INT'L L. & POL. 517 (1982-1983) (citing increasing interdependence among nations).

22 See APA § 551(1).

23 GAAP is a term used in several countries for their own interpretation of GAAP. Thus, when this article refers to GAAP as defined in the United States, it uses the term "U.S. GAAP."

24 See Sarbanes-Oxley Act § 2(a)(2). Sarbanes-Oxley Act defines an audit as an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the SEC or PCAOB, for purposes of expressing an opinion on such statements.
International concerns and implications are explored in the remaining parts of the article. Part V analyzes the EU’s new legal status in 2005 for accounting authorities and the new process for adopting auditing authorities as substantial evidence of a dramatic international trend of making a legal status for authorities effecting financial reporting.\(^{25}\) Part VI considers the global implications, especially for securities litigation and the need for increasing the professionalism of accountants and auditors through legal standards that now can effectively establish *negligence per se.*\(^{26}\)

Finally, in Part VII, this article concludes by summarizing the evidence for the article’s thesis that in the leading capital market countries, more accounting and auditing authorities have become law, which will help to increase accountability of public companies, their auditors, and the accounting and auditing standard setters.\(^{27}\) The authorities have advanced from a historic quasi-legal status as professional standards to often having direct legal effect, creating huge potential repercussions in increased legal responsibilities for global business, and a need for greater professionalism from accountants and auditors.\(^{28}\)

**II. Basis for U.S. Regulations: Administrative Procedures Act (APA)**

This part introduces the U.S. APA, a law which has helped make government more accountable to its citizenry. The APA applies to the SEC, Internal Revenue Service (IRS), and many other agencies having an extensive reliance on accounting and auditing authorities.\(^{29}\) Understanding the judicial application of


\(^{27}\) *See generally* id. (creating rules of law that increase the accountability of the accounting profession).

\(^{28}\) *See generally* Volcker, *supra* note 5 (expressing the need for globalization of accounting standards).

\(^{29}\) For example, “[a]ll IRS records are subject to FOIA requests. However, . . . [t]he IRS may withhold information pursuant to nine exemptions and three exclusions contained in the FOIA statute.” IRS, *GUIDE TO THE FREEDOM OF INFORMATION ACT*, http://www.irs.gov/pub/irs-utl/irs_foia_guide.pdf [hereinafter IRS GUIDE].
these acts is especially important to entities performing financial functions. Insofar as U.S. accounting and auditing authorities are concerned, such an understanding is necessary before considering whether the APA applies to the FASB and PCAOB. If the APA applies, it changes the legal status of their accounting and auditing issuances, as well as their processes. The APA definition of an "agency" is critical, especially as applied by the courts to entities often disguised by some independence from government.30

A. APA's Purpose for Greater Accountability

The APA addresses the problem of "phantom government," or government operating by rules known only to a select few and which are inconsistently applied.31 When the United States enacted the APA in 1946,32 the law focused on agency rulemaking and adjudication. The APA introduced greater uniformity of administrative practices among diverse agencies that had widely varying customs. The APA now incorporates other important acts that address the public's access to information, especially the Freedom of Information Act (FOIA).33

An agency often has multiple roles in a quasi-judicial function as investigator, prosecutor, and judge for administrative adjudication. While the APA provides basic procedural rights, an agency has the discretion to provide parties with more procedural

30 See generally APA § 551(1) (defining "agency").
CREATING ACCOUNTABILITY

An agency may also perform a quasi-legislative role in adopting regulations and other authorities that have legal importance. Proposed agency rules under the APA must follow a notice and comment procedure for the agency rulings to have the force of law. The APA explicitly exempts from notice-and-comment requirements interpretive ruler, general statements of policy, or rules of agency organization, procedure, or practice . . . .

Under the APA, agencies must publish their substantive rules in the Federal Register. Failure to publish substantive rules may prevent proper enforcement of the agency rule, although equity may permit the regulation to remain while the agency provides proper procedural process. Substantive rules or regulations are distinguishable from "interpretive rules," which provide statements as to what the administrative officer thinks the statute or regulation means. Interpretive rules are not governed by the APA.

35 See APA § 553(b) and (c).
37 "The Congressional Review Act provides that agencies must submit certain regulations to Congress sixty days before they are scheduled to take effect." See APA § 801(a)(3)(A).
38 See Hotch v. United States, 212 F.2d 280, 283 (9th Cir. 1954) (reversing a court-reversed conviction arising from a violation of a Department of Interior fishing regulation that was not published in the Federal Register).
39 See Fertilizer Inst. v. U.S. EPA, 935 F.2d 1303, 1312 (D.C. App. 1991) (allowing exemptions to a rule promulgated by the Environmental Protection Agency [EPA] to remain in place until the EPA conducted a new round of notice and comment).
40 See generally 2 Am. Jur. 2d Administrative Law § 146 (2005) (listing what constitutes an "interpretive" rule so as to exempt an agency from the notice requirements of the APA).
The APA also requires agencies to publish in the *Federal Register* general descriptions of their organization,\(^43\) decisional procedures, and statements of general policy adopted by the agency.\(^44\) Publication enables the public to acquire information about the agency’s procedures, and to evaluate the validity of the agency’s actions and procedures under established standards of administrative law.\(^45\)

The APA was not viewed as a disclosure statute until FOIA was enacted in 1966.\(^46\) FOIA was created in an effort to provide citizen access to most forms of government records.\(^47\) FOIA requires agencies to make public their statements of policy, rules, instructions to staff that affect the public, adjudicatory decisions, and other materials not covered by a legal exclusion or statutory exception,\(^48\) such as “sensitive institutional, commercial, and personal interests that can be implicated in government records.”\(^49\)

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\(^{43}\) See 5 U.S.C. § 552(1)(A). An unpublished structure of an agency can void the agency’s actions. See, e.g., Pinkus v. Reilly, 157 F. Supp. 548, 551 (D.N.J. 1957) (voiding the administrative actions of the Post Office for the failure of the agency to publish its organizational structure in the *Federal Register*).

\(^{44}\) See 5 U.S.C. § 552(a)(2).

\(^{45}\) See MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE (2d ed. 2005), at 1.111[1].


B. "Agency" Language and Characteristics for When the APA Applies

"Agency" is defined differently within the U.S. Code, depending on its purpose. For purposes of the APA is defined in relevant part as "each authority of the Government of the United States, whether or not it is within or subject to review by another agency." The legislative history explains the necessity "to define agency as 'authority' rather than by name or form, because of the present system of including one agency within another or of authorizing internal boards or 'divisions' to have final authority."

Subsequent to the passage of FOIA, the statutory definition of "agency" was expanded in 1974 as part of a comprehensive Congressional effort to strengthen and expand accountability to the public. FOIA plays an important role in assuring greater accountability from various "agencies and has most of the litigation further defining the key concept of an 'agency.'"


For purposes of judicial review, "agency" includes "any U.S. department, independent establishment, commission, administration, authority, court or bureau." See 5 U.S.C. § 701. Another definition of "agency" includes various enumerated types of entities, as well as the Botanic Garden, Government Printing Office, but does not include a government-controlled corporation. See 5 U.S.C. § 5721(1).

The definition specifically excludes the Congress, courts of the United States, governments of territories and the District of Columbia. Id.


government corporation,54 'government controlled corporation,' or 
other establishment in the Executive branch.55 The legislative 
history indicates that, while expanding its coverage to quasi-
government entities, Congress did not intend to cover certain 
corporations which merely received some government funding, 
but were neither chartered by the federal government, nor 
controlled by it.56 

"Regulatory agencies"57 are agencies empowered to create and 
enforce rules that carry the full force of law and are covered by 
the APA.58 Litigation was required to establish that many regulatory 
agencies are agencies for purposes of the APA or FOIA.59 
Examples include the Cost Accounting Standards Board (CASB), 
the Federal Home Loan Mortgage Corporation (FHLMC), and 
several others.60 

Hybrid agencies are also covered by the APA, such as the 
CASB. Congress created the CASB in 1950 as a Congressional 
agency independent of the executive branch.61 The CASB had 
authority to promulgate, amend, and rescind cost accounting 
standards and interpretations.62 The CASB's goal was to achieve 
uniformity and consistency in the cost accounting standards.63 

54 A "government corporation" is defined as "a corporation owned or controlled by 
departments as agencies.
56 FOIA would apply to entities like the Federal Deposit Insurance Corporation, but 
not to the Corporation of Public Broadcasting. H.R. Rep. No. 93-876 (2d Sess. 1978), as 
regulatory agencies exist, including the Federal Reserve Bank. Id.
58 The Federal Reserve is an agency covered under the APA since it is an 
"authority" of the United State that performs important government functions and 
exercises powers entrusted to it, and it is not specifically excluded under 5 U.S.C. § 551 
59 See generally id.
60 See generally id.
63 See id.
These standards govern the measurement, assignment, and allocation of costs to contracts with the United States. In *Petkas v. Staats*, the government argued that the statutory authorization for the CASB said it was an agency of Congress, therefore falling outside the definition of agency. The court in *Petkas*, however, held that the definition of an agency does not depend on how Congress labels it. Thus, the *Petkas* court determined that the CASB was an agency; consequently, the FOIA applied.

The court held that the FHLMC was an agency in *Rocap v. Indiek*. The FHLMC shared many characteristics of other quasi-federal entities clearly intended to be included within the "government controlled corporation" language. The court examined the legislative history of the 1974 amendments and found that Congress intended to extend the FOIA to certain hybrid governmental and private entities, such as FHLMC.

An entity is an agency under the FOIA where it exercises some "independent function" or can promulgate rules or guidelines on its own authority. Therefore, the courts have adopted a functional analysis in determining whether the FOIA applies. The courts look at whether the organization has authority in law to

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64 41 U.S.C. § 422(f)(1) (2000). Cost accounting standards apply to organizations entering into contracts with or receiving grants from the federal government. The Office of Management and Budget (OMB) also issues circulars specifying the particular cost principles applicable for educational organizations, non-profit organizations, profit organizations, and state and local governments.

65 Petkas, 501 F.2d at 887 (D.C. Court of Appeals affirmed that CASB was an agency but remanded the case on the interpretation of an exemption to FOIA).

66 Id. at 682 (holding CASB was an agency but ruled an exemption to FOIA applied to the requested information). CASB had originally published its regulations citing the FOIA as authority. *Id.*

67 CASB is now under the oversight of the GAO. 48 C.F.R. § 30.101 (2000).


69 Id. at 177


71 *Id.*

72 Ciba-Geigy Corp. v. Mathews, 428 F. Supp. 523, 527 (S.D.N.Y. 1977) (holding that a university group making scientific recommendations to the Federal Drug Administration (FDA) was not an agency under the FOIA, because it had no independent legal authority to make decisions for the FDA).
perform the decision-making functions of a federal agency.\textsuperscript{73} The courts also consider whether an organization's structure and daily operations are subject to substantial federal control.\textsuperscript{74} Although various factors are weighed,\textsuperscript{75} the critical question is whether the entity "has any authority in law to make decisions."\textsuperscript{76}

Financial institutions with strong government connections are usually considered an agency for purposes of the FOIA,\textsuperscript{77} such as the Federal Open Market Committee of the Federal Reserve.\textsuperscript{78} In 1993, the court recognized the Office of Management and Budget (OMB) as an agency for purposes of the FOIA because it is a permanent agency with significant staff and broadly delegated powers.\textsuperscript{79}

A few financial organizations are not agencies because they do not exercise independent authority. The Council of Economic Advisers is not an agency under the FOIA because, although it has a staff, budget, and defined structure, it has no regulatory power or other function suggesting that it exercises independent authority.\textsuperscript{80} Without explanation, a court held that the New York Stock Exchange was not an agency under the FOIA.\textsuperscript{81}

Private corporations are usually not considered agencies under the FOIA. The Court found that auditing and reporting

\textsuperscript{73} Id.

\textsuperscript{74} See generally id.


\textsuperscript{77} For a summary discussion of other cases considering the definition of agency, see Marjorie A. Shields, Annotation, What Constitutes "Agency" for Purposes of Freedom of Information Act, 165 A.L.R. Fed 591 (2005).

\textsuperscript{78} Fed. Open Market Committee v. Merrill, 443 U.S. 340 (1979) (In a 7-2 decision, the Court held the Federal Open Market Committee had an exemption from disclosure in the FOIA).

\textsuperscript{79} Meyer v. Bush, 981 F.2d 1288, 1294 (D.C. Cir. 1993).

\textsuperscript{80} Armstrong v. Executive Office of the President, 90 F.3d 553, 559 (D.C. Cir. 1996).

\textsuperscript{81} Indep. Invest. Protective League v. N.Y. Stock Exch., 367 F. Supp. 1376, 1377 (S.D.N.Y. 1973) (suggesting that the self-regulatory scheme of the New York stock Exchange did not satisfy the FOIA definition of "agency").
requirements, as well as the restrictions on certain activities, were a means for the government to protect its investment and did not constitute virtual day-to-day supervision. Thus, the quasi-private railroad Conrail was not a federal agency. Legislation establishing AMTRAK stated that it was not an agency or establishment of the government; rather, it was a hybrid government corporation. However, the Comptroller General decided that Amtrak was an agency, noting that Congress resolved the issue in the legislative history to the FOIA. Not-for-profit entities that perform government functions may also be agencies.

III. Accounting and the Financial Accounting Standards Board (FASB)

Consumers of financial information, especially investors and creditors, "rely heavily on credible, transparent, and comparable financial reports for effective participation in the capital markets." Financial reports are based on accounting rules for summarizing, reporting, and disclosing financial information. The complexity of today's business and financial transactions has

82 See id.
86 The Smithsonian was an agency for purposes of the FOIA; it performed governmental functions as the national museum responsible for the safekeeping and maintenance of national treasures, Cotton v. Adams, 798 F. Supp. 22, 24 (D.C. 1992). However, the Smithsonian was not an agency for purposes of the APA's Privacy Act, which uses the same definition of an agency. Dong v. Smithsonian Inst., 125 F.3d 877, 879 (D.C. Cir. 1997), cert. denied, 524 U.S. 922 (1998).
88 Internationally, a complete set of financial statements normally includes the Balance Sheet, the Income Statement, a Statement of Changes in Financial Position (which may be presented in a variety of ways, such as a Statement of Cash Flows or a Statement of Funds Flow, and those notes and explanatory material that form an integral part of the financial statements). IASB, The Framework for the Preparation and Presentation of Financial Statements, Financial ¶ 7 (2001). In the United States, four statements are required. AICPA, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises ¶ 191 (1970).
made accounting rules more complex, extensive, and important to understand.  

A. SEC's Authorities on Accounting

Various U.S. federal agencies have important accounting jurisdiction.  

The most important rules governing accounting in the private sector in the United States are based on the powers granted to the SEC and the legal authorities that the SEC subsequently created. The private sector in the United States includes over 12,000 companies listed on a stock exchange, including more than 1,300 non-U.S. companies from fifty-six countries.  

The SEC was established under the Securities Exchange Act of 1934 (1934 Act). The SEC has the statutory authority to establish accounting standards for “public companies.” Public companies are companies with more than ten million dollars in assets whose securities are held by more than 500 owners. Public companies must maintain books, records, and accounts, which accurately and fairly reflect its transactions and the disposition of its assets in reasonable detail. Public companies

89 See, e.g., SFAS 149 (on hedge funds); cf. IAS 39.  


91 Id.  


95 See id., § 78l(g)(1994); 17 C.F.R. 240.12g-1, 12g3-2(a).  

must also create and maintain internal controls sufficient to allow
the preparation of financial statements in conformity with U.S.
GAAP and to maintain the accountability of assets.\textsuperscript{97}

SEC regulations are the strongest legal authorities for
interpretation of securities laws.\textsuperscript{98} While several regulations affect
accounting for public companies,\textsuperscript{99} regulation S-X "addresses
those areas in U.S. GAAP in which standards were not explicit
and there was a need for an authoritative source for specific
requirements. The disclosures required for foreign private issuers
provide an example of regulation S-X requirements."\textsuperscript{100}

The SEC's administrative interpretations include various types
of SEC Releases, as listed in Table 1.\textsuperscript{101} A few key SEC releases
provide the SEC's positions on accounting authorities. In ASR No.
150, the SEC recognized the FASB as the primary source of U.S.
GAAP.\textsuperscript{102} The pronouncement also generally accepts the
principles and standards issued by the FASB as having
"substantial authoritative support."\textsuperscript{103} SEC filings must follow

\textsuperscript{97} 1934 Act § 13(b)(2)(B).

