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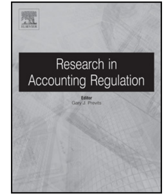

Regular Paper

The PCAOB's role in audit conduct and conscience

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ABSTRACT

The mission of the Public Company Accounting Oversight Board (referred to herein as the PCAOB or the Board) is to protect investors and further the public interest. In this article, the regulatory approach of the PCAOB is contrasted with the Securities and Exchange Commission (SEC) in the context of the "capture" and "public interest" models of regulatory behavior. After the WorldCom fraud, Congress could have stripped the CPA profession of its auditing franchise, but it chose to take a less drastic measure. The independent public accountants retained their audit franchise, but with a new regulator to augment their conscience. The approach is consistent with the SEC strategy in that the auditor continues to fulfill an important role in the financial reporting supply chain. The article discusses the ways in which it appears that the drafters of SOX attempted to infuse the Board with the qualities that have made the SEC so successful. While SOX was prescriptive in many areas, it also imparted a significant degree of discretion to the Board. The article analyzes how the Board has used the discretion granted to it by SOX in ways that are either consistent or inconsistent with the SEC model. Although the PCAOB was structured very similarly to the SEC, the Board has exercised its discretion in ways that appear to deviate from the SEC strategy. The decision to name itself as the auditing standard-setter is an example of the departure from the SEC's own strategy.

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1 Introduction

The Public Company Accounting Oversight Board (referred to herein as the PCAOB or the Board) was established by the Congress when it enacted the Sarbanes–Oxley Act of 2002 (SOX) on July 30, 2002. The PCAOB's purpose, as specified in the law, is to protect investors and further the public interest. Interestingly, the PCAOB is a nonprofit corporation, and not an agency or establishment of the United States Government. Although the idea of establishing a public accounting regulator was not new, there was insufficient public support when the concept first arose in the mid-1970s. The prospect of an accounting regulator was first discussed in 1976 when Congressman John Moss and Senator Lee Metcalf conducted hearings on the role of the accounting profession (Previts & Merino, 1998, p. 380). Subsequent to those hearings, Moss introduced a bill that would create a National Organization of Securities and Exchange Commission Accountancy (NOSA). If the bill had passed, auditors of SEC registrants would have been required to register with the NOSA. The profession was able to defer the establishment of an accounting regulator through the establishment of the SEC Practice Section, the Public Oversight Board, and peer review. From 1977 to 2002, the Public Oversight Board (POB) reported on the profession's self-regulation based on monitoring the SEC Practice Section of the Division for CPA Firms of the AICPA (Flesher & Sharp, 2014).

The tipping point came decades later when the WorldCom fraud was announced in June 2002. The announcement of the fraud provided the necessary public and Congressional support – the bill creating an entity to regulate the public accounting profession, the PCAOB, became law on July 30, 2002. The creation of the PCAOB in reaction to a major financial fraud is a parallel to the creation of the Securities and Exchange Commission (the

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Commission) which was also created in reaction to a major financial fraud, the pyramid scheme of the "Match King", Ivar Kreuger (Flesher & Flesher, 1986).

Although relatively recent events, especially Bernie Madoff, raise questions as to its effectiveness, the Commission has historically been viewed as an effective regulator. McCraw (1982) attributes this success largely to the strategy undertaken by the drafters of the Securities Act of 1933 and the Securities Exchange Act of 1934 (collectively referred to herein as the Securities Acts). Specifically, the strategy was to work with those parties to be regulated to achieve the Commission's objectives. While an approach by a regulator to collaborate with the regulated to enforce the law might risk actual or perceived "capture", the success of the Commission seems to contradict that notion, perhaps because the Commission's strategy was to allow the profession to rely on its conscience.

In this paper, the regulatory approach of the PCAOB is contrasted with the Commission in the context of the "capture" and "public interest" models of regulatory behavior. According to McCraw, historical writing demonstrates that none of the models of regulatory behavior (e.g., capture, public interest, the two together) are satisfactory. However, these models provide an appropriate starting point for analysis. The paper discusses the ways in which it appears that the drafters of SOX attempted to infuse the Board with the qualities that have made the Commission so successful. In addition, the paper analyzes how the Board has used the discretion granted to it by SOX in ways that are either consistent or inconsistent with the Commission's model.

