I. The Public Accounting Oversight Board After Dodd-Frank

A. Introduction

Following the Enron and WorldCom financial scandals, Congress responded by creating the Public Company Accounting Oversight Board ("PCAOB" or "Board") as a watchdog and regulator of the auditing industry.[1] The recent Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "Act"), primarily motivated by the Financial Crisis of 2008, includes provisions enhancing the regulatory powers of the PCAOB.[2] As with many other provisions of Dodd-Frank, the portions of the Act affecting the PCAOB generally empower rulemaking authority.[3] As such, the full operative effect of Dodd-Frank on the PCAOB's role will not be known until the Board promulgates new rules. The Act permits the PCAOB to generate rules in two important new areas.[4] First, the Board may now regulate brokers and dealers of securities. Second, the Board has new authority to collaborate with foreign audit overseers.[5] As of now, the PCAOB has rolled out temporary rules for the brokers and dealers requiring the use of the Generally Accepted Auditing Standards ("GAAS").[6] However, the PCAOB anticipates continuing developments in the contours of the rules governing the auditing of brokers and dealers as the PCAOB develops a permanent plan for the regulation of this industry.[7]

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[1] Nancy Lucas, *An Interview with United States Senator Paul S. Sarbanes*, 11 J. LEADERSHIP & ORG. STUDIES 3 (2004).
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[3] *Id*. at §§ 981-82.
[4] Press Release, Public Company Accounting Oversight Board, Fact Sheet—Proposed Interim Inspection Program for Broker-Dealer Audits (Dec. 14, 2010) [hereinafter PCAOB Fact Sheet], *available at* http://pcaobus.org/Rules/ Rulemaking/Docket032/Inspection_Rules_Fact_Sheet.pdf; News Release, PCAOB, PCAOB Statement upon Signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jul. 21, 2010) *available at* http://pcaobus.org/News/Releases/Pages/07212010_DoddFrankct.aspx [hereinafter July 21, 2010 News Release].
[5] *Id*.
[6] PCAOB Fact Sheet, *supra* note 4.
[7] *Id*.

B. PCAOB, Generally

The first major financial crisis of this millennium was the primary catalyst for the PCAOB's creation. In early 2001, investment analysts began to question the financial stability of Enron.[8] The company's stock had soared 90 percent the previous year, but the means through which the company generated revenue remained opaque.[9] For financial experts, these facts raised red flags.[10] Ultimately, deep accounting discrepancies, public disclosure irregularities, and general fraud proved to be the primary drivers for the company's apparent growth.[11] Following Enron's 2001 implosion, WorldCom, assailed by similar internal accounting irregularities and fraud, also collapsed and destroyed billions of dollars of shareholder value.[12] Senator Paul Sarbanes has explained that these corporate collapses and bankruptcies motivated him in drafting the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act of 2002 ("Sarbanes-Oxley" or "Sarbanes-Oxley Act").[13] Sarbanes-Oxley, among other things, created the PCAOB as a regulatory agency tasked with overseeing, investigating, and sanctioning accounting firms located both within the United States and abroad.[14]

The PCAOB stands out among other federal agencies because of its location within the federal government and high-salaried employees. First, the PCAOB is an administrative agency nested within another administrative agency, the Securities and Exchange Commission ("SEC").[15] As outlined by statute, the PCAOB is a non-profit corporation under the supervision and control of the SEC.[16] Though the PCAOB generally operates autonomously

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[8] Kurtz, Howard, *The Enron Story That Waited To Be Told*, WASH. POST, Jan. 1, 2002.
[9] *Id.*
[10] *Id*.
[11] *Id*.
[12] Simon Romero & Riva D. Atlas, *WorldCom Collapse: the Overview; WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES, Jul. 22, 2002; Susan Pulliam & Deborah Soloman, *Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom*, WALL. ST. J., Oct. 20, 2002.
[13]Lucas, *supra* note 1.
14 *See* 15 U.S.C. § 7211(c), (f).
[15] 15 U.S.C. 7211 (2006).
[16] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 § 101;

from the SEC, the SEC oversees and approves the PCAOB's actions, rulemaking authority, and selection of board members.[17] Secondly, the PCAOB does not follow the standard federal pay scale in remunerating its board members.[18] As of 2003, the first members of the board set their salaries at $452,000.[19] Thus, since the PCAOB's inception, it was conceived as a federal agency distinct from its counterparts.