\textsuperscript{98} See U.S. GEN. ACCOUNTING OFFICE, Securities and Exchange Commission, GAO
No, 01-718, Review of Accounting Matters Related to Public Filings: Report to the
Ranking Minority Member, S. Subcomm. on Financial Institution, Comm. on Banking,

\textsuperscript{99} See, e.g., Reg. S-X, Form and Contents of Financial Statements 17 C.F.R. part
210; Reg. S-K, Standard Instructions for Filing Forms, 17 C.F.R. § 229 (1994); Reg. S-
T, General Rules and Regulations for Electronic Filings, 17 C.F.R. § 232 (1994); and

\textsuperscript{100} A foreign private issuer not using U.S. GAAP, but another comprehensive body
of accounting standards must provide an audited reconciliation to U.S. GAAP. See Reg
S-X, 17 C.F.R. 210.4-01(a)(2) and 210.2-01(2005); see generally SEC Form 20-F, items
17(c) and 18(b).

\textsuperscript{101} SEC Releases are numbered so that the first two digits refer to the relevant
securities statute. For example, SEC Release 33-8040 refers to the 1933 Act. SEC
Releases are comparable to the administrative ruling category in tax that would include
Revenue Rulings and Revenue Procedures. See Reg S-X, 17 C.F.R. 210.4-01(a)(2) and
210.2-01(2005)

\textsuperscript{102} Accounting Series Release No. 150, [1937-1982 Accounting Series Release
1973).

\textsuperscript{103} See id.
U.S. GAAP because the SEC provided in ASR No. 4 that financial statements filed with the SEC and prepared with "no substantial authoritative support" are presumed to be misleading or inaccurate, even if there is footnote disclosure.\(^{104}\)

### Table 1. Major SEC Releases on Accounting and Auditing

<table>
<thead>
<tr>
<th>Source</th>
<th>Name of the SEC Release</th>
<th>Function</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRR</td>
<td>Financial Reporting Releases(^{105})</td>
<td>Updates the codification of financial reporting policies and regulations for SEC filings.</td>
</tr>
<tr>
<td>AAER (ER)</td>
<td>Accounting and Auditing Enforcement Releases</td>
<td>Discusses specific cases for SEC enforcement.</td>
</tr>
<tr>
<td>ASR</td>
<td>Accounting Series Releases(^{106})</td>
<td>Served two purposes as the predecessor source to both FRRs and AAERs. ASRs existed from 1937-1982.</td>
</tr>
<tr>
<td>LR</td>
<td>Litigation Releases</td>
<td>Describes SEC's cases in federal courts.</td>
</tr>
</tbody>
</table>

The SEC's position is that a public company's financial disclosure is sufficient only if there is substantial authoritative support; the position of the SEC was not previously expressed in its regulations, rules, or other official releases.\(^{107}\) In 2001, however, the SEC cautioned accounting professionals that compliance with the technical professional standards in U.S. GAAP may not be sufficient to communicate important information to the investors if "not accompanied by appropriate

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\(^{105}\) In 1982, the SEC created Financial Reporting Releases (FRR) which contains interpretive guidance by the SEC about financial reporting. See, e.g., Accounting Series Release, supra note 102.

\(^{106}\) From 1937 to 1982, the SEC issued 307 ASRs relating to accounting and auditing. About 200 of these ASRs adopted or amended accounting rules. Because GAAP has changed, much of the ASRs are no longer relevant. SEC Release, Release Nos. 33-6395, 34-18648, 35-22456 (April 15, 1982).

\(^{107}\) See, e.g., Accounting Series Release, supra note 102.
and clear analytical disclosures to facilitate understanding." As the U.S. courts have repeatedly stated, this SEC release suggests that compliance with the technical professional standards in U.S. GAAP are not enough. Instead, a professional must comply with the underlying intentions of the law and regulations for financial information.

There are additional SEC administrative materials that have no precedential value, but are still considered influential. The staff of the SEC publishes Staff Accounting Bulletins (SAB). SABs represent interpretations and practices followed by the SEC's Division of Corporate Finance and the SEC's Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws. A report prepared by the GAO (the General Accounting Office, now called the Government Accountability Office) noted that SABs, answers to "frequently asked questions," speeches, and letters by the SEC are useful sources to discover the SEC staff position used for enforcement of U.S. GAAP. Thus, even the SEC's informal position on accounting issues usually influences the entire accounting profession.

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108 SEC Release 33-8040, 34-45149 [2001 WL 1583348] (Dec. 12, 2001) ("[E]ven a technically accurate application of [U.S. GAAP] may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate an investor's understanding.").

109 In 2001, the SEC indicated that they intended to consider new rules to force more precise disclosure about accounting policies that are most critical to the portrayal of a company's financial condition. Id.


113 For example, Sarbanes-Oxley Act § 99, which discusses "materiality" and concludes the concept cannot be reduced to a numerical formula, had a major impact on the accounting profession and lead to a change in auditing standards. SEC SAB No. 99, 17 C.F.R. Part 211.
B. U.S. GAAP and Its Hierarchy

The responsibility to prepare a company’s financial statements rests with the company’s management. Public companies listed in the United States are required to use U.S. GAAP.\(^\text{114}\) U.S. GAAP is a “technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time.”\(^\text{115}\) U.S. GAAP, per se, does not include any SEC regulations, rules,\(^\text{116}\) or releases.\(^\text{117}\) As the U.S. Supreme Court has noted, “[U.S. GAAP] can tolerate a range of reasonable treatments, leaving the choice among alternatives to management.”\(^\text{118}\)

The SOX limits U.S. GAAP to accounting principles established by a standard setting body, which is organized primarily by a board that does not have a majority of CPAs, but does have procedures to consider emerging accounting issues and submits annual reports and audited financial statements.\(^\text{119}\) The SEC has delegated most of its authority to create accounting rules

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\(^{114}\) U.S. GAAP consists of accounting conventions by which financial information is recorded, attributed to particular periods, and summarily presented in the form of financial statements. AICPA, APB Statement No. 4 ¶ 31, 2 CCH APB Accounting Principles at 9065 (1971); see also James F. Strother, The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards, 28 VAND. L. REV. 201, 203 (1975).

\(^{115}\) American Institute of Certified Public Accountants, Statement on Auditing Standard No. 69 at 69.02 (1992), referenced by United States v. Arthur Young & Co., 435 U.S. 805, 811 (1984) (holding that respondent’s workpapers were relevant to petitioner’s investigation but reversed the part of the judgment which created an accountant-privilege), quoted by Sanders v. Jackson, 209 F.3d 998, 1001 n.3 (7th Cir. 2000) (affirmed because the term net worth, used to determine damages under the Fair Debt Collection Practices Act, was properly defined as book value and not fair market value).

\(^{116}\) “SEC rules in regulation S-X have an authority similar to “[accounting] pronouncements by [the] FASB for SEC registrants.” GAO REPORT, supra note 98, at 5-6.

\(^{117}\) In 2002, the FASB agreed to include references to related SEC literature in future editions of the FASB’s Current Text, a treatise which summarizes FASB authorities. See FASB.org, Action Alerts: Action Alert No. 02-03 (Jan. 16, 2002), http://www.fasb.org/action/aa011602.shtml.


to the FASB, for purposes of establishing U.S. GAAP.120

Currently, U.S. GAAP has five different levels of authority, all of which are required.121 The higher level authorities carry more weight; however, "[m]ore specific guidance at a lower level should be carefully considered even though more general guidance may exist at a higher level."122 In 2005, the FASB finally took ownership for the hierarchy in GAAP away from the auditors.123 The FASB has also indicated that it expects to reduce the hierarchy to two levels in the future.

The GAAP hierarchy has expanded over the years.124 U.S. GAAP consists of over 2,000 individual accounting and reporting pronouncements made by several organizations in a variety of formats.125 The sources for each GAAP level of authority for private sector accounting primarily come from the FASB and, to a lesser extent, the American Institute of Certified Public Accountant (AICPA). The FASB has continued to recognize

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123 AICPA's Statement of Auditing Standards (SAS) No. 69 was adopted by the PCAOB as part of its Interim Standards. AICPA's SAS No. 69; see supra note 122, at § 411. By redefining the audit phrase, the report "present[s] fairly in accordance with U.S. GAAP" to mean compliance with the sources in each level of the hierarchy, to the extent that the sources do not contradict rules in a higher level, SAS No. 69 effectively mandated all of the pronouncements in the U.S. GAAP hierarchy. Previously, only the first level of SAS 69 authorities was mandatory. Leonard C. Soffer, Compliance with Non-Rule 203 Pronouncements Before SAS No. 69: The Case of Accounting for Greenmail Payments, 7 ACC. HOR. 4 (Dec. 1993).

124 Prior to SAS No. 69, U.S. GAAP had four levels. Levels B and C were combined, but concern existed that it was not clear within the category, which authorities were stronger. See also James H. Thompson, The New U.S. GAAP Hierarchy, 38 THE NATIONAL PUBLIC ACCT. 18 (Oct. 1993). Cf. SAS 43.

125 The multitude of pronouncements for GAAP "results in inconsistent methods and different levels of details." FEI, FASB Chairman Herz Addresses NJ Chapter (Jan. 18, 2005), http://www.fei.org/news/FASB_1_18_2005.cfm.
some of the preceding authority from the AICPA.126 Also, until 2003, the AICPA continued to issue pronouncements for the lower levels of U.S. GAAP.127 The authorities within each level of U.S. GAAP are summarized in Table 2.

Table 2. U.S. GAAP Hierarchy and Authorities for the Private Sector

<table>
<thead>
<tr>
<th>Level</th>
<th>U.S. GAAP Authorities for the Private Sector</th>
</tr>
</thead>
</table>
| A     | FASB Statements of Financial Accounting Standards (SFAS)128  
       | AICPA Accounting Principles Board Opinions (APB Opinions) (1959-1973)129  
       | AICPA’s Accounting Research Bulletins (ARB) (1936-1959)130  
       | FASB Interpretations of existing SFAS, APB Opinions, and ARBs |
| B     | FASB Technical Bulletins (FTBs)  
       | AICPA Industry and Audit Guides (if cleared by the FASB)131  
       | AICPA Statements of Position (if cleared by the FASB)132 |

126 SAS No. 69 does not refer to the SEC or PCAOB, but “a body designated by the AICPA Council to establish such principles, pursuant to rule 203 of the AICPA Code of Professional Conduct.” SAS No. 69. These bodies were the FASAB (federal accounting), FASB, GASB (state and local accounting), and several AICPA committees and the AICPA’s ASB. See ACIPA, Council Resolution Designating Bodies to Promulgate Technical Standards, http://www.aicpa.org/about/code/et_appendixes.html (Appendix A to the AICPA Code). “Congress assigned the Comptroller General of the United States the responsibility of prescribing accounting principles to be used by executive agencies in developing their accounting systems.” Pierre L. Titan & Dean W. Di Gregorio, The Changing Landscape of Accounting Standards Setting, 73 THE CPA J. at 18 (Nov. 2003). The Comptroller General heads the U.S. GAO. See generally the Chief Financial Officers Act, Pub.L. No. 101-576, 104 Stat. 2838.


129 The AICPA’s APB issued 31 APB Opinions, 19 of which are still part of U.S. GAAP. Steven M. Bragg, ACCOUNTING REFERENCE DESKTOP 18 (2003).

130 The AICPA’s Committee on Accounting Procedures issued 51 ARBs, but the first 42 were consolidated in ARB 43. The ARBs were not based on significant academic research, but only committee members’ experience. See Knott & Rosenfeld, supra note 122, at 867.

131 AICPA Industry Guides provide guidance for particular industries, such as health care and banking.

132 In October 2002, the AICPA agreed to stop issuing SOPs. AICPA News Release, Nov. 5, 2002, cited in Knott & Rosenfeld, supra note 122, at 869 n.30.
<table>
<thead>
<tr>
<th>Level</th>
<th>Examples</th>
</tr>
</thead>
</table>
| C     | FASB’s Emerging Issues Task Force’s Consensus Opinions (EITF)<sup>133</sup>  
AICPA Practice Bulletins<sup>134</sup> |
| D     | AICPA Accounting Interpretations  
FASB’s Staff Positions (FSPs)<sup>135</sup>  
Industry practices widely recognized and prevalent in that industry |
| E     | All other accounting literature, including:  
FASB Statements of Financial Accounting Concepts<sup>136</sup>  
International Accounting Standards Board’s Standards  
Textbooks and journal articles |

The highest level of U.S. GAAP authority (Level A) consists of pronouncements from FASB and its predecessor authoritative accounting bodies, unless the FASB has amended or superseded them.<sup>137</sup>

The third-highest level of U.S. GAAP (Level C) consists of pronouncements needing to quickly address industry-specific issues for timely guidance. U.S. GAAP Level C issues are often so specialized that they are not otherwise addressed by sources in higher levels of authority.<sup>138</sup> Historically, only the first- and second-highest levels of U.S. GAAP authorities (Level B) consist

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<sup>133</sup> Starting in 2003, an EITF is effective only after ratification by the FASB at a public hearing. See, Robert H. Herz, Chairman, FASB, 24th Annual SEC and Financial Reporting Conference (June 2, 2005), http://www.fasb.org/SEC_FRI_24th_Conference.pdf.

<sup>134</sup> AICPA Practice Bulletins were issued by the AICPA Accounting Standards Executive Committee. The Practice Bulletins “provide guidance on selected narrow financial accounting and reporting issues.” David Herwitz and Matthew Barrett, Accounting for Lawyers, 140 (2d ed. 1997).

<sup>135</sup> FSPs are often written in question and answer format. They were previously known primarily as “Implementation Guides” by the FASB Staff. See Weirich, et al., Accounting and Auditing Research: Tools and Strategies 70 (6th ed. 2004). One reason to create the FSP’s was to publicly solicit comments on proposed staff issuances. See generally Herz, supra note 125.

<sup>136</sup> The FASB has released seven “Concepts.” “FASB has used the conceptual framework in SFAS’s in developing accounting standards, but . . . the framework is incomplete, internally inconsistent, and ambiguous.” Knott & Rosenfeld, supra note 122, at 874.

<sup>137</sup> See generally FASB, Current Text Accounting Standards (2001) (synthesizes GAAP Level A authorities and selected other ones).

of pronouncements created under a due process procedure for notice and comment from the public. However, in 2003, the FASB changed the process for the EITF such that their releases now require FASB approval.

The fourth level of U.S. GAAP (Level D) represents sources documenting practices that are widely recognized as prevalent in the industry. The FASB’s Chairman has noted that any AICPA issuances after Fall 2002 will fall in level D. The lowest level of U.S. GAAP (Level E) consists of all other accounting literature.

This lowest level is considered only in the absence of any source on point from the higher U.S. GAAP levels. Factors to consider in weighing a source within this category include its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority.\footnote{139}

C. Accounting Standards from the Historic Judicial Perspective

U.S. court decisions have increasingly relied upon accounting standards and other professional standards.\footnote{140} In the 1990s, about forty percent of U.S. Supreme Court cases cited to materials outside of legal authorities. The courts, however, have struggled as to the appropriate level of legal deference to give to U.S. GAAP. Few courts have distinguished among the GAAP hierarchy of authorities.

For example, in a 1996 case relating to financial facts,\footnote{141} the U.S. Supreme Court referenced several sources to understand and explain the accounting treatment. References included a SFAS and an APB Opinion from U.S. GAAP “Level A,” as well as various secondary authorities, only some of which would qualify as U.S. GAAP “Level E.”\footnote{142} Usually a court has not recognized any hierarchy in the value of these different materials; however, in

\footnote{139} Thompson, \textit{supra} note 127 at 18.