2 The SEC strategy and the structure of the PCAOB

The SEC is "an independent, non-partisan, quasi-judicial regulatory agency" with the primary responsibility "to promote full and fair disclosure in order to protect the public interest" (Previts, Roybard, & Coffman, 2003, p. 148). The Commission was created to regulate the sale of securities to investors, which includes the information provided to investors. At the time the Commission was established, the United States was clawing its way out of the Great Depression. The SEC's mission was to restore faith in the capital markets to help lift the economy out of the doldrums. As McCraw (1982, p. 362) points out, "In 1933, it was not difficult to think in terms of the economy as a whole and to focus on national prosperity and economic growth. This is what the SEC's architects did …".

When the Commission was established, according to McCraw (1982), "the strategic choice was whether the SEC would pursue its mandate mostly with its own staff, or whether it would work through the existing institutional structures." The Commission chose to work through the existing structures, including the public accounting profession. The accounting profession was a beneficiary of the Commission's strategy as it was granted the exclusive right to provide mandated audits to all SEC registrants.

At the time that Congress was debating the bills that would become the Securities Acts, during the congressional hearings, Senator Alben Barkley asked Arthur Carter, then managing partner of Haskins & Sells and president of the New York Society of CPAs, who would regulate the auditors. His response was that the auditor would be regulated by his conscience (see Previts & Merino, 1998, p. 457). In 2002, the auditor's "conscience" appears to have been supplanted by the PCAOB as the public accounting regulator. After the WorldCom fraud, Congress could have stripped the CPA profession of its auditing franchise, but it chose to take a less drastic measure. The independent public accountants retained their audit franchise, but with a new regulator to augment their conscience. The approach is consistent with the SEC strategy in that the auditor continues to fulfill an important role in the financial reporting supply chain.

The PCAOB is structured similarly to the Commission. Just as there are five SEC Commissioners, there are five PCAOB Board Members who serve on a full-time basis. The term of office for both the SEC and the PCAOB is five years, although the PCAOB members are limited to two terms. However, there are also distinct differences in their structure. The most important difference is that the Commission is an agency of the United States federal government whose members are appointed by the President and confirmed by the Senate, whereas the PCAOB members are appointed by the Commission.

Some believe that the PCAOB was structured as a nonprofit corporation and not a federal government agency to avoid the government pay scale. It is reasonable to expect that the PCAOB could attract higher-quality talent if it had the ability to compensate employees at market rates. The SEC is recognized for its ability to attract highly talented individuals and has successfully done so despite being a federal agency. An alternative explanation for the PCAOB's legal structure is that the PCAOB was intended to have a finite life. In other words, the PCAOB would be a catalyst to help the public accounting profession "reset" and regain its focus on the public interest. Some of the PCAOB's decisions and actions are inconsistent with an expectation of a finite life. For example, the PCAOB named itself as the auditing standard-setter.

A further premise could be that the PCAOB was modeled after another not-for-profit organization, the National Association of Securities Dealers (NASD), which was established by the industry with SEC oversight. The NASD was created in response to the over-the-counter market that, prior to 1938, according to McCraw (1982, p. 357) "had harbored some of the sleaziest characters in American business." The SEC and the industry, represented by the Investment Bankers Conference Committee, worked together to draft the legislation that would create the NASD. NASD, now known as Financial Industry Regulatory Authority (FINRA), investigates violations and is empowered to levy fines and take other actions such as suspension or dismissal.

Although the PCAOB is structured similarly to FINRA, there is also a distinct difference. While FINRA is governed by the industry, the PCAOB members are appointed by the Commission. The SOX requires that two, and only two members of the Board, be certified public accountants. A plausible explanation for the decision to limit the CPA profession's representation on the Board is that it was intended to mitigate the risk that the Board would be overtly captured by the profession. However, this provision also ensures that the majority of the Board will have no first-hand knowledge or experience in the industry they have been appointed

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