In the years between the PCAOB's creation and the financial crisis of 2008, numerous academics and business people levied significant criticism against the negative impacts of the PCAOB. Researchers from the University of Pittsburgh performed a comparative study of American and British businesses in the years following the passage of Sarbanes-Oxley.[20] The study concluded that firms subject to Sarbanes-Oxley's regulations suffered a chilling effect on risk taking as a result of the enhanced auditing requirements.[21] Kate Litvak, a professor of law at Northwestern University, analyzed the effects of the auditing requirements the PCAOB enforces on equities markets.[22] Professor Litvak concluded that heightened compliance standards damaged the value of corporations' equity shares.[23] Litvak's study argued that investors perceive heightened corporate auditing as having a net negative effect on corporate strength.[24] In a much-debated study, Ivy Zhang, formerly of the William E. Simon Graduate School of Business Administration, estimated that the costs of increased auditing exceed any benefits by $1.4 trillion.[25] The Dodd-Frank Act's PCAOB reforms rest within the context of pervasive criticism of the benefits the PCAOB has brought to the corporate sector.

Free Enterprise Fund v. Public Company Accounting Oversight Board, 561 U.S. - - (2010) (providing an overview of the relationship between the SEC and PCAOB's respective authority).

[17] Sarbanes-Oxley, *supra* note 16, § 107.

[18] Stephen Labaton, *Six Months Later, New Audit Board Holds First Talks*, N.Y. TIMES, Jan. 9, 2003, at C17.

[19] *Id.*

[20] *Five Years Under the Thumbs*, THE ECONOMIST, Jul. 26, 2007.

[21] *Id*.

[22] *Id*.

[23] *Id*.

[24] *Id*.

[25] *Id*.

C. Tenuous Connection Between The Financial Crisis and Accounting Standards

The Dodd-Frank Act expands the powers of the PCAOB;[26] however, the connection between the 2008 Financial Crisis, which motivated the passage of Dodd-Frank, and public companies' accounting standards is tenuous at best. In response to the Financial Crisis, the federal government established the Financial Crisis Inquiry Commission ("Commission") to investigate the causes of the meltdown in domestic and global lending.[27] The Commission published an extensive report exploring several interconnected explanations for the Financial Crisis, including failures in financial regulation, excessive borrowing, overly risky investments, over-the-counter derivatives markets, and the government's incapacity to react.[28] However, the report does not list corporations' failure to enforce accounting standards or the PCAOB's failure to oversee accounting firms as significant contributing causes of the Financial Crisis.[29] Nevertheless, the Dodd-Frank Act, which aims to rectify federal regulations in response to the 2008 Financial Crisis, undertook to expand and enhance the PCAOB.

The timeline of Dodd-Frank's enactment and the Commission's report on the causes of the 2008 Financial Crisis explains, at least in part, the disconnect between the primary causes of the Crisis and statutory reform of the PCAOB's powers. The federal Commission charged with investigating and analyzing the causes of the Crisis completed its report outlining its conclusions of the causes of the financial crisis in January 2011.[30] However, Dodd-Frank was signed into law in July of 2010.[31] Thus, it was impossible for the drafters of the Act to tailor the statute to the Commission's findings.

Different possible explanations exist as to why the Dodd-Frank Act provisions are not completely congruous with the pre-

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[26] Dodd-Frank, *supra* note 2, § 7601 *et seq*.
[27] Fraud Enforcement and Recovery Act of 2009, PUB. L. NO. 111-21 § 5 (2009).
[28] FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xv-xxviii (2011).
[29] *Id*.
[30] *Id*.
[31] Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES, Jul. 21, 2010.

sumptive primary causes of the Financial Crisis. First, it is possible that lawmakers viewed the weaknesses within the American financial system as so pervasive and pressing as to warrant swift legislative action. They may have reasoned that waiting for the Commission to issue its report prior to enacting Dodd-Frank would have left the nation exposed to imminent peril. Second, it is possible that political factors motivated lawmakers to expand and implement as much regulation as possible. The desire to ramp up the regulatory power may have superseded a desire to tailor Dodd-Frank to respond to the main causes of the Financial Crisis. Regardless of whether these or other explanations account for the nature of the Dodd-Frank Act, one fact remains: Dodd-Frank's expansion of the PCAOB's authority is unrelated to the primary presumptive causes of the 2008 Financial Crisis as outlined by the Commission's report.