\footnote{142} The secondary authorities cited by the Supreme Court in the plurality opinion included a treatise on accounting, an accounting textbook, a dictionary on accounting, and three law review articles. \textit{Id.} at 850-56.
2003, the Court of Appeals for the Federal Circuit noted the existence of the professional GAAP hierarchy.143

Standards of care governing accountants’ legal liability are established by statutes, regulations, and case law. The legal standards are not dictated by the industry’s professional standards of care. Thus, professional standards without legal effect do not conclusively define the legal standard of accountability; however, professional standards are typically considered by a judge or jury to determine the appropriate standard of professional care, even though they are not controlling in the case.144

Usually, compliance with the professional standards of care is essential for an accountant’s defense. However, compliance may not be sufficient to avoid legal liability.145 The judicial system, through both government and private party lawsuits, also helps hold accountants responsible for their professional actions.146

For securities violations, the plaintiffs often allege a misrepresentation in the financial statements. The most commonly used securities violations are under Section 10(b)(5) of the 1934 Act.147 A plaintiff citing section 10(b) must prove that the auditing process was so deficient that the audit amounted to no audit at all. Alternatively, plaintiffs allege that the audit was an


146 The reasons for these lawsuits have included common law negligence, section 10(b)(5) of the Securities Act of 1934, state “blue sky” statutes, breach of contract, defamation, and other causes. See generally Constance Frisby Fain, Accountant Liability, 21 OHIO N.U.L. REV. 355 (1994).

147 A section 10(b)(5) securities violation requires the plaintiff to show (1) a misrepresentation, a false and misleading omission, or complete nondisclosure (2) of a material fact, (3) scienter, (4) reliance by the plaintiff, and (5) injury to the plaintiff. Often at issue in 10(b)(5) cases is whether scienter exists. “Scienter is a [state of mind] embracing intent to deceive, manipulate or defraud.” Aaron v. SEC, 446 U.S. 680, 686 n.5, quoted in SEC’s AAER No. 1412 [SEC Rel. 34-44460] (June 21, 2001), http://www.sec.gov/litigation/admin/34-44460.htm.
The egregious refusal to see the obvious or to investigate the doubtful. Another source of securities violation is if "the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." The Private Securities Litigation Reform Act of 1995 raised a plaintiff's burden of proof for a Section 10(b)(5) securities violation. The Act effectively requires most plaintiffs to reference appropriate U.S. GAAP authorities.

Sometimes the courts will look at the intent of accounting rules. For example, the U.S. Supreme Court, in the criminal case *United State v. Simon*, took the position that "the fair presentation standard of financial statement disclosure transcends the more technical requirement of compliance with U.S. GAAP." Thus, at least for legal purposes, accountants must consider legal principles and SEC sources for the review of financial statements, rather than just the profession's traditional U.S. GAAP authorities.

Accountants are sometimes called as expert witnesses to testify in court to explain U.S. GAAP. An accountant's testimony, like that of other expert witnesses, is subject to the U.S. Supreme Court's *Daubert* analysis to ensure the reliability and relevancy of expert testimony. Under the *Daubert* analysis a witness with

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148 *In re Software Toolworks, Inc.*, 50 F.3d 615, 628 (9th Cir. 1994) (quoting WOW II, 35 F.3d 1407, 1426 (9th Cir. 1994)).


150 The Private Securities Litigation Reform Act requires the plaintiff in a 10(b)(5) lawsuit to identify each statement alleged to be misleading and the reason each statement is misleading, thereby, essentially requiring reference to GAAP. *Id.* However, the appeals court said, "[a]llegations of U.S. GAAP violations are insufficient, standing alone, to raise an inference of scienter. Only where these allegations are coupled with evidence of corresponding fraudulent intent might they be sufficient." *K-Tel Int'l*, et al. v. *SEC*, 300 F.3d 881, 889 (8th Cir. 2002), *in accord with* DSAM Global Value Fund v. *Altris Software Inc.*, 288 F.3rd 385, 390 (9th Cir. 2002); *in accord with* City of Philadelphia v. Fleming Cos., Inc., 264 F.3d 1245, 1261 (10th Cir. 2001).

151 United States v. Simon, 425 F.2d 796 (2d Cir. 1969) (affirming because the evidence was sufficient for submission to the jury and no legal errors were committed).

152 *Id.* at 805.

153 See *Kumho Tire Co. v. Charmichael*, 526 U.S. 137, 149 (1999) (extended the *Daubert* analysis to testimony based on technical or specialized knowledge).

expert knowledge, skill, experience, training, or education, may testify if (1) the testimony is based on sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the expert witness has applied the principles and methods reliably to the facts of the case. However, even professional accounting experts can disagree on the appropriate accounting treatment and sometimes do so in court.

According to the Ninth Circuit Court of Appeals in 2002, it is an open question "whether a U.S. GAAP violation makes financial disclosure misleading per se is an open question." Courts have noted that a showing of sub-standard accounting practices is circumstantial evidence that can support an inference of bad faith for a Sec.10 (b) claim. The sub-standard accounting practices should suggest the representation was so flimsy that there was no genuine belief in the accounting position taken.

155 Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Proposed Amendments to the Federal Rules of Evidence, Rule 702, http://www.uscourts.gov/rules.index.htm. The Daubert test is not much of an obstacle for Certified Public Accountants (CPAs) to surpass. If the accountant is knowledgeable about the facts needed for the accounting, the accountant meets the first prong of the Daubert test. The second prong is met because there are recognized sources of accepted accounting authority and a recognized hierarchy of U.S. GAAP to show reliable principles and methods. The third prong is met if the underlying subject for the CPA's testimony is based on a substantive accounting issue, which the CPA is knowledgeable about so as to apply the U.S. GAAP. If the CPA is also applying methodologies from other disciplines (such as actuarial valuations), the standards of both disciplines must apply. See Sofia Adrogue & Alan Ratliff, Kicking the Tires After Kumho: The Bottom Line on Admitting Financial Expert Testimony, 37 Hous. L. Rev. 431, 451-52 (2000).


At trial, an accounting-fraud defendant may offer expert testimony that his accounting judgments were within U.S. GAAP, or that U.S. GAAP was immaterial. This expert testimony may present unique challenges. Although the government may present its own expert testimony, this may leave a lay jury with the wrong impression that the case is about a debate within the accounting profession, not criminal wrongdoing.

157 Stanley Peltz v. Polyphase Corp et al., 36 F. Appx. 316, FED. SEC. L. REP. P91,924 (2002) (court affirmed summary judgment because the required scienter for a 10(b)(5) claim was not established).
D. FASB’s Origins and Revised Powers After the Sarbanes Oxley Act

In 1938, the SEC voted to rely on the public accounting profession to lead in developing standards in the private sector, while having the SEC retain an oversight function and final authority. Until 1973, the American Association of Certified Public Accountants (AICPA), a private sector trade association for certified public accountants, set the professional accounting standards. In 1973, the SEC updated its policy statement to recognize that the Financial Accounting Standards Board (FASB) would be the primary source for U.S. GAAP. The SEC recognized that the principles, standards, and practices issued by the FASB in its Statements and Interpretations would have “substantial authoritative support.” The SEC would also accept the pronouncements of FASB’s predecessor bodies, unless the positions were amended or superseded by the FASB. In 1980, the SEC noted that while the SEC may conclude that it cannot accept a FASB standard in a particular area, such events are rare.

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158 SEC’s vote to delegate authority was supported by only three of the five SEC commission members. Tracey N. Tucker, It Really Is Just Trying to Help: The History of the FASB and its Role in Modern Accounting Practices, 28 N.C. J. INT’L L. & COM. REG. 1023, 1024 (2003). One commentator explains the decision as follows: “People have a natural tendency to belittle expertise that they do not possess. The SEC has been composed primarily of lawyers. Lawyers do not want to be bothered by accounting, which they view as merely ‘technical.’ Hence the SEC has been willing to leave accounting to the accountants.” George Mundstock, The Trouble With FASB, 28 NC. J. INT’L L. & COM. REG. 813, 827 (2003).

159 “The first private sector body to assume the task of setting accounting standards was the Committee on Accounting Procedure (CAP). The CAP was a committee of the American Institute of Accountants (AIA). The AIA was renamed the AICPA in 1957... In 1959 the Accounting Principles Board (APB replaced the CAP). Members of the APB also belonged to the AICPA.” J. DAVID SPICEL AND ET AL., INTERMEDIATE ACCOUNTING 10 (3d ed. 2004).


161 Id.

162 Id.

163 “[T]he SEC’s accounting staff can place matters on the FASB’s agenda, raise
In 2003, the SEC reaffirmed the status of the FASB as a "Private Sector Standard Setter."¹⁶⁴ In that release the SEC remarkably noted that "[t]his policy statement is not an agency rule requiring notice of proposed rulemaking, opportunities for public participation, and prior publication under the provisions of the APA."¹⁶⁵ Even so, the reality in the post-SOX era, as noted by the chairman of the FASB, is that the FASB's "process of working closely with the PCAOB and SEC provides feedback on whether [accounting] standards are understood and working as intended."¹⁶⁶

The mission of the FASB is "to establish and improve standards of financial accounting and reporting . . . ."¹⁶⁷ The FASB describes itself as an independent private-sector organization.¹⁶⁸ The chairman of the FASB explains, "We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission – to establish and improve standards of financial accounting and reporting for both public and private enterprises . . . ."¹⁶⁹

¹⁶⁵ Id.
¹⁶⁹ See Commerce, Trade, and Consumer Protection Subcomm of the Comm. on
The FASB explains its structure as "independent of all other business and professional organizations." However, the FASB has a parent entity, the Financial Accounting Foundation (FAF), a not-for-profit board that also oversees the Government Accounting Standards Board (GASB). The FAF's oversight allows the FASB to meet the requirements under SOX that any accounting principles must be established by a standard setting body organized primarily by a board that does not have a majority of CPAs. Also, the organization must have procedures to consider emerging accounting issues and changing business practices and to maintain high quality accounting standards.

The FASB claims to use extensive due process in acquiring public input before it issues a FASB statement. The FASB explains on its website that "[a]ctions of the FASB have an impact on many organizations within the Board's large and diverse constituency . . . . This process was modeled on the Federal APA and, in several respects, is more demanding." FASB Board meetings and its EITF meetings for emerging issues are open to the public. "The Chief Accountant of the SEC attends EITF meetings regularly as an observer with the privilege of the floor."

Historically, the FASB's historically slow pace in setting and revising accounting standards was a problem. The FASB has addressed this problem by reducing the vote required to enact a

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171 See id. The Financial Accounting Foundation (FAF) has a Board of Trustees made up of various industry organizations having an interest in financial reporting. FAF's Board is chaired by Paul Volcker. Id.

172 See Securities Act of 1933 § 19(b); Sarbanes-Oxley Act § 108(b), 15 USC § 78.

173 The FASB's predecessor AICPA also claimed to follow a due process for public notice and comment. The AICPA's process typically involved identifying the need; researching current practice, existing literature, and alternative approaches; analyzing and deliberating; issuing a draft exposure before issuing the final pronouncement; and then following up on implementation and application questions. AICPA.org, More About the Audit and Attest Standards, http://www.aicpa.org/members/div/auditstd/about.htm.


standard with majority approval, acquiring more budgetary funds (post-SOX), and in stating a "Process Effectiveness Initiative" in order to respond in a more timely fashion. Quick response by the FASB is important, because accounting regulators and standard setters must respond quickly to close new loopholes in accounting. By comparison, Congress needs to close new tax loopholes every few years.

The FASB has also decided to establish less detailed accounting standards in the future by using the SEC's suggestion of "objectives-oriented" standards, which offer a balance between the rules-based and principles-based approaches to setting accounting standards. The objectives-oriented standards should have a clearly defined scope, minimal exceptions, and few bright-line tests, but sufficient implementation guidance. The FASB now refers to its object-oriented approach as "principles-

176 See Tara L. McKenna, Improving the Effectiveness of the FASB's Process, FASB REPORT (Aug. 29, 2003).


179 When FASB was formed, a rules-based approach to accounting standard setting was created because of dissatisfaction with the existing principles-based standards. Furthermore, the SEC noted in a prior release examining international accounting standards that the U.S. experience with less detailed standards "was not favorable." International Accounting Standards Exchange Act Release No. 33-7801, 34-42430 (Feb. 16, 2001) (citing AICPA, The Report of the Wheat Commission, Establishing Financial Accounting Standards, A Report on the Study on Establishment of Accounting Principles, at 38 (March 1972)).

180 Advocates for the principles-based approach to accounting standard setting imagine that streamlining the details in the standard would make accounting practitioners and corporate management focus on conforming to the spirit of the rules. Also, most of the world uses a principles-based approach to accounting standards. The advocates for a principles-based approach believe that the rules-based approach encouraged accountants to search for loopholes in the rules. Id.

based.”

The FASB is also expected to codify a substantial portion of U.S. GAAP from various sources to simplify the process for financial accounting research. Codification arose in part because of the challenges and complexities facing current professional accounting research. The FASB surveyed accountants in 2004 and discovered that less than ten percent considered the structure of GAAP as understandable. Most accountants were uncomfortable with research results under normal operating conditions and almost twenty percent felt uncomfortable with research results even when they had unlimited research time.

In the early 2000s, the FASB was operating at a substantial deficit. Even so, the FASB continued to generously compensate its seven board members paying them about a half-million dollars each. The FASB derived a substantial, but declining, amount of its revenues from selling its publications containing the accounting standards. This publication revenue may explain why the FASB has not widely allowed other publishers to disseminate the FASB’s other accounting authorities. In 2003, however, the FASB started to publish its SFASs on its website. SFASs represent only part of “Level A” of U.S. GAAP authorities. The FASB

183 See Project Updates: Codification and Simplification Efforts FASB, http://www.fasb.org/project/c&s_efforts.shtml.
184 See Sarbanes-Oxley Act § 108(d); see also FASB, FASB Board Meeting Handout (Sept. 25, 2002), http://www.fasb.org/board_handouts/index.shtml.
185 Herz, 24th SEC Conf., supra note 133, at 5.
186 See FAF 2003 ANNUAL REPORT, at 29, http://www.fasb.org. “FAF’s annual reports indicate an operating deficit of $4.3 million in 2002 and $1.1 million in 2001. FAF has incurred operating deficits for the past five years because contributions and publication sales have not kept pace with expenses.” J. Richard Williams, Funding FASB: Public Money, Public Domain, 74 THE CPA J. at 9 (May 2004). FAF’s $18 million endowment, however, could sustain operations for a few more years. Id.
187 The FASB’s members’ annual salary is $452,000. The FASB chairman is paid $560,000. See generally PCAOB Proposes Rules to Collect Fees From Public Companies to Fund Budget, 3 PENSION & BENEFITS 50 (Mar. 17, 2003).
189 See CURRENT TEXT ACCOUNTING STANDARDS, supra note 128.
has gradually added more sources since that time. Thus, beyond SFAS, FASB Interpretations, and SEC sources, U.S. private sector accounting sources on the Web and in commercial databases are generally limited to summaries.\textsuperscript{190}

In 2003, the FASB began to receive substantial funds which are legislatively dictated through a fee on public companies.\textsuperscript{191} The SOX directs the SEC to provide guaranteed funding to the FASB, as well as the PCAOB, in order to protect the organizations' "independence" from accounting firms or companies whose financial statements must conform to the FASB rules.\textsuperscript{192}

The FASB has a permanent staff of almost seventy professionals drawn from public accounting, industry, academia, and government, along with support personnel.\textsuperscript{193} Critiques have described the FASB as "a textbook bureaucracy."\textsuperscript{194} The FASB has placed a genuine interest on its own existence rather than fulfilling its mission, \textsuperscript{195} and has bowed to various pressures in establishing accounting standards.\textsuperscript{196}

\section*{E. Consequences If the APA and FOIA Apply to the FASB}

Determination of "agency" status for the FASB is most

\begin{itemize}
  \item Finding accounting authorities is best done using the FASB's Financial Accounting Reporting System (FARS). See generally Herz, supra note 133. The FARS database, however, does not include any SEC authorities. RIA's Financial Reporting Database in RIA's Checkpoint database and divides FASB materials separately from SEC materials. The RIA database divides SEC materials into SEC compliance and a SEC reference library on statutory laws that include the major securities legislation. Other databases, such as LEXIS, also provides selected information on financial sources. Because accounting standards are often long, many accounting professionals rely primarily on a leading treatise on U.S. GAAP, such as HBJ's MILLER ON U.S. GAAP.
  \item See FASB.org, supra note 170. Previously, the FASB had a staff of about 40 professionals. See FAF 2003 ANNUAL REPORT, supra note 186, at 6.
  \item \textit{Id.}
  \item See William Beaver, \textit{What Have We Learned From the Recent Corporate Scandals That We Did Not Already Know?} 8 STAN. J. L. BUS. & FIN. 155, 164 (2002).
\end{itemize}
important in determining the legal standing of the FASB’s various accounting authorities. For the purpose of illustration, assume that—since it has increased federal funding from the mandated fees it recovers from public companies—the FASB is an agency under the APA. The next issue is to determine the legal effect of the FASB authorities. Various parts of U.S. GAAP would have different legal equivalencies, whether as regulations, interpretive authorities or merely influences.\footnote{197}{See FASB.org, \textit{supra} note 170.}

The GAO has elevated an SEC regulation to the status of a FASB Standard.\footnote{198}{See GAO Report, \textit{supra} note 98.} It is more important, however, to determine the opposite relationship by which FASB authorities should receive the same deference as an SEC regulation.\footnote{199}{In determining the level of deference a court should give to an agency’s interpretation of a statute, the U.S. Supreme Court has created a two-prong analysis. First, if Congress expresses a clear intent on the precise question at issue, then the court must give effect to unambiguously expressed intent of Congress. Secondly, if the statute is silent or ambiguous, then the court must defer to the agency’s interpretation, unless it is unreasonable. \textit{See} Chevron v. Natural Resources Defense Council, 467 U.S. 837, 842-43 (1984).} If the APA applies to the FASB, one would expect U.S. GAAP’s “Level A” to qualify as a regulation. The GAO’s interpretation seems to support this line of thinking. Also, the FASB standards arise from an authoritative body that followed due process in issuing an exposure draft to acquire public input. The FASB’s process has resembled the APA’s process of public notice and comment employed before a regulation is finalized.\footnote{200}{The FASB’s due process for public input is similar to the way that the IRS issues a Proposed Regulation before it becomes a regulation, or the way that the SEC issues concept releases and rule proposals before rule adoption.}

Similar to the historic judicial treatment of regulations, in determining the appropriate accounting treatment, courts have shown strong deference to GAAP “Level A” FASB’s Statements.\footnote{201}{\textit{See} Delaney, \textit{supra} note 129 at 3.} Any deviation from the designated accounting rulemaking body would require an auditor to either qualify an opinion or to explain in the audit report the reasons and effects of the departure.\footnote{202}{\textit{See} id.} This disclosure requirement is somewhat similar
to the requirement of clear disclosure when a taxpayer.\textsuperscript{203}

SOX's elimination of self-regulation for the accounting profession has made U.S. GAAP's reliance on the AICPA's pronouncements inappropriate prior to the creation of FASB in 1973. Therefore, the FASB should have made it a priority to restate the AICPA's materials as FASB pronouncements. The AICPA's issuances, such as ARB's and APB Opinions, should not have relevance. Otherwise, there is a substantial issue as to whether the AICPA's materials in U.S. GAAP "Level A" should qualify as regulations.

