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Rein in the Public Company Accounting Oversight Board

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The Public Company Accounting Oversight Board is a not-for-profit corporation established by the Sarbanes-Oxley Act to regulate the business of auditing public companies. Although industry self-regulatory organizations are not unusual, this one has the extraordinary power to tax all public companies to support its operations. Its freedom from the ordinary mechanisms of accountability for quasi-governmental functions is already having an effect, shown in its rapidly growing budget. But that is only one of the costs that this agency will impose on the economy. Before these costs get completely out of hand, Congress should intervene and bring it under control.

In all of the commentary about the Sarbanes-Oxley Act, not much attention has focused on the act's creation of the Public Company Accounting Oversight Board (PCAOB). This entity has some truly unique and troubling features. Although it was established by congressional legislation, it is a District of Columbia not-for-profit corporation, not a government agency. It is supposed to be a self-regulatory organization for the auditing activities of the accounting industry, but it is not supported by the industry it regulates; instead, it was authorized by Congress to fund itself by levying fees on all public companies—essentially a tax on the economy as a whole. Finally, although it is supposed to regulate the business of auditing public companies, no more than two of its five members—who must serve full-time—can have had backgrounds as accountants or auditors. This turns the whole concept of a self-regulatory body on its head. The original idea (of New Deal origin) was that industries could best regulate themselves because the regulators are experts in the way the industry functions; the PCAOB, however, was designed so as to prevent control by experts in accounting or auditing.

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This apparent bias against the accounting profession—so that accountants were not even permitted to control their own so-called self-regulatory organization—is a direct result of the overheated atmosphere in which the Sarbanes-Oxley Act was legislated. Passed in the wake of the Enron and WorldCom scandals, the act reflected hostility and distrust of corporate managements and the accounting profession, and out of this grew the regulations of Nasdaq and the NYSE that required public companies to be governed by boards with majorities of "independent" directors. In boardrooms, the act has impaired the collegiality that once prevailed between directors and management, and may be impairing the management risk-taking that is an essential element of economic growth. But for the accounting profession, it has created a sense of adversity between accountants and their regulator. Important rules and standards, which will profoundly affect the cost of audits and how auditors deal with their clients, are being developed by an inexperienced board staff that, from all reports, is keeping practicing accountants and auditors—those who understand the costs and issues involved—at arm's length. This is a prescription for trouble that the business community will ignore to its regret.

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Although Congress has in the past authorized the creation of nongovernmental organizations, such as the Municipal Securities Rulemaking Board (MSRB), to regulate particular sectors of the economy, these self-regulatory organizations (known as SROs) have always been selected from and financially supported by the industry they regulate. The PCAOB, however, is not funded by the accounting profession but by fees levied on over 8,400 public companies. This is a significant difference, which raises questions about both the constitutionality of this organization and the degree to which its power and reach can be controlled.

It is difficult to imagine, for example, that Congress could constitutionally delegate to a private company what is essentially the power to tax the entire economy in support of its regulatory activities. There may be room in constitutional theory for SROs—regulatory bodies composed of industry members and supported by an industry—but under what principle can Congress authorize private companies to exercise what seem to be governmental regulatory powers and to support themselves through a delegated power to tax? On a more technical level, the Securities and Exchange Commission (SEC) appoints the members of the PCAOB, and constitutional scholars may wonder how this could have complied with the appointments clause of the Constitution, which clearly vests "in the President alone" appointments of officers of the United States. To be sure, the Sarbanes-Oxley Act declares that the members of the board and their staff are not "officers of the United States," but it seems highly unlikely that Congress can avoid the appointments clause simply with a form of words, or by authorizing a private corporation to do what the government itself would otherwise do.

The constitutionality of the PCAOB is an important issue that is likely to reach the courts in conjunction with its first major enforcement action, but this issue of the *Financial Services Outlook* will primarily consider a narrower question—whether there are any effective checks on the growth of the PCAOB and the costs it will continue to impose on the economy. As outlined below, by permitting the PCAOB to fund itself by taxing all public companies, Congress has freed the organization from all controls that normally place necessary and practical limits on the activities of both explicit government agencies and SROs.

Are there any effective checks on the growth of the PCAOB and the costs it will continue to impose on the economy?

Unchecked Authority

It is an axiom of American government that the exercise of all governmental power is subject to control. At the highest level, of course, the executive, legislative, and judicial branches of the government are all bound in a constitutional web of checks and balances. In this structure, Congress controls the other branches through its power to appropriate funds for their operations. Because the PCAOB has the power to make and enforce its own regulations, to hold disciplinary proceedings, and to impose penalties, there is little doubt that it has the normal attributes of a government agency. Yet, because it is authorized