D. Primary Impact of Dodd-Frank Act

1. Rulemaking Authority

Many parts of Dodd-Frank do not have direct influence on the rules which govern financial institutions; instead, the Act, in large part, empowers agencies to make new rules.[32] As with a great deal of the Dodd-Frank Act, the statute itself does not have a weighty impact on the law governing oversight of accounting firms;[33] rather, the PCAOB has the power, in conjunction with the SEC, to make rules which govern accounting firms and standards.[34] Once the PCAOB completes notice-and-comment review of rules it proposes, the SEC must approve the rule in order for it to take effect.[35] As of February 22, 2011, the PCAOB completed notice-and-comment review for an interim rule to govern the inspection of broker-dealer auditors, but the SEC had yet to approve the rule.[36] As such, Dodd-Frank expanded the PCAOB's rulemaking authority; however, the

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[32] Phil Mattingly, *'Torturous' Dodd-Frank Rulemaking Can Succeed, Regulators Say*, BUSINESS WEEK Sept. 30, 2010.
[33] *Id.*
34 *Rulemaking Releases and Comments*, PCAOB.ORG, http://pcaobus.org/Rules/Rulemaking/Pages/default.aspx (last visited Mar. 5, 2011) (containing a list of rules considered and approved by the PCAOB).
[35] *Id.*
[36] *Id.*

true impact of Dodd-Frank will not become clear until the PCAOB has exercised its authority and the SEC has approved these rules.

2. Broker-Dealers

Dodd-Frank imbues the PCAOB with new authority to meaningfully regulate auditors of brokers and dealers of securities.[37] Under Sarbanes-Oxley, auditors of brokers and dealers bore the responsibility of registering with the PCAOB.[38] Under current law, the PCAOB now has the authority to set standards for, inspect, or discipline auditors of brokers and dealers.[39]

At this point, the PCAOB appears to be proceeding at a cautious pace as it begins to regulate broker-dealers' auditors. As of December 2010, the PCAOB proposed that a temporary rule which would guide Board inspections of broker-dealer auditors.[40] The temporary rule would permit the PCAOB both to commence inspecting broker-dealer auditors and to make fully informed judgments on the scope and nature of the permanent program.[41] The temporary rule does not attempt to alter the basic standards to which auditors of broker-dealers must adhere.[42] Broker-dealers must continue to utilize the auditing protocols GAAS as the SEC has previously explained.[43] However, the PCAOB anticipates that applicable rules and standards may change as the interim period unfolds.[44] The Board draws special attention to open questions regarding the permanent broker-dealer auditor inspection program.[45] The open questions include: 1) whether to differentiate among classes of brokers and dealers; 2) whether differing inspection schedules would be appropriate with respect to auditors that issue audit reports only for brokers and dealers that do not receive, handle, or hold customer securities or cash or are not members of the Securities Investor Protection Corporation; and 3) whether to exempt

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[37] Dodd-Frank, *supra* note 2, § 7601.
[38] July 21, 2010 News Release, *supra* note 4.
[39] *Id*.
[40] PCAOB Fact Sheet, *supra* note 4.
[41] *Id.*
[42] *Id*.
[43] *Id*.
[44] *Id*.
[45] *Id*.

any public accounting firm from such an inspection program.[46] Throughout the release outlining the interim inspection program, the PCAOB highlighted the fact that it plans to review continuously the efficacy of the interim program. The PCAOB plans to use this period of continuous review in order to modify the inspection program prior to proposing a permanent program.[47]

3. International Regulation

Dodd-Frank permits the PCAOB to collaborate with foreign audit oversight boards and participate in global audit regulation.[48] Under Sarbanes-Oxley, the PCAOB had authority, in certain circumstances, to share information with domestic state and federal authorities; however, the Board lacked the authority to share information with foreign regulators.[49] Dodd-Frank relies on the growth in government audit overseers around the world and now permits the PCAOB to share audit information with the goal of enhancing the regulatory capabilities of audit overseers.[50] As outlined by statute, the PCAOB may use its discretion to disclose information to foreign auditor regulators when the disclosure may protect investors or fulfill other purposes of the Dodd-Frank Act.[51]

The ability to share information with foreign audit oversight committees has the potential to assist the PCAOB in responding to challenges created by the proliferation of cross-border stock listings and securities issuances. Two weeks prior to the enactment of Dodd-Frank, the PCAOB issued a press release detailing the challenges the Board faced in regulating companies incorporated in the United States but operating primarily aboard.[52] Foreign companies can create this structure by reverse-merging with an American shell corporation which has previously registered securities under U.S.