U.S. GAAP's Levels B and C belong in the legal framework as "interpretations" equivalent to SEC rulings. Departures from accounting positions in this interpretations category would require accountants and auditors to document and justify their positions with great detail.\textsuperscript{204} Thus, a public company must follow these interpretative pronouncements, unless supported by reasoning from a higher level of legal authority.

A hierarchy of authorities helps to resolve potential conflict. For instance, a hierarchy of judicial authority exists by the level of the courts. Similarly, a hierarchy can and should exist within the interpretative category of accounting pronouncements to clarify their priorities. Consider Level C's Consensus Positions of the FASB's Emerging Issues Task Force, which provides a brief exposure to the public before issuance in order to resolve problems quickly that would otherwise result in widespread divergent practices.\textsuperscript{205} The consensus opinions should continue to take priority over Level D's FASB's Staff Positions, which do not provide an opportunity for public comment.\textsuperscript{206}

U.S. GAAP authorities can also have an influential effect when no other authorities exist on the issue.\textsuperscript{207} The influential effect is illustrated by Level D's inclusion of widely recognized

\footnotesize{\textsuperscript{203} See generally id.}
\footnotesize{\textsuperscript{204} Id.}
\footnotesize{\textsuperscript{205} See id. at 6.}
\footnotesize{\textsuperscript{206} The analogy is that while IRS revenue agents must follow revenue rulings and revenue procedures, other administrative authorities issued to specific taxpayers provide no precedential value, but are often influential. See ABA, ABA Section of Taxation Report on the Task Force on Judicial Deference, 104 TAX NOTES 1231, 1237-39 (2004).}
\footnotesize{\textsuperscript{207} Id.}
industry practices and the sources in U.S. GAAP's Level E.\textsuperscript{208} Such lower level authorities are best classified as "non-primary authorities."\textsuperscript{209} The authorities in Levels D and E should not serve as legal precedent.\textsuperscript{210} The FASB could better guide the profession and the courts on its authorities.\textsuperscript{211} This may also provide more influence for a court to use the highest authorities from GASB, the sister organization of the FASB, or from the IASB for International Accounting Standards.\textsuperscript{212} The FASB could also encourage universities to teach professional accounting research and judgment, rather than just memorization of existing standards.\textsuperscript{213}

The process of organizing accounting sources according to their legal status could also help force a higher quality review of U.S. GAAP.\textsuperscript{214} Such a review could help determine whether to elevate selected accounting sources to a higher level of accounting authority.\textsuperscript{215} Instead, it appears that the FASB is focused on combining all of its authorities in a more simplistic handbook of principles.\textsuperscript{216} This forthcoming FASB handbook also appears as part of an effort to converge accounting authorities with those of the EU and other international accounting authorities.\textsuperscript{217}

\textsuperscript{208} Id.
\textsuperscript{209} Id.
\textsuperscript{210} Id.
\textsuperscript{211} ABA, supra note 206.
\textsuperscript{212} Id.
\textsuperscript{213} Id.
\textsuperscript{214} Id.
\textsuperscript{215} For instance, the FASB's Concept Statements were probably placed in Level E because procedurally FASB did not issue them for public review. Given the general importance of the FASB Concept Statements, the FASB should probably give the concepts a public hearing and then elevate their status in U.S. GAAP to qualify as an "interpretive statement." Similarly, the FASB's EITF consensus opinions were elevated in SAS No. 69. See James H. Thompson, The New U.S. GAAP Hierarchy, 38 THE NAT'L PUB. ACCT. 18 (Oct. 1993).
\textsuperscript{216} Id.
\textsuperscript{217} See Memorandum of Understanding, FASB and International Accounting Standards Board (IASB), http://www.fasb.org/intl/convergence_iasb.shtml [hereinafter FASB, Convergence Agreement]. The Convergence Agreement provides that the FASB and IASB will use their best efforts to make the standards as fully compatible as soon as practical, as well as work together thereafter to maintain the compatibility. Id.
Even if the FASB is not an agency, the FASB Statements are treated by many courts with almost the same deference applied to regulations. This may arise because the FASB’s Statements are derived from an authoritative body that follows a process that resembles the APA’s requirement of public notice and comment before a regulation is finalized. The courts generally provide substantial deference to the agency authority, unless that authority is unreasonable. The courts should at least clarify whether the quasi-legal status extends to lower-level GAAP authorities. The more appropriate division is probably to recognize the part of GAAP which has gone through the FASB’s sixty day notice and comment process.

The FASB has attempted to show that it is meeting the intent of the APA and FOIA without admitting that it is subject to these laws. In 2002, the FASB began to publish its Statements on its website, but they are only part of U.S. GAAP “Level A” authorities. If the FASB was an agency under the APA, it would probably need to release the first four levels of U.S. GAAP and perhaps explain or eliminate the last level of U.S. GAAP. Perhaps the FASB is preparing for the possibility of such a status, through its three-to-five year codification of accounting authorities project. Indeed, U.S. GAAP may change in a few years due to the codification project. However, some might then envision switching to International Accounting Standards in order to avoid political interference and to ensure public accountability.

F. Application of the APA to the FASB

From a legal perspective, SOX has significantly enhanced the possibility that the FASB now qualifies as an “agency.” The FASB’s characteristics and powers after SOX provide the factual basis needed in order to examine whether the APA applies to the

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218 Id.
219 Id.
220 See FASB, Project Update, supra note 183.
FASB. The resulting consequences are significant, both for the FASB and the public, as to whether and which of the FASB’s accounting issuances have formal legal status and which should be supplied under particular circumstances.

A functional analysis of the FASB’s legal authority to perform the decision-making functions of a federal agency would suggest that the accounting standards used for some securities and tax law purposes qualify as a government function. In determining whether the APA applies to the FASB, a major factor is the extent of the federal government’s supervision of the FASB. The sufficiency of the requirement that the FASB report and extensively consult with the SEC is unclear, given that Congress has threatened to overturn particular standards of the FASB. However, the FASB probably has enough detailed oversight to qualify as an agency.

The FASB qualifies as an agency for the same reason that the Court of Appeals for the District of Columbia Circuit affirmed the decision that the CASB was an agency. The FASB, like the CASB, is “independent of the Executive Department.” Both the FASB and the CASB have authority to promulgate, amend, and rescind a type of accounting standards, but neither has to submit its standards to another government agency for approval. However, the SEC could adopt a provision that overrides the FASB accounting treatment on a particular matter. Perhaps the only major difference is while the CASB originally published its regulations citing FOIA as authority, the FASB has consistently claimed that it was not covered by the APA and FOIA. While making this claim, the FASB attempts to “cherry-pick” the parts of the APA and FOIA that it wants to apply.

224 See id.
225 Rocap, 539 F.2d at 174.
226 The FASB defines its public record as “transcripts of public hearings, letters of comment and position papers, research reports, and other relevant materials on projects leading to issuance of pronouncements.” The FASB provides this information for inspection in a public reading room at FASB offices. FASB, FASB Facts: How Topics Are Added to the FASB’s Technical Agenda 5, http://www.fasb.org/facts/tech_agenda.shtml.
The FASB and the FHLMC share many characteristics of other quasi-federal entities intended to be included within the "government-controlled corporation" language of the FOIA. The fact that SOX states that the FASB is a not-for-profit corporation is not significantly different from the legislative history of the 1974 amendments to FOIA. This history shows that Congress intended to extend the FOIA to certain hybrid governmental and private entities.\footnote{See Freedom of Information Act, Pub. L. No. 93-502, 88 Stat. 1561 (1974) (subsequently amended), \textit{reprinted in} Rocap, 539 F.2d at 176.}

The FASB is similar to various other financial institutions having strong government connections such as the OMB that are classified as agencies for purposes of the FOIA. Both organizations are permanent, have significant staff, and possess broadly delegated powers.\footnote{See Meyer v. Bush, 981 F.2d 1288, 1294 (D.C. Cir. 1993).}

The federal government’s involvement in the FASB,\footnote{The FASB does not make voluntary recommendations to a federal agency. However, the FASB claims to interact closely with the SEC. This close interaction distinguishes the FASB from the scientific panel’s work for the Federal Drug Administration which was not held as an agency in Ciba-Geigy Corp. v. Mathews, 428 F. Supp. 523, 528 (S.D.N.Y. 1977).} such as financing the post-SOX FASB goes beyond protecting the government’s investment. This distinguishes the FASB from Consolidated Rail which was not an agency.\footnote{See Railway Labor Executives Ass’n v. Consol. Rail Corp., 580 F. Supp. 777 (D.D.C. 1984).}

The critical question is whether the FASB “has any authority in law to make decisions.”\footnote{Washington Research Project v. Dep’t of Health, Education, and Welfare, 504 F.2d 238, 248 (D.C. Cir. 1974).} It is possible for courts to hold that not-for-profit entities that perform government functions, like the FASB, qualify as agencies.\footnote{The FASB provides a stronger case as an agency for purposes of the FOIA than the Smithsonian because the FASB performs a rule-making function. Dong v. Smithsonian Inst., 125 F.3d 877 (D.C. Cir. 1997), \textit{cert. denied}, 524 U.S. 922 (1998).}

IV. Auditing and the Public Company Accounting Oversight Board (PCAOB)

The U.S. Supreme Court summarized the important legal role
of auditing in 1984 in *U.S. v. Arthur Young*:233

[SEC] regulations stipulate that these financial reports must be audited by an independent certified public accountant [CPA] in accordance with [GAAS]. By examining the corporation’s books and records, the independent auditor determines whether the financial reports of the corporation have been prepared in accordance with [GAAP]. The auditor then issues an opinion as to whether the financial statements, taken as a whole, fairly present the financial position and operations of the corporation for the relevant period.234

As part of SOX, Congress expanded the auditor’s role beyond the traditional audit opinion of the financial statements. Auditors of public companies must also issue a new second required audit related to management’s representation of the company’s internal controls.235

SOX changed the auditing profession in various ways. It is now illegal for directors, officers, and others under their direction to mislead or coerce auditors.236 Also, SOX created the PCAOB with the power to regulate the industry through registration237 and the issuance of auditing and other related authorities.238 The PCAOB’s characteristics and powers provide the factual basis needed before examining whether the APA applies to the PCAOB. The resulting consequences are significant for the PCAOB, the accounting profession, the legal profession, and the public.


234 Id. at 811.

235 See Sarbanes-Oxley Act § 404. Companies must include the auditor’s report on management’s assessment of the effectiveness of the company’s internal controls in their annual report filed with the SEC. See Public Company Accounting Oversight Board, Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (June 17, 2004).

236 See Sarbanes-Oxley Act § 303(a); 17 C.F.R. § 240.13b2-2.

237 See Sarbanes-Oxley Act § 102.

238 See Sarbanes-Oxley Act § 103(a). PCAOB has approved a package of “Auditing and Related Professional Standards” (Rule 3100), which consists of Interim Auditing Standards (Rule 3200T), Interim Attestation Standards (Rule 3300T), Interim Quality Control Standards (Rule 3400T), Interim Ethics Standards (Rule 3500T), Interim Independence Standards (Rule 3600T), and related professional areas. See PCAOB Rule 3100; SEC Rel 34-48730 (Oct. 31, 2003).
A. PCAOB's Characteristics and Powers from SOX

A need existed for strong governmental oversight of financial reporting, as explained by the Chair of the “2000 Panel on Audit Effectiveness”\textsuperscript{239} in testimony before Congress:

The profession’s combination of public oversight and voluntary self-regulation is extensive, Byzantine, and insufficient. The Panel found that the current system of governance lacks sufficient public representation, suffers from divergent views among its members as to the profession’s priorities, implements a disciplinary system that is slow and ineffective, lacks efficient communication among its various entities and with the SEC, and lacks unified leadership and oversight.\textsuperscript{240}

The desired characteristics for the PCAOB were explained by a former chairman of the SEC, Arthur Levitt. He wanted “a truly independent oversight body that has the power not only to set the standards by which audits are performed, but also to conduct timely investigations that cannot be deferred for any reason and to discipline accountants.”\textsuperscript{241} Independence was needed particularly from the accounting firms that audited public companies.\textsuperscript{242}

SOX established the PCAOB “to oversee the audit of public companies that are subject to the U.S. securities laws.”\textsuperscript{243} This oversight could protect and further the public interest in the

\textsuperscript{239} The Panel on Audit Effectiveness was an \textit{ad hoc} committee of the Public Oversight Board (POB). The POB:

was composed of five non-CPA public members with business, legal, legislative, and/or regulatory experience. It also had a professional staff and was funded through the AICPA. However, this structure [of the POB] was criticized as not being sufficiently aggressive in disciplinary cases. After the Enron situation was discovered, SEC Chairman Harvey Pitt proposed the creation of a new public regulatory structure. Angry at not being consulted in advance consultation, the POB voted to dissolve, and did so on May 1, 2002.


\textsuperscript{241} \textit{Id.} at 10 (Testimony of Arthur Levitt, former Chairman of the SEC).

\textsuperscript{242} \textit{See} John, \textit{supra} note 239, at 3.

\textsuperscript{243} \textit{Id.}
preparation of informative, accurate, and independent audit reports for companies whose securities are sold to, and held by and for, public investors.\textsuperscript{244} PCAOB is a corporation that is treated as a "self-regulatory agency."\textsuperscript{245} The PCAOB describes itself as "a private-sector, non-profit corporation created by [SOX], to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports."\textsuperscript{246}

The PCAOB has significant responsibilities.\textsuperscript{247} Public accounting firms that prepare audit reports for public companies must register with the PCAOB,\textsuperscript{248} including European and other foreign accounting firms.\textsuperscript{249} The PCAOB has the authority to enact rules governing accounting firms and investigations of them.\textsuperscript{250} Furthermore, the PCAOB can force accounting firms or companies to provide documents or testimony and impose sanctions on non-complying firms that range from suspension to multi-million dollar fines.\textsuperscript{251}

The PCAOB also regularly conducts periodic reviews of accounting firms’ quality controls for their accounting and auditing practices to determine their compliance with U.S. GAAP and the Standards of the PCAOB.\textsuperscript{252} The PCAOB annually

\textsuperscript{244} Sarbanes-Oxley Act § 101(a), 15 U.S.C. § 7211(a).
\textsuperscript{245} A proposed amendment to Sarbanes-Oxley Act considered by the H.R. Banking Committee would have named the PCAOB, the "Public Accounting Regulatory Board." This amendment failed by only one recorded vote (25 to 26). Summary of Comm. Rep. 107-414, TECHPOLITICS, (Apr. 22, 2002), http://www.techpolitics.org/hr3763/3763commvotes.htm.
\textsuperscript{252} Sarbanes-Oxley Act § 101(c), 15 U.S.C. § 7211. The PCAOB is the 2003 replacement terminology for GAAS. Interpretation: Commission Guidance Regarding the Public Company Accounting Oversight Board’s Auditing and Related Professional Practice Standard No. 1, SEC Release Nos. 33-8422; 34-49708; FR-73; 17 CFR parts
inspects every large accounting firm, while other registered accounting firms are reviewed every three years.

After the PCAOB adopts a proposed auditing or related "professional practice standard" it must then submit it to the SEC for its stamp of approval. For example, in an SEC release, the SEC approved the interim auditing standards adopted by the PCAOB. The PCAOB is subject to SEC oversight and review to assure that the [PCAOB] Board's policies are consistent with the administration of the federal securities laws, and to protect the rights of accounting firms and individuals subject to the [PCAOB] Board's jurisdiction. Oversight also allows the public an important forum for commenting on [PCAOB] Board rules relating to auditing, quality control, and related standards.

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256 See Sarbanes-Oxley Act § 107(b)(2).


The PCAOB itself, however, has not provided notice in the *Federal Register*.

The PCAOB, similar to the FASB, is indirectly publicly funded through “accounting support fees” paid by public companies. SOX directs the SEC to provide guaranteed funding to the PCAOB. The PCAOB’s budget is then subject to approval by the SEC. PCAOB has a considerable sized staff exceeding 200 professionals who are auditors, analysts, attorneys, and others.

The governing board of PCAOB consists of five members appointed by the SEC, only two of whom can have a background as an accountant or an auditor. PCAOB’s governing board set the compensation for its members and decided to pay them the same lavish half-million dollar salaries as provided for the FASB Board members. Critiques note that the “PCAOB has

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259 1934 Act § 13(b)(2), Sarbanes-Oxley Act § 109(h).


263 Sarbanes-Oxley Act § 101(g) (provides for rules of the board). The Committee Report explains that the PCAOB “is to provide for staff salaries that are fully competitive with those for comparable private sector, self-regulatory, accounting, technical, supervisory, or related staff or management positions.” Public Company Accounting Reform and Investor Protection Act of 2002, S.Rep 107th Cong. 7 (2002).
a funding pipeline directly to all public companies, with no congressional appropriators involved."\textsuperscript{264} This makes it easy for the SEC to offload projects onto the PCAOB.

\textbf{B. Auditing Authorities from the PCAOB}

The second most important line of defense against financial fraud after considering the effectiveness of a company’s internal controls,\textsuperscript{265} is auditing by independent third parties.\textsuperscript{266} In 2003, the PCAOB issued interim standards for auditing, which essentially used prior GAAS authorities previously established by the AICPA.\textsuperscript{267} The PCAOB issued its first standard to replace GAAS with references in the auditors’ reports to the “Standards of the PCAOB (U.S.).”\textsuperscript{268} Thus, auditing authorities, even under the PCAOB’s Interim Standards, follow the GAAS hierarchy issued by the AICPA in 2002 shown in Table 3.\textsuperscript{269}

\textsuperscript{264} Wallison, \textit{supra} note 261, at 4.

\textsuperscript{265} Internal Controls were first required in the Foreign Corrupt Practices Act. See generally ABA Comm. on Corporate Law and Accounting, \textit{A Guide to the New Section 13(b)(2) of the Accounting Requirements of the Securities Act of 1934 (Foreign Corrupt Practices Act of 1977 § 102), 34 Bus. Law. 307 (1978-1979).} The requirement for internal controls was strengthened in Sarbanes-Oxley Act.

\textsuperscript{266} Two additional lines of defense are government oversight and law enforcement. The conceptual framework for lines of defense is provided in Commission of the European Communities, \textit{Communication from the Commission to the Council and the European Parliament on Preventing andCombating Corporate and Financial Malpractice, COM 611 (2004), http://europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0611en01.pdf.} Audit practices regulated by the PCAOB are inextricably linked to the tax activities overseen by the IRS, according to the IRS Commissioner. He has suggested that the IRS could provide valuable information to the PCAOB. See Allen Kenney, \textit{Year in Review: Everson Evaluates State of IRS, Pledges Strong Agenda for 2005, 106 Tax Notes 40, 45 (2005).}


Table 3. GAAS Hierarchy for the Private Sector (adopted by PCAOB)

<table>
<thead>
<tr>
<th>Level</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1</td>
<td>The ten General, Fieldwork, and Reporting Standards(^{270}) and Statements on Auditing Standards (SASs) (issued by the Auditing Standards Board).</td>
</tr>
<tr>
<td>Level 2</td>
<td>Auditing Interpretations (issued by the AICPA Audit Issues Task Force)(^{271})</td>
</tr>
<tr>
<td>Level 3</td>
<td>Other auditing publications(^{272})</td>
</tr>
</tbody>
</table>

Auditors are still required to follow the first two levels of the GAAS hierarchy.\(^{273}\) Other auditing publications comprising the third level have no authoritative status, but may provide guidance.

\(^{270}\) The ten auditing standards include: (1) standards relating to auditor qualifications (the general standards); (2) standards relating to the conduct of an audit (fieldwork standards); and (3) standards regarding the audit report (reporting standards). These ten standards provide the framework for organizing most of the other authorities in the first two levels of the GAAS hierarchy in a codification. Thus, AICPA's Professional Standards series are divided into various "AU" sections, and GAAS authorities are commonly referred to by either their AU section numbers, their original SAS, or Auditing Interpretations numbers. See AICPA, CODIFICATION OF STATEMENTS ON AUDITING AND PROCEDURES (2003).

\(^{271}\) See id. Auditing Interpretations are in the second level of GAAS and consist of: (1) auditing interpretations of SASs, (2) auditing guidance in AICPA's Audit Guides, and (3) Auditing Statements of Position issued by the AICPA's Audit Issues Task Force.

\(^{272}\) This third or lowest level of GAAS includes textbooks, journal articles, audit programs, and other auditing materials. U.S. GEN. ACCOUNTING OFFICE, GAO-03-673G, Government Auditing Standards § 1.01 (2003), http://www.gao.gov/govaud/yb2003.pdf. This level includes AICPA Audit Guidelines which are interpretive publications that provide recommendations on the application of SASs in specific circumstances. The AICPA Auditing Standards Board has catalogued documents of various level of authority in the auditing standards literature. Public Oversight Board staff, Status Report: Recommendations of the Panel on Audit Effectiveness 7 (Aug. 31, 2000), http://www.pobauditpanel.org.

\(^{273}\) A separate set of auditing standards exist for governmental auditing. The U.S. Generally Accepted Government Auditing Standards (GAGAS) established by the GAO (Government Accountability Office, previously Government Accounting Office) govern the auditing of federal, state, and local governments. GAGASs are regularly published in the "Yellow Book" by the GAO and is freely available at http://www.gao.gov/govaud/ybk01.htm. Additional auditing authorities may be found in OMB Circulars, administrative authorities providing instructions to federal agencies, or as issued by the relevant governmental agency, such as the Department of Agriculture’s rules for specialized audits. 7 C.F.R. 1773.7 (2005).
to auditors in applying auditing standards.

Auditors are subject to standards of professional conduct adopted by the PCAOB, the AICPA’s Code of Professional Conduct,\textsuperscript{274} and former GAAS. GAAS requires auditors to exercise “due professional care” during the planning and performance of audits and in the preparation of audit reports.\textsuperscript{275} For example, the due professional care standard requires auditors to search for errors that would have a material effect on the financial statements\textsuperscript{276} and conduct an audit with “an attitude of professional skepticism.”\textsuperscript{277}

SOX strengthened the potential enforcement of due professional care in the auditing of public companies.\textsuperscript{278} SOX created stronger documentation standards\textsuperscript{279} and added new civil and criminal penalties against auditors for improper conduct. Auditors are increasingly subject to more extensive audit documentation requirements.\textsuperscript{280}

C. Consequences If the APA Applies to the PCAOB

Whether or not the APA applies to the PCAOB, it is important to recognize that after enactment of SOX, all auditing authorities issued by the PCAOB and ratified by the SEC have legal status at least as strong as the SEC releases.\textsuperscript{281} The courts have not yet

\textsuperscript{274} Ensuring compliance under the AICPA’s Code of Professional Conduct requires one to research not only principles of professional conduct and rules of conduct, but also interpretation of rules and rulings.

\textsuperscript{275} AICPA AUDITING AND PROCEDURES, supra note 270, AU §§ 150.02 and 230.02.

\textsuperscript{276} Id. at AU § 316.05.

\textsuperscript{277} Id. at AU § 316.16.

\textsuperscript{278} See Sarbanes-Oxley Act § 802 (criminal penalty for altering documents).

\textsuperscript{279} PCAOB strengthened the documentation requirements in its second rule. It took some ideas from the documentation requirement used for governmental auditing standards issued by the GAO. Auditors must document significant audit findings, actions taken to address them, and the basis for final conclusions reached. Thus, auditors are now expected to find and document in their working papers, all relevant authorities. AICPA AUDITING AND PROCEDURES, supra note 270, at AU § 312.

\textsuperscript{280} The due professional care standard also requires proper audit documentation. This standard provides evidence for the auditors’ compliance with U.S. PCAOB standards during the performance of audits and support for the auditors’ conclusions in the audit reports. See AICPA AUDITING AND PROCEDURES, supra note 270.

\textsuperscript{281} The PCAOB releases its authorities on its website, with a parallel cite to the SEC release approving them. See AICPA AUDITING AND PROCEDURES, supra note 270.
examined the legal meaning of the PCAOB's auditing authorities.\textsuperscript{282} The PCAOB's auditing standards incorporate GAAS, which includes three levels of authority, and an issue is whether legal status applies to the second GAAS level.\textsuperscript{283}

Although the PCAOB has attempted to show it is meeting the intent of the APA and the FOIA, the application of those acts to the PCAOB would have significant consequences.\textsuperscript{284} Most notably is the required due process that the PCAOB must follow. The requirement applies not only in its rule-making, but also in its investigations and adjudicatory functions in potentially penalizing an accounting firm.\textsuperscript{285}

If the PCAOB qualified as an agency, then its highest level of auditing issuances, similar to the GAAS hierarchy (Level 1) should qualify as regulations, not as an interpretative SEC release.\textsuperscript{286} The PCAOB would need to publish the authorities in the \textit{Federal Register} to ensure legal effect, so that the courts will give proper deference to the ten auditing framework standards and Statements on Auditing Standards.\textsuperscript{287} The second level of GAAS could then qualify similar to an SEC release as an interpretive rule which is not covered under the APA.\textsuperscript{288}

If the PCAOB is an agency under the APA and FOIA, the public can hold the PCAOB more accountable through greater Congressional oversight and through the public budgeting process.\textsuperscript{289} Better oversight is needed because the PCAOB decided that it should match the salaries of the FASB, even though

\textsuperscript{282} \textit{Id.}

\textsuperscript{283} A court should easily affirm that the highest level of GAAS (the ten auditing standards for the framework and the SAS's) now have the legal status of a SEC release. However, since GAAS does not mandate the third level in its hierarchy, the lowest level would have no legal status. The real issue then becomes if the second level of GAAS is violated, what is its legal status. \textit{Id.}

\textsuperscript{284} \textit{Id.}

\textsuperscript{285} \textit{See} AICPA AUDITING AND PROCEDURES, \textit{supra} note 270.

\textsuperscript{286} \textit{See id.}

\textsuperscript{287} \textit{Id.}

\textsuperscript{288} Interpretative rules are similar in authority to the IRS's revenue rulings and revenue procedures. \textit{See APA, supra} note 37. The agency publishes the interpretive rules, rulings, and procedures, but not in the \textit{Federal Register}.

\textsuperscript{289} \textit{Id.}
the FASB was operating at a substantial deficit.\textsuperscript{290} Paying the PCAOB board members approximately half a million dollars each exceeds the compensation paid to the President of the United States and far surpasses the compensation paid to the SEC Commissioner.\textsuperscript{291} It is not surprising that the PCAOB’s budget is increasing at a substantial rate and the SEC has little incentive to restrain it.\textsuperscript{292}

\section*{D. Application of the APA to the PCAOB}

If SOX had remained silent about the status of the PCAOB, application of the court’s analysis should lead to a clear conclusion that the PCAOB is an agency. However, SOX stated, that “\textquoteright\textquoteright [t]he [PCAOB] shall not be an agency or establishment of the United States Government, except as otherwise provided in this Act, and shall have all the powers conferred upon a nonprofit corporation.”\textsuperscript{293} The SOX’s language is similar to the language for the FHLMC in \textit{Rocap v. Indiek}, which is not determinative, but is highly influential.\textsuperscript{294} It might appear that Congress simply wanted the PCAOB to remain responsible for its own expenses.\textsuperscript{295}

At issue is whether SOX’s expression of PCAOB’s legal status contradicts the APA’s provision discussing the effect of subsequent statutes. The APA provision states “\textquoteleft\textquoteleft subsequent statute[s] may not be held to supersede or modify this subchapter\textquotesingle\textquotesingle except to the extent that it does so expressly."\textsuperscript{296} Thus, it may be a question of interpretation whether SOX’s expression that the PCAOB is not an agency qualifies as an express statement that Congress did not want the APA and FOIA to apply to the PCAOB.\textsuperscript{298} Agency status has different

\begin{footnotesize}
\begin{align*}
290 & \textit{Id.} \\
291 & \textit{Id.} \\
292 & \textit{Id.} \\
294 & \textit{Rocap}, 539 F.2d at 176. \\
295 & \textit{Conversation with Prof. William Allen, NYU Prof. of Law and Business and Director, Center for Law and Business} (Feb. 16, 2005). \\
297 & \textit{See id.} \\
298 & \textit{The courts might apply various statutory constructs to achieve whatever result}
\end{align*}
\end{footnotesize}
implications in different parts of the U.S. Code and is defined slightly differently in the various provisions.\textsuperscript{299} SOX's expression is probably not sufficiently proven to override judicial review of what constitutes an agency for the APA.

The SOX's expression about PCAOB's legal status is somewhat similar to the case of AMTRAK.\textsuperscript{300} In both situations, legislation stated that the entity was not an agency or establishment of the government.\textsuperscript{301} However, just as the Comptroller General determined that AMTRAK was an agency for various acts within the APA,\textsuperscript{302} it is easier to find that the PCAOB is an agency. The PCAOB's federal funding and its substantive rulemaking and adjudicatory powers expose the PCAOB to agency status.

If SOX's expression that PCAOB is not considered an express statement that the APA and FOIA do not apply to the PCAOB, the issue becomes whether the subsequent SOX statute creating the PCAOB overrides the APA.\textsuperscript{303} SOX's declaration that the PCAOB is not an agency potentially conflicts with the court's prior expression that the court decides whether an organization is an agency for purposes of the APA and its related statutes.\textsuperscript{304}

Under the court's typical analysis of an agency under the APA, the PCAOB should qualify as an agency. The PCAOB determines rules that serve a government function and has a considerable staff in excess of 200 employees.\textsuperscript{305} Also, the PCAOB relies exclusively on funding from the federal government.\textsuperscript{306}

The PCAOB, like another accounting related entity, the CASB, is legislatively declared as "independent of the Executive

\textsuperscript{299} See id.
\textsuperscript{300} See id.
\textsuperscript{301} 45 U.S.C. § 541.
\textsuperscript{303} Id.
\textsuperscript{304} Id.
\textsuperscript{305} Id.
\textsuperscript{306} See id.
Both organizations have the authority to promulgate, amend, and rescind either auditing or cost accounting standards. The CASB’s exclusive authority is stronger, however, because the PCAOB must submit its regulations to the SEC for approval. The decision-making boards of both PCAOB and CASB are similar in size. Given that the Court of Appeals for the District of Columbia Circuit affirmed the decision that the CASB is an agency under the FOIA, it would probably reach a similar conclusion for the PCAOB.