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[46] *Id*.
[47] *Id*.
[48] Dodd-Frank, *supra* note 2, § 7602.
[49] July 21, 2010 News Release, *supra* note 4.
[50] *Id.*
[51] Dodd-Frank, *supra* note 2, § 7602 (b).
[52] News Release, PCAOB, PCAOB Issues Staff Audit Practice Alert Regarding Requirements When Using Work of Other Auditors or Engaging Outside Assistants (Jul. 12, 2010) *available at* (http://pcaobus.org/News/Releases/Pages/07122010_SAPA.aspx (noting that many companies with this structure operate primarily in China).

law.[53] Companies of this type often rely on two firms to conduct their audits.[54] The firm that completes the majority of the procedures resides abroad.[55] Then, an American registered public accounting firm participates in a portion of the work.[56] The PCAOB has grown concerned that American audit firms may not always fulfill their obligations when relying on the work of other firms or assistants.[57] In order to understand the challenges associated with inspecting audits of these companies, the PCAOB commissioned a report on reverse mergers involving companies located in the People's Republic of China, Hong Kong SAR, and Taiwan which occurred between January 2007 and March 2010.[58] The research report notes an example of an American auditor relying on research conducted by consultants located in China.[59] In this case, the audit work performed by the consultants was insufficient for the firm to assert that the audit provided a reasonable basis for the firm's opinion on the financial statements.[60] The Board also determined that auditors are failing to fulfill their legal duties arising from SEC rules when relying on the work of other independent auditors.[61]

E. Conclusion

The Dodd-Frank amendments to the mandate of the PCAOB fall into three general categories.[62] First, under Sarbanes-Oxley, the PCAOB did not regulate the auditors of securities brokers and

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[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] Research Note, Public Company Accounting Oversight Board Office of Research and Analysis, Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010 (Mar. 15, 2011), *available at* http://pcaobus.org/Research/Documents/ Chinese_Reverse_Merger_Research_Note.pdf.
[59] *Id.* at 7.
[60] *Id.*
[61] CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, § 543 (Am. Inst. of Certified Pub. Accountants 1972); *See also* Exchange Act Release No. 34-50253, 2004 WL 1917976 (Aug. 25, 2004) (approving PCAOB's proposed changes to rule governing audits performed by other independent auditors).
[62] Dodd-Frank, *supra* note 2.

dealers.[63] Now, the Board has the authority to investigate and discipline broker-dealer auditors. Second, the PCAOB has new authority to share information with foreign audit oversight boards.[64] Third, the PCAOB, in conjunction with the SEC retains its rulemaking authority.[65] The impact of the Dodd-Frank Act on the law which governs auditors cannot be clearly understood until the PCAOB has exercised its rulemaking power. Currently, the PCAOB has approved interim inspection procedures and anticipates drafting new permanent oversight rules in the future.[66]

The reasons for using the Dodd-Frank Act, a law generally aimed at responding to the 2008 Financial Crisis, to reform audit oversight are not self-evident. Fraud and audit irregularities are not among the presumptive causes of the 2008 meltdown;[67] thus, it is not immediately clear that reforming audit oversight provides a regulatory environment which enhances the safety and soundness of the American financial system. Nonetheless, the law on audit oversight has changed and will continue to evolve, because of rulemaking, into the near future.

Mick Bordonaro[68]

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[63] Sarbanes-Oxley Act of 2002, *supra* note 16.
[64] July 21, 2010 News Release, *supra* note 4.
[65] *Id.*
[66] PCAOB Fact Sheet, *supra* note 4.
[67] FINANCIAL CRISIS INQUIRY COMM'N, *supra* note 28.
[68] Student, Boston University School of Law (J.D. 2012).