The PCAOB and the FHLMC share many characteristics of other quasi-federal entities intended to be included within the “government-controlled corporation” language. The fact that SOX states that the PCAOB is a not-for-profit corporation is not significantly different from the legislative history of the 1974 amendments that found that Congress intended to extend the FOIA to certain hybrid governmental private entities.

At issue is whether the PCAOB is unable to exercise some “independent function” or can essentially promulgate rules on its own authority when it needs approval from the SEC for each release. It is necessary to apply a functional analysis to the PCAOB in order to determine whether the PCAOB has legal authority to perform the decision-making functions of a federal agency and whether the PCAOB’s structure and daily operations are subject to substantial federal control. Unlike the Council of Economic Advisors, which had no regulatory power, the PCAOB has extensive regulatory powers as explained in the SOX. Perhaps the critical question is whether the PCAOB “has

310 Id.
312 Id.
313 Id.
314 See Armstrong v. Executive Office of the President, 90 F.3d 553 (D.C. Cir. 1996) (holding that the National Security Council is not an agency and is an advisory council with no authority to implement or make policy).
315 The PCAOB is distinguishable from the voluntary recommendations made by a
any authority in law to make decisions."

Some might argue that the PCAOB is similar to the NYSE, because both are deemed to be self-regulatory agencies that affect public companies. However, the PCAOB’s powers extend far beyond the NYSE. At issue is whether the reporting requirements and restrictions on certain PCAOB activities are simply a means for the federal government to protect its investment, or whether they provide some effective supervision of these PCAOB activities. A court considering the issue should recognize the reality that for purposes of the APA, the PCAOB is an agency, and one whose influence extends far beyond its borders.

V. International Accounting Standards (IAS) and Emerging Auditing Authorities

Differences in international accounting standards can cause confusion for investors and creditors. The differences impede comparability. While conducting business globally, it makes little sense to perform accounting provincially. National accounting rules create a barrier for foreign issuers.

The International Accounting Standards Board (IASB) is a wholly private organization governed by fourteen members and scientific panel’s work to the FDA. Ciba-Geigy Corp. v. Mathews, 428 F. Supp. 523 (S.D.N.Y. 1977). The PCAOB is similar to other financial institutions with strong government connections and are agencies for purposes of the FOIA, such as the OMB, Meyer v. Bush, 981 F.2d 1288, 1294 (D.C. Cir. 1993), and the Fed. Open Mkt. Comm. of Federal Reserve Sys. v. Merrill, 443 U.S. 340 (1979), on remand to 516 F. Supp. 1028 (D.D.C. 1981) (holding that an exemption from disclosure in the FOIA applied).


319 The fourteen members of the IASB in 2004 are from the following countries: U.S. (5); U.K. (1); Germany (1); France (3); Japan (1); Canada (1); Sweden (1); Australia (1); and South Africa (1). See ISACF 2003 ANNUAL REPORT, 22 (2003), http://www.iasb.org/uploaded_files/documents/8_24_ar2003.pdf. In the EU, this composition has become controversial.
a U.S. non-profit parent organization.\footnote{320} The IASB's objective is to write a single set of high quality global accounting standards, following a due process procedure.\footnote{321} The IASB was created in 2001 in response to international bodies involved in the global capital markets expressing the need for a credible global accounting standard setter.\footnote{322}

Internationally, accounting standards consist of "International Financial Reporting Standards" (IFRS) and "International Accounting Standards" (IAS).\footnote{323} IFRS are issued by the IASB.\footnote{324}

\footnote{320} The parent organization of ISAB is the International Accounting Standards Committee Foundation (IASCF), a not-for-profit corporation incorporated in the U.S. state of Delaware. \textit{See} ISAB, \textit{General Information} (2005), http://www.iasb.org/about/general.asp. The IASCF "appoints the IASB members, exercises oversight and raises the funds needed, but the IASC has sole responsibility for setting accounting standards." \textit{Id.} \textit{See generally} ISAB, \textit{IASB Structure} (2005), http://www.iasb.org/about/structure.asp (diagram of the IASB structure).

\footnote{321} The IASB attempts to follow a due process for releasing exposure drafts. It provides a basic notice and comment period, has meetings generally open to the public with public agendas in advance, and publishes a basis for conclusions to accompany each published standard. \textit{See ISAB's Operating Procedures; Due Process} (2005), http://www.iasb.org/about/due_process.asp; \textit{see also} IASC, ISAC FOUNDATION CONSTITUTION, art.31-32, http://www.iasb.org/upload_files/documents/8_11_isacf-constitution.pdf (elaborating the IASB's powers and responsibilities). However, the IASB in 2004 began thinking about strengthening its due process when it published a consultation paper titled \textit{Strengthening the IASB's Deliberative Procedures} 7-8 (2005), http://www.iasb.org/upload_files/documents/8_11_isaf-constitution.pdf. This was accomplished in 2005, as part of the revised Constitution for the IASB. \textit{See} Press Release, IASCF, \textit{Trustees Approve Constitutional Changes} (2005), http://www.iasb.org/upload_files/documents/10_466_PRConstitutionReviewCompletion.pdf [hereinafter IASCF, 2005 Press Release].


\footnote{324} As of January 1, 2005, the IASB had issued five IFRS. \textit{See id.} Companies relying upon IAS/IFRS dominate certain industries throughout the world, including automobile manufacturing, financial services, pharmaceuticals and telecommunications. \textit{See} Patrick Casabona & Victoria Shaof, \textit{The Time Has Come: True International Financial Reporting Standards}, 24 AFP EXCHANGE 64 (2004). The IASB has an interpretative body known as the International Financial Reporting Interpretations Committee the issues authoritative consensus on accounting issues that might receive conflicting interpretations. \textit{See} IASB, \textit{International Financial Reporting Interpretations Committee},
IAS was issued by the predecessor of the IASB, the International Federation of Accountants Committee (IFAC). A second level of accounting authorities referred to as "Interpretations," was issued by both the ISAB and the IFAC.

Historically, bilateral, regional, and global attempts to harmonize accounting authorities had little success until global organizations, such as the International Monetary Fund, pressured countries to adopt them. More recently, international accounting standards (IAS/IFRS) have started to influence the accounting standards in most of the world.

http://www.iasb.org/about/ifric.asp.

325 As of the end of its accounting standard setting in 2001, the IFAC had issued forty-one IASs and a second level of Interpretations. See IASB, Annual Report, supra note 320. However, only thirty-four standards were effective. Of those forty-one IASs, fourteen were heavily criticized. "We knew we had to fix those [inherited] standards if international standards were going to be acceptable to N.Y. and the SEC." New World Order: IASB Chairman Sir David Tweedie Says Global Accounting Standards Are Within Reach—A CFO Interview, CFO: MAGAZINE FOR SENIOR FINANCIAL EXECUTIVES, (Mar. 2004), http://www.findarticles.com/p/articles/mi_m3870/is_3_20/ai_114086013.


328 Press Release, IASB, IASB and IASC Foundation News 2 (Jan. 21, 2005), http://www.iasb.org/news/press.asp?showPageContent=no&xml=10_282_30_21012005.htm (explaining that ninety-four countries either require or permit the use of FRSs for publicly traded companies beginning in 2005). In a 2002 survey of fifty-nine countries, two countries (Kenya and Cyprus) indicated they already adopted IFRS/IAS as the mandatory standard. Another thirty-nine countries had a formal plan of adoption or convergence with the IFRS/IAS. Another fifteen countries indicated an intent to
Auditing helps to enforce accounting standards. However, "[i]t is not an accepted professional norm in the regulatory culture, in some countries, to administer a public rebuff to the managements of large, listed companies." In theory, having rigorous, enforceable international auditing standards should help to change the culture in many countries and provide the environment needed for a flourishing capital market.


330 "In Asia, the trend is to over-regulate but under-enforce. People act on relationships, sensitivities, and emotions." Ms. Alexa Lam, former high official of the H. K. Sec. & Futures Comm'n, Regulation of Securities Markets in Hong Kong and China: Convergence? Speech at NYU Law School (Feb. 6, 2005).

331 Floyd Norris, Global Overseer of Auditing Rules is Born, N.Y. Times, Mar 1, 2005, at C9. PIOB was proposed in 2003; see IFAC, Reform Proposals (Sept. 10, 2003), at 9, http://www.ifac.org/downloads/ifac_reform_proposals.pdf. PIOB's predecessor was the International Auditing and Assurance Standards Board of IFAC, a worldwide organization for the accounting profession. IFAC.org, Facts About IFAC, http://www.ifac.org. PIOB will have members selected by nominating members' body including the International Organization of Securities Commissions (IOSCO), the Basel Committee on Banking Supervision, European Commission, the World Bank, and the International Association of Insurance Supervisors. Id.

332 At least seventy countries have either adopted International Standards of Auditing or there is no significant difference between their domestic standards and the international auditing standards. See Letter from Greg Larsen, Chief Executive, CPA Australia, 4 (Nov. 15, 2004) (citing IAASB's Annual Report (2003)).

333 See IFAC, Reform Proposals, supra note 331, at 10-11.

334 IFAC's standard setting on auditing was handled by the International Auditing and Assurance Standards Board (IAASB). Before 2002, IAASB was known as the
particularly for auditing, assurance, ethics, and independence standards.\textsuperscript{335}

This part of the article explains the dramatic development that, starting in 2005, the EU has legally adopted almost all of the accounting authorities issued by the IASB.\textsuperscript{336} One EU Commissioner explains this historic importance as "the beginning of a new era of transparency and the end of the Tower of Babel in financial reporting in Europe."\textsuperscript{337} This part also examines how the EU expects to imitate establishing an oversight board for auditing, similar to the U.S. PCAOB, in making auditing standards legally enforceable for greater accountability to the investing public.

A. European Union's International Accounting Standards (IAS/IFRS) in 2005

Within the EU, the main harmonization authorities for accounting arise from the Fourth Directive on Company Law,\textsuperscript{338} and the Seventh Directive on Consolidated Accounts.\textsuperscript{339} These two "Accounting Directives" merely provide general principles for minimum standards and do not attempt to regulate all practical applications.\textsuperscript{340} The Accounting Directives apply to all limited liability companies in Europe, whether listed or not.\textsuperscript{341} However,

\textsuperscript{335} EU Regulations: Monitoring the Audit Profession, EIU VIEWS WIRE, New York, Dec. 3, 2003.


\textsuperscript{337} Id.


\textsuperscript{341} Id. In 2004, the European Commission as part of the "Company Law Action Plan" proposed four major revisions of the EU's Accounting Directives to enhance
little harmonization occurred in accounting because the Accounting Directives were too flexible and allowed EU member countries to specify additional requirements. In 2003, both Accounting Directives were amended by the “Modernization Directive” to address off balance sheet financing.

The purpose of harmonizing financial information within the EU was “to ensure a high degree of transparency and comparability of financial statements.” This creates efficient functioning of the EU’s capital market. In 1999, after adopting the Euro, the three major elements of the EU’s “Financial Services Action Plan” were created: the Transparency Directive, the Prospectus Directive, and the IAS Regulation.


Id.


In 2002, under the authority of the Directives, the European Parliament and Council adopted the IAS Regulation, effective in 2005. The IAS Regulation requires about 8,000 European companies to prepare their consolidated financial statements in accordance with IAS as adopted by the EU. Starting in 2005, all EU-listed companies must prepare their consolidated accounts in accordance with the single set of accounting standards. Previously, EU member countries each had their own accounting standards. Sometimes these were professional standards, such as in the United Kingdom, and sometimes they were legal standards, such as in Germany.


The Prospectus Directive requires most issuers of securities to include in the prospectus, financial statements prepared in accordance with the IFRS. See Commission of the European Communities, 2003/71/EC, http://europa.eu.int/commlinternal-market/securities/docs/prospectus/implementation-draft/2004-draft_en.pdf. The Prospectus Directive requires that from Jan. 1, 2007, third country securities issuers making a public offer in Europe must either file their financial statements in accordance with EU’s IAS/IFRS or the third country’s national standards, if they are endorsed by the EU as equivalent to IAS/IFRS. Id.


Companies are defined in the Treaty of Rome, Art. 48 (ex. 58). “Companies which are not subject to IAS Regulation continue to have national accounting requirements derived from the Accounting Directives as the basis for their accounts.” Comments, supra note 351, at ¶ 2.2.1.

IAS Regulation, supra note 345, art. 5; Comments, supra note 351, at ¶ 2.3. Member states of the EU may elect to extend it to unlisted companies. Press Release, FASB, Financial Reporting: Commission Welcomes IASB/ FASB Convergence Agreement, IP02/1576 (Oct. 29, 2002), http://www.fasb.org/news/nr102902.shtml.

See generally K. MICHAEL OLDMAN, ACCOUNTING SYSTEMS AND PRACTICE IN EUROPE (1987).
The IAS Regulation gives legal status to the IAS/IFRS adopted by EU's Accounting Regulatory Committee.\textsuperscript{356} If an IAS is not yet endorsed, it is not legally required.\textsuperscript{357} Also, in certain cases companies are not permitted to apply the regulation in preparing their financial statements in accordance with EU's IAS Regulation.\textsuperscript{358} A company must apply all EU-adopted IAS/IFRS irrespective of any contrary, conflicting or restricting requirements in national law.\textsuperscript{359} As such, EU member countries are not able to restrict explicit choices contained in AIS/IFRS.\textsuperscript{360}

Political pressure was evident in the EU's decision as to which IAS/IFRS to legally adopt.\textsuperscript{361} "EU finance ministers stepped up


\textsuperscript{357} To adopt an accounting standard, the EU requires that the standard is not contrary to the principles of the Council Directives. Furthermore, the standard must be conducive to the European public good and meet the criteria of understandability, relevance, reliability, and comparability required of the financial information. IAS Regulations, supra note 345.

\textsuperscript{358} For purposes of the IAS Regulation, international accounting standards includes not only IAS/IFRS, but also related interpretations, subsequent amendments to these standards and future standards issued or adopted by the IASB. IAS Regulation, supra note 345 at 3. In contrast to the FASB, the EU's Interpretations of the Standing Interpretations Committee are made freely available to the public, in addition to the IAS/IFRS. 2003 O.J. (L 261) 3, http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/1_261/1_26120031013en00030004.pdf.

\textsuperscript{359} See IAS Regulations, supra note 345.

\textsuperscript{360} Commission of the European Communities, Comments, supra note 351, at 10.

political pressure on the IASB, demanding that European viewpoints—especially when it comes to calculating the value of derivatives in company audits—carry greater influence in decision-making.”

The EU did not adopt part of one complex accounting standard on derivatives (IAS 39), because EU banks objected to how it results in strong account volatility in accounts. Some believe the EU caved in to the lobbying from bankers and the French Government in order to avoid embarrassing results.

As a result of the controversy, in 2005, the EU Internal Market Commissioner stated that “[r]epresentation within the international standard-setter and within a public oversight body should correspond more appropriately to jurisdictions that directly apply the standards.”

Responsibility of accounting and auditing standard setters, became a more prominent issue in the EU.

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365 French President Jacques Chirac also had harsh words for the IASB’s process: “Several other standards could also have negative effects on companies and the European economy [referring to the expensing of stock options]. . . . [It is] urgent and necessary, given my experience, to quickly start thinking thoroughly about the institutional framework which is put in place to adopt accounting standards.” Hessen, supra note 362, at 1.


367 See Charlie McCreevy, European Commissioner for Internal Market and Service, *Governance and Accountability in Financial Services*, Speech (Feb. 1, 2005), (transcript available at http://europa.eu.int/comm/commission_barroso/mccreevy/speeches/index_en.htm (follow “Governance and Accountability in Financial Services” hyperlink). However, Paul Volker rejected the EU’s call for more representation on the IASB, explaining that the IASB must also consider the interests of countries such as China, India, and Japan. David Reilly, *Volker Rejects EU Call for Bigger Role in IASB*, WALL ST. J., Feb. 28, 2005, at C3. The IASB added three members in its June 2005 revised Constitution for greater representation in the Asia-Oceania. See IASCF, 2005 Press Release, supra note 321.
B. Enforcement by the Committee of European Securities Regulators (CERS)

The EU's Eighth Council Directive on Statutory Audit governs the qualifications for performing statutory audits law. The EU has centralized the qualifications for statutory auditors, because such work requires a fundamental knowledge of the laws on financial reporting, taxation, company law, and several related fields.

In 2003, the Commission adopted an action plan for "Modernizing Company Law and Corporate Governance." As part of this reform, the EU is expected to amend the Eighth Directive to enhance auditing and the enforcement of reliable financial statements. The amendment will establish principles for public oversight in EU member countries. The plan is to improve corporate governance, including "auditing proposals

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369 Until the EU member state laws are sufficiently analogous, it is necessary to maintain safeguards, such as the Eighth Directive. Communication from the Commission to the Council and the European Parliament, Reinforcing the Statutory Audit in the EU, 2003 OJ (C 236) 14.


371 The Eighth Directive lacked "a comprehensive set of elements for ensuring an appropriate audit infrastructure (for example public oversight, disciplinary systems and systems of quality assurance) and it does not refer to the use of auditing standards, independence requirements and ethical codes." Eighth Council Directive, supra note 368, at 14.


This proposed Directive provides "a complex and comprehensive set of legislative reforms that reaches into the very heart of the boardroom." The EU agency responsible for audit oversight is not its Court of Auditors, but the CESR. The CESR is similar to the U.S. SEC. The primary role of the CESR is to improve coordination among securities regulators, act as an advisory group to the EU Commission, and ensure more consistent and timely implementation of revised securities laws in EU member countries.

The Commission proposed a new "Audit Regulatory Committee," similar to the U.S. PCAOB. "Public oversight is a


An example of the mirroring of Sarbanes-Oxley Act is that the corporate governance proposal includes requiring a description of the internal controls, similar to the U.S. new requirement for a second audit of internal controls. Modernization Directive Proposal, supra note 370, at 12.

James Turley, Get Ready for the EU's 8th Directive, 8 DIRECTORSHIP 18 (June 2004).

The Court of Auditors oversees the financial management of the EU budget. See European Court of Auditors, http://www.eca.eu.int/index_en.htm.

CESR is an independent committee established in June 2001 (2001/527/EC), for more information, see CESR, http://www.cesr-eu.org.

The CESR was created in response to proposed reforms of the European regulatory structure in the securities area. The four types of reforms consisted of (1) framework legislation, (2) regulatory measures to implement the securities legislation, (3) establishment of the CESR for greater day-to-day cooperation by national supervisors and regulators to ensure consistent implementation and enforcement, and (4) more effective enforcement of EU law. See European Commission, Financial Services: Turning the Corner, supra note 348, at 11-12.


major element in the maintenance of confidence in the audit function. The present erosion of confidence is partly based on a public perception that any self-regulating profession runs a risk of conflicts of interests in dealing with its shortcoming.”

The Commission envisions using International Standards of Auditing (ISA) as a requirement for all EU statutory audits. Therefore, the CESR has urgently asked the IFAC’s International Auditing and Assurance Standards Board to complete its project on new auditing standards. This will help develop harmonized audit reporting within the European Union.

Enforcement of financial reporting standards in Europe and the monitoring of auditing is handled by each EU member state, but coordinated within CESR. However, the Commission recognizes that it may be difficult to harmonize sanctions due to differences in judicial and legal systems. The Commission will consider further steps towards the convergence of disciplinary procedures, notably with regard to transparency and publicity. An obligation to [cooperate] in cross border cases will be included and the systems of disciplinary sanctions should be subject to public oversight.

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380 Id. at 6.
381 Id. at 5.
383 Id.

385 Id. at 10. The areas of concern for a transatlantic capital market are:
The CESR Secretary General explained that consistent enforcement of international accounting standards is important, not only in the twenty-five EU member countries, but also by the regulators outside the European Union, and particularly the United States.\(^3\)\(^8\)

**C. Global Convergence to Appease U.S. Regulators and World Institutions**

Global convergence recognizes the reality that foreign shareholders comprise a substantial portion of most public companies.\(^3\)\(^8\) Global convergence enables investors to compare investments, lowers the cost of capital for companies, results in more efficient allocation of resources, and creates a higher level of global economic growth.\(^3\)\(^8\) A specific immediate goal of convergence is to allow companies to cross-list easily among major stock markets.\(^3\)\(^8\) Global convergence substantially gained

"certification of financial statements and internal control systems, registration of EU audit firms in the U.S., direct U.S. access to EU audit working papers, auditor independence, loans to bank management, and audit committees." *Id.* at 11. The EU opposes the idea of registration of EU audit firms in part because of conflicts of law both with European and national laws on data protection and professional secrecy. *Id.* at 12.


\(^3\)\(^8\) For example, in the EU, foreign shareholders in listed companies comprise 30-35% in the larger EU member countries and 70-80% in the smaller EU member countries. Charlie McCreevy, European Commissioner for Internal Market and Services, *The European Corporate Governance Action Plan: Setting Priorities*, Speech at the Second European Corporate Governance Conference in Luxembourg, (June 28, 2005) (transcript available at http://europa.eu.int/comncomniission-barroso/mccreevy/speeches/index_en.htm).


\(^3\)\(^8\) A survey of companies explains why cross-listing on stock exchanges was important: "The most popular motive for these firms to list on a foreign exchange was to raise equity (100%), followed by strategic considerations to increase publicity and visibility (60%), and the desire to have international investors in order to have
momentum in 2001 when the U.S. SEC issued a "Concept Release" requesting feedback on whether the SEC should accept financial statements of private issuers using IASs without filing reconciliation to U.S. GAAP.

In recent years, U.S. securities legislation has had extraterritorial effects. SOX has assisted the SEC in obtaining foreign audit documentation in accounting fraud investigations. Also, SOX states that any foreign public accounting firm that prepares or furnishes an audit report is subject to SOX, rules of the PCAOB, and the SEC. Extraterritorial effects have resulted because, as the former SEC Chairman Donaldson has noted, "[t]here was a more widespread erosion of standards throughout our markets, with questionable practices becoming accepted and geographic dispersion of ownership (33%)."


See Sarbanes-Oxley Act § 106. For example, thirty-three Japanese companies were listed in the U.S. capital market as of December 2002, and an estimated 380 non-Japanese companies were registered with the SEC and operating in Japan. See Letter from the Japanese Institute of Certified Public Accountants to Jonathan G. Katz, Secretary, SEC, on Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules Relating to Registration System (File No. PCAOB-2003-03) at 39-40 (supplement 2) (June 27, 2003).
ethical corners being cut on a too frequent basis. The net effect
has been to undermine the faith investors have in the integrity of
the world’s capital markets.”

SOX’s provision for the foreign audit documentation violated
various laws within the EU that require its auditors to maintain
strict confidentiality with respect to audit work papers. The EU
managed to avoid a showdown on SOX’s spillover effects to
foreign jurisdictions and has instead been cooperating with the
SEC and the PCAOB. The desire to qualify for an exemption
from registration with the PCAOB is motivating the EU and other
leading capital markets to raise the quality of their accounting
standards and auditing oversight institutions. By making
European agencies independent of the accounting profession,
the U.S. PCAOB has agreed to waive its contentious requirement
for U.S. inspection of European audit firms that audit a company
whose stock is traded in the U.S.

Global convergence is occurring in the EU and the U.S.
regarding accounting and auditing oversight.

By introducing these stringent requirements, Europe

396 See Koski-Grafer, supra note 390, at 10.
397 Engelen, supra note 3, at 43 and 45.
398 The EU is not the only country to change to IAS standards and seek to enhance
the oversight of enforceable auditing standards. Australia adopted the Australian
equivalents of IAS, called AASB Standards, for financial reporting periods starting in
2005, even for government entities. Australia’s Corporation Law requires use of AASB
Standards, consistent with the Acts Interpretation Act 1901, to remove references to any
external documents. AASB.com, Change to Process for Issuing Australian Equivalents
/aasb_mr_04-09-03.htm.

Also in 2005, Australia’s Federal Register of Legislative Instruments will
Auditing and Assurance Standards Board (AUASB) was legally reconstituted in 2004 as
an independent statutory body. See Corporate Law Economic Reform Program (Audit
Legislation/ActCompilation1.nsf/0/3B3EE9EA6EFA3DA7CA256F7100581F1B/$file/1
032004.pdf. For the next two years, the AUASM will focus on redrafting auditing
standards as legal instruments, based on international auditing standards. See generally
id.

399 See SEC, SEC-CESR Set Out the Shape of Future Collaboration, SEC News
400 New legal oversight of the accounting profession is also occurring in such
countries as Canada and Japan. See Koski-Grafer, supra note 390.
will have a comprehensive regulatory basis for effective and balanced international cooperation between European and third-country regulators. For example, the [revised] Directive proposed and parallel regulatory initiatives of the PCAOB have laid the framework for mutual and reciprocal co-operation on auditor oversight between the EU and the U.S.\textsuperscript{401}

In the EU, the CESR has started to implement measures to consider equivalence between its IAS/IFRS and selective other countries' GAAP as the third prong for comparison.\textsuperscript{402} Thus, CESR has published a concept paper for assessing the equivalence and will follow it by a review of U.S. GAAP,\textsuperscript{403} then Canadian GAAP\textsuperscript{404} and Japanese GAAP.\textsuperscript{405} If the CESR does not recognize the country's national accounting standards as equivalent to IAS/IFRS by 2007, then the EU will require those foreign companies to submit financial statements in accordance with IAS/IFRS.\textsuperscript{406}

\textsuperscript{401} European Commission, Financial Services: Turning the Corner, supra note 348, at 6. On March 25, the EU-US regulatory cooperation was confirmed. \textit{Id.}


\textsuperscript{404} Canadian GAAP fundamentally differs from U.S. GAAP by focusing more on the underlying principles and objectives, rather than on more rule-oriented standards reflecting U.S. legal jurisprudence. Canadian GAAP also differs by having just one set of standards, applicable to both the public and private sectors. See James M. Sylph, Technical Director, International Auditing and Assurance Standards Board, Global Convergence—Near or Far?, Presentation at American Accounting Association Auditing Section 2005 Mid-Year Conference in New Orleans, LA (Jan. 14, 2005), http://www.ifac.org (speeches). However, without rules, vigilant oversight, and enforcement, Canada suffers from substantial accounting related litigation cases, although they receive little publicity. See Al Rosen & Mark Rosen, Canada's GAAP Not Good Enough, NAT'L POST, Sept. 17, 2003, at FP15.

\textsuperscript{405} Japan dramatically changed its accounting in 1996 in its "Accounting Big Bang" legislation. Japan is committed to improve Japanese GAAP so that the "accounting standards of Japan, the U.S. and Europe are steadily meshed." Japan's Report, supra note 3, at 15-16.

\textsuperscript{406} See Press Release, CESR, CESR Begins Work on Implementation Measures to
The challenges of global convergence of accounting standards have just begun. The head of the IASB has predicted that over the next few years, convergence will address setting accounting standards on "sacred cows such as leasing, insurance, performance reporting, and pensions. 'There will be blood all over the streets' . . . referring to an expected uproar from companies that might object to the new standards if they felt they would put their accounts into a poor light.'

VI. Implications for Accountants, Auditors, and Securities Litigation

The legal status of accounting and auditing authorities in the U.S. and the EU has significant implications for the worldwide capital markets. Most important are the emerging worldwide


The Chairman of the International Accounting Standards Committee has noted the challenges of convergence include both technical and non-technical challenges. The non-technical difficulties arise from countries having different traditions, approaches, and varying degrees of professional development. See Paul A. Volker, Notes for Remarks at Financial Executives International Conference (Nov. 12, 2001), http://www.iasb.org/uploaded_files/documents/8_128_011112-pav.pdf.

One problem is that IAS/IFRS are becoming more complex. Therefore, there may be a shortage of accounting professionals who have adequate knowledge of IAS/IFRS. See Pat Barrett, Auditor General for Australia, Contemporary Developments in Restoring Public Trust in the Accounting Profession—Information Disclosure, Transparency and Related International Standards, Address at the Second Taipei Corporate Governance Forum at 15, 17, http://www.ifac.org/MediaCenter/?q=node/view/65&PHPSESSID=6db84466ae6a2776f3979b631fb9f1.


The accounting standards also have potential implications for tax purposes. Most significantly, in 2003, the European Commission proposed "creating a common tax base using IAS/IFRS." See Chuck Gnaedinger, EC Releases Reviews Company Tax Issues, 32 TAX NOTES INT'L 785 (2003). In the U.S., various provisions in the Internal Revenue Code indirectly rely on the FASB's authorities, such as having the IRS rely on audited financial statement provisions in assessing taxes in parts of the Internal Revenue Code. For example, a temporary dividend received a deduction enacted in the American Jobs Creation Act of 2004, after a review of the certified financial statements. I.R.C. § 965(b)(1)(B) (2005).
accounting and auditing authorities with a legal hierarchy. This means that accountants and auditors must meet higher standards of professional care to assure compliance with the law, reflecting the policy that responsibilities of "CPAs" extend beyond the client, to the public.412

A. Securities Litigation Applying Legalized Accounting Authorities

Securities litigation in the EU arises under the laws of the EU member countries. In 2001, only two-thirds of the EU member countries had specific legislation applying to the liability of auditors.413 Litigation against auditors in EU countries is usually based on contract law in lawsuits by the audited company against the auditing firm414 and tort law for third party lawsuits.415 In some countries, such as Germany, third party litigation on securities fraud was historically non-existent.416 Portugal is the only EU

411 This article uses CPAs to reflect licensed accountants, who in the United States are called CPAs, but similar professionals may be called Chartered Accountants in the United Kingdom, and have other names elsewhere. See A Study on Systems of Civil Liability of Statutory Auditors in the Context of a Single Market for Auditing Services in the European Union, at Introduction (Jan. 15, 2001), http://europa.eu.int/comm/internal_market/auditing/docs/other/auditliability_en.pdf [hereinafter EU Auditors' Liability Study].

412 See, e.g., In re Touche, Niven, Bailey & Smart, ASR No. 78, 37 SEC 629, 670 (1957) [1957 SEC LEXIS 1014] (explaining that materially misleading accountants were displaced of their privilege to practice).

413 In Denmark, Ireland, Luxembourg, the Netherlands, and the United Kingdom, general rules of civil liability applied. Thus, in common law countries, negligence could apply. In civil law countries, plaintiffs use relevant sections of the Civil Code. See EU Auditors' Liability Study, supra note 411, § 1.1.1.

414 See id. § 1.1.2 (indicating exceptions for Finland and France which use tort law in lawsuits by the audited company because they emphasize the public policy nature of the auditors' duties).

415 See id. § 1.1.2 (revealing exceptions for Austria, Germany, and Portugal, which have a third-type of liability, such as requiring a showing that the auditing contract had "protective efforts" towards the third parties or "culpa in contrahenda," which compels reliance on the audit to make a decision).

country allowing class actions. Furthermore, EU member countries vary widely on the amount of damages that auditors might have to pay. Some countries have a civil liability cap or enable liability limits to exist in an audit engagement contract.

Securities litigation in the U.S. has primarily focused on fraudulent financial statements under Section 10(b)(5). Liability requires materiality as to false financial statements, and not materiality as to the major line items in the financial statements. Thus, the historic application of the law tolerated use of many improper accounting practices, as long as they did not materially affect the financial statements as a whole.

In an era when many corporations have over 1,000 subsidiary corporations operating throughout many parts of the world, the policy issue is whether the law should tolerate distortions of geographical or segment data that may be important to governments, creditors, or investors. Legalized accounting authorities would make it impermissible to hide material distortions within the often gigantic consolidated financial statements of multinational corporations and other listed companies.

In one case, the defendant violated U.S. GAAP by failing to timely perform an impairment review and write down over one billion of goodwill associated with its Latin American operating segment. Arguably, the failure occurred in order to inflate earnings on the income statement and assets on the balance sheet. The court in *Bell South Corp. v. Securities Litigation*

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420 See id.

421 See *Green Paper, supra* note 418.

422 See id.

423 Id.

424 Id.
found that mere publication of accounting figures that violated GAAP was insufficient alone to create liability.\textsuperscript{425} The district court noted that the Fifth Circuit Court of Appeals in an earlier opinion stated, "The party must know that it is publishing materially false information, or must be severely reckless in publishing such information. . . . [The accounting problems can] arise from negligence, oversight, or mismanagement, none of which rise to the standard necessary to support a securities fraud action."\textsuperscript{426}

A legal hierarchy of accounting authorities should change the focus of securities litigation\textsuperscript{427} such as in \textit{Bell South}. The new emphasis in securities litigation will probably switch to negligence, because the standards for negligence would be those established by the legalized accounting authorities.\textsuperscript{428} A breach of that legalized standard could create negligence \textit{per se}.\textsuperscript{429} Thus, making the accounting standards legal authority may reduce the need for expensive expert witnesses explaining GAAP or IAS/IFRS.\textsuperscript{430}

Courts will then have to scrutinize more carefully whether fundamental accounting principles were followed, such as writing down goodwill. The FASB, in conjunction with the IASB, might water down the expected future codified treatise of principled accounting standards because they are afraid of their use as the legal standard of care.\textsuperscript{431} CPAs and accountants for publicly listed


\textsuperscript{426} Abrams v. Baker Hughes, Inc., 292 F.3d 424, 432-33 (5th Cir. 2002).

\textsuperscript{427} For an in-depth discussion of current securities litigation standards in the U.S., see Gideon Mark, Note, \textit{Accounting Fraud: Pleading Scienter of Auditors Under the Private Securities Litigation Reform Act}, 60 N.Y.U. ANN. SURV. of Am. L. (forthcoming Fall 2005).

\textsuperscript{428} An expert is not needed to testify "that the care, skill, or knowledge . . . [of the defendant] fell outside acceptable professional standards." See Hubbard v. Reed & Kardon, 774 A.2d 495, 497 (N.J. 2001) (the court allowed the jury to infer the defendant’s negligence in a common knowledge malpractice case from the applicable medical professional standards).

\textsuperscript{429} See \textit{id}.

\textsuperscript{430} Id.

\textsuperscript{431} See Mark, supra note 427.
companies, however, will need to know and rigorously apply the accounting law, such as writing down permanently impaired goodwill.\footnote{Id.} Failure to perform a meaningful analysis of accounting records could and should create negligence \textit{per se}. The new era of legalized accounting and auditing authorities should close the Enron, WorldCom, and Parmalat era in which the global capital markets were subject to massive accounting manipulations.\footnote{Id.}

Given a legal hierarchy of accounting authorities, it is helpful to make the distinction clear as to the probable legal status of the different parts of U.S. GAAP and the IAS/IFRS framework in the EU Clarification of what authorities within U.S. GAAP's hierarchy have legal authority could sharpen the court's analysis when it considers securities litigation alleging untrue financial statements.\footnote{Consider the case of City of Monroe Employees Retirement Systems et al. v. Bridgestone Corporation, 399 F. 3d 651 (6th Cir. 2005). The court considered the reporting of contingent losses within the complex interactions between U.S. GAAP and Japanese GAAP. Under both sets of GAAP, if a loss or asset impairment was probable, the financial statements must accrue the loss. The footnotes to the company's consolidated financial statements merely discussed contingent liabilities, but did not disclose the contingency of any losses from tire products due to lawsuits, regulatory scrutiny, or safety related concerns. Before the financial statements were issued in March, thousands of legal claims had arisen from automobile accidents attributable to a new type of tire. At issue before the court was whether the lack of an impairment representation in the financial statement was material. The court held the representation was actionable so as to preclude summary judgment. While a securities case with a section 10(b)(5) claim is difficult to win, if legalized accounting standards were recognized, negligence \textit{per se} liability should arise. \textit{See generally} City of Monroe Employees Retirement Systems et al. v. Bridgestone Corporation, 399 F. 3d 651 (6th Cir. 2005).} A legal framework reduces the possibility that a court will hold accountants liable under aspects of U.S. GAAP for which a broad range of judgment will occur.\footnote{See Ted Allen, Interest in Class Actions Grows Outside the U.S., \textit{Governance Weekly}, http://www.issproxy.com/governance/publications/2005archived/107.jsp.}

Pressure on the EU and its member countries should enable all third party investors and lenders relying on the financial statements to have a remedy, including more efficient class action lawsuits. However, liability limits are appropriate, because
auditing firms are not insurance companies.436

B. Strengthening Accountants’ and Auditors’ Standards of Professional Care

Accountants and auditors must not only master an "increasingly complex web of technical principles, rules, and interpretations governing the reporting of financial transactions . . . but also understanding . . . the ethical, legal, and institutional imperatives underlying the practice of [the accounting profession]."437 When standards are legalized, a profession is often worried about losing its control over the standards. Fear arises from a greater possibility that the standards will become unreasonable and unreachable.438

The accounting profession should expect that more legal liability concerns will soon surface. The wave of corporate accounting scandals at the start of the century and the increased legalization of accounting and auditing authorities will create more litigation.439 Accountants will need to work with lawyers more often to help clarify potential legal exposure from the various accounting alternatives.440

Various accounting and auditing standards exist to encourage corporate management and their accountants to exercise due professional care in the performance of their duties.441 Enforcement of the professional standards relies primarily on the responsible individual or organization, secondarily upon the accounting professional, thirdly on auditors, and lastly on


438 Author’s discussion with Stanley Siegel, N.Y.U. Prof. of Law, and chair, ABA Subcomm. on Int’l Accounting (Feb. 23, 2005).

439 Before the recent financial scandals, multinational accounting firms had redefined themselves as “professional service firms” and the AICPA’s vision statement in 2000 for the profession for the next decade even failed to mention accounting.


441 See AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, AU §§ 150.02 and 230.01(2003).
investigation by the overseeing government agency. The judicial system also enforces the requirements for accountants and auditors to exercise due professional care.

Auditing standards generally require "due professional care" during the performance of the audit and in the preparation of the audit report. Due care imposes a professional responsibility on the auditors to follow GAAS, or equivalent, auditing standards. For example, professional care requires that auditors search for errors that would have a material effect on the financial statements and conduct the audit with "an attitude of professional skepticism."

The standards of professional conduct in the SEC practice area are in the SEC's "Rules of Practice." The SEC's Rules of Practice apply to lawyers, accountants, and corporate officers appearing or practicing before the SEC. It is no longer enough to just have SEC suspension or disbarment arising from "(1) failing to qualify the audit opinion for departures from U.S. GAAP, (2) allowing an accounting treatment that does not comply with U.S. GAAP, or (3) engaging in various other improper conduct."

Financial misconduct is too important for the law to ignore, whether it is caused by carelessness, incompetence, or fraud. Thus, SOX added various legal requirements for professional

\[442\] See id.
\[443\] See id.
\[444\] See id.
\[445\] Id. at AU § 230.02.
\[446\] See id. at AU § 316.05.
\[447\] AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, supra note 441, AU § 316.16; see SEC's AAER No. 420 (1992).
\[448\] See 17 C.F.R. § 201.
\[449\] See 17 C.F.R. § 201.102(b). The SEC may impose administrative sanctions on practitioners who acted improperly. Id. The sanctions include suspension and disbarment where the SEC denies a practitioner, temporarily or permanently, the privilege of appearing or practicing before the SEC. Id. at § 201.102(e).
\[450\] See 17 C.F.R. § 201.102(c). The SEC's actions against the practitioners are published in the SEC's AAER. Id. The SEC can also issue a censure or civil injunction to order violators to comply with the securities laws in the future. Id. Other SEC remedies include a stop order to suspend the effectiveness of a company's registration on the stock market. Id.
Most well known is the requirement that the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) certify the accuracy of the company's financial statements. If a public company is required to restate financial statements because of any wrongful, material noncompliance with a financial reporting requirement, the CEO and CFO are required to forfeit any bonus, incentive, or equity based compensation or profits from the stock traded in the last year.

C. Consequences Arising from the New Legal Realities

The FASB's and PCAOB's legal status need not alter the framework in the United States for adopting accounting and auditing standards. As in the EU, it is still possible to have the

451 For example, increased record retention requirements were placed on accountants under § 802, SEC Rel. No. 33-8180, 34-47241 [2003 SEC LEXIS 196] (Jan. 24, 2003). This will enable more examination of accountants' work and should require the profession to elevate its documentation standards, at least to a level similar to that expected in tax practice.

452 See Sarbanes-Oxley Act § 303; 1934 Act §§ 13(a) and 15(d); 18 U.S.C. § 1350(a)-(b). Similarly, the EU has placed the responsibility on the Board of Directors as a whole. Commission Proposal for Amending the Accounting Directives—Frequently Asked Questions, Memo/04/246 (Oct. 28, 2004), http://www.interniaudit.cz/download/EC_FAQ_041028_amend_4_and_7_Dir.pdf (“strengthening the collective role of the entire board and enhancing self discipline within a board”).

453 If the SEC Office of Compliance Inspections and Examinations finds a violation that appears too serious for informal correction, the case is referred to the SEC’s Division of Enforcement. The SEC can acquire books and records through a subpoena, but the SEC’s Division of Enforcement must often seek approval from the SEC’s Board of Commissioners for a formal order of investigation. Prior to the PCAOB, it was the SEC that decided whether to bring an enforcement action internally before an administrative law judge or in the federal courts. Factors used by the SEC to make this decision include the seriousness of the wrongdoing, the technical nature of the matter, and the type of remedy sought. The SEC brings about 400-500 civil enforcement actions a year against individuals and companies. See The Investor’s Advocate: How the SEC Protects Investors and Maintains Market Integrity, reprinted at http://www.sec.gov/about/whatwedo.shtml. Confidentiality of the investigation results become public if the SEC issues an AAER.

standards first win approval of those possessing the desired professional skills, experience, and judgment, to determine appropriate professional standards. Recognition of the legal status for the FASB and the PCAOB would merely provide greater protection to the public.\textsuperscript{455} It would also create greater accountability for corporate executives operating in fiduciary capacities, their accountants, and auditors.

Regulatory authority belongs in a legitimate government agency that is subject to the legislative budget process and regular public oversight.\textsuperscript{456} The attempt to remove decision-making from entities that have federal responsibilities for regarding the fiscal integrity of the accounting by public companies is contrary to the purposes of the APA and administrative law.\textsuperscript{457} When an agency has the ability to make important accounting rule changes and those decisions are not subject to public oversight, its decisions are more likely to lead to future problems. This was shown by the U.S. savings and loan crisis in the early 1980s.\textsuperscript{458}

The chairman of the FASB, Robert Herz, has stated that, once completed, the expected codification of GAAP "will become the authoritative source of GAAP, thereby allowing us to eliminate the


\textsuperscript{456} See id. at 5.

\textsuperscript{457} See id.

\textsuperscript{458} The S&L crisis was intensified when the Federal Home Loan Bank Board (FHLBB) adjusted the accounting rules without public scrutiny. The accounting adjustments included allowing intangible capital such as goodwill to count, permitting S&Ls to exclude subordinated debt, enabling S&Ls to defer loan losses, and adjusting the way capital was determined. See Jan S. Blaising, Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis, 25 IND. L. REV. 475, 479 n. 21 (1991), citing Cope, Did Pratt's Piloting Sink S&L Industry, AM. BANKER (Oct. 1, 1990). A former chairman of the SEC characterized the problem stating that:

The FHLBB sanctioned unsound accounting practices that operated to inflate the calculation of thrift capital and earnings. By creating the appearance that troubled thrift institutions were in compliance with capital requirements, these accounting standards concealed or minimized the magnitude of the problems facing the industry. As a result, thinly capitalized or insolvent institutions were permitted to pay dividends out of capital, make acquisitions, pay lavish salaries, and engage in aggressive growth.

This codification idea ignores the hierarchy that exists in legal authorities with regulations followed by interpretative authorities that receive less deference from the courts. The remarks also fail to convey the essential overriding legal authority hierarchy in securities law in the accounting for public companies. The accounting standard setting body should routinely acknowledge higher legal authority from the SEC. The FASB's codification project for accounting authorities is long overdue and should assist the researcher in using authoritative accounting sources. It is a myth, however, to believe that simplifying the standards and the supporting literature will assist the profession.

Historically, accounting sources were limited in their distribution in order to raise funds for the organizations which issued them. Thus, accountants either had to subscribe to the FASB's FARS database or purchase the various publications from the FASB, AICPA, and the services summarizing securities laws. The FASB still continues to rely on substantial revenues from publishing its authorities, instead of releasing all the various authorities for professional standards to the public on the FASB website. It is outrageous that after 2003, the FASB will no longer reveal its income from publications in its future financial statements. The FASB has dragged its feet in fulfilling its mission "to establish and improve standards of financial accounting and reporting" by making the professional standards more widely available. The FASB should enable all publishers


460 One exception is that the SFAS is available from the FASAB website. See FASB, Original Pronouncements, http://www.fasab.gov/codifica.html. More recently, the FASB added FASB Interpretations, Technical Bulletins, and Concepts to its website. See FASB, FASB Pronouncements, http://www.fasb.org/st.

461 Thus, the FASB has had an exclusive contract with one publisher (Wiley), which effectively prevented widespread release of its materials in various educational textbooks of other publishers that seek to improve the professionalism of accountants and auditors. See Conversation with Craig Avery, Thomson Learning, at the American Accounting Association convention in Orlando, FL (Aug. 2004).

462 Id.

463 Id.
to reprint all accounting authorities related to U.S. GAAP.

Rather than trying to enable an agency to evade various government procedures, it is in the public's interest to face the reality that PCAOB should qualify as a government agency. Such recognition might help force Congress to address systemic problems in enabling all agencies to issue some legal authorities, as determined by experts in the field. It is possible to make such a process in an orderly, but expeditious, manner to assure both due process and timely results.

Some claim that a regulatory structure adds layers of supervision and monitoring that are wasteful and inefficient. Regulation can malfunction. A critique of government regulation argues that regulation may create entitlements, redistribute wealth, promote economic efficiency, shape or discourage certain preferences, become paternalistic, and reflect interest group pressures. Self-regulatory agencies, however, have repeatedly demonstrated the tendency to overpay their executives. Rather than hiding high salaries paid to those overseeing accounting and self-auditing practices, Congress should seek to rationalize the compensation using market benchmarks in the various agencies, government-controlled corporations, and self-regulatory agencies. Increased visibility of these salaries may lead to pay cuts for the FASB and PCAOB board members, but it would help to rationalize pay increases for the President, government agency executives, SEC employees, treasury employees, and other important agencies helping to make the financial markets work smoothly.

VII. Conclusions

This article has shown that in the global capital markets dominated by the United States and EU, accounting and auditing authority is becoming increasingly more legalized. Corporate

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lawyers must, therefore, become more sophisticated in examining accounting and auditing authorities and their application. Accountants should raise their professional work standards to cope with the litigious environment in which they work, to shape that environment, and to reach ethical decisions within it.\textsuperscript{467} Instead, the fear is that a simplified codification of accounting authorities might try to lower the standards to shield accounting and auditing professionals from full legal scrutiny.\textsuperscript{468}

After SOX, auditing authorities became part of the U.S. law by having the PCAOB submit its proposal to the SEC. Finding that the PCAOB is an "agency" would reflect the reality that the PCAOB is conducting a function of government.\textsuperscript{469} The PCAOB should, therefore, comply with the APA. The APA will create greater accountability for the PCAOB and is not problematic, but merely poses an adjustment process. The EU shows that it is possible to have a political process for adopting professional standards as legal authority.

Regarding the hierarchy of accounting authorities, at least the two highest level of accounting authorities are part of the EU law, the IAS/IFRS and their interpretations. Historically, the legal status of accounting authorities in the U.S. arose from a quasi-legal status accorded to it by the courts and stemming from the SEC regulation of accounting for public companies. If a court recognizes the reality that FASB performs a government function in setting accounting standards, the court should give the highest level of accounting authorities direct legal status. This legal status would arise after SOX and the SEC's increased federal recognition and support. Thus, the FASB could probably qualify as an agency under the APA.

The global capital markets depend upon high quality work from accountants and auditors. These professions in the U.S. and EU must rise to the new legal standards. Otherwise, the U.S. Congress is likely to take legislative action and place greater pressure on other countries to ensure proper financial reporting. Given the current hierarchy of accounting authorities, more clarity

\textsuperscript{467} See generally Robert A. Prentice, \textit{supra} note 437, at 8 (addressing ethical standards of the accounting profession).

\textsuperscript{468} Id.

\textsuperscript{469} See APA, \textit{supra} note 19.
may be needed in national laws. International treaties may also be a desirable way to incorporate their accounting authorities into the existing body of international law.

The accounting profession will not welcome increased legal exposure, but the profession will undoubtedly bear a greater risk of legal liability for improper financial reporting. Society should not tolerate the grossly negligent failures in accounting and auditing which 10(b)(5) securities litigation have ignored. The global capital markets need professional accounting and auditing work to maintain investor confidence in the integrity of the capital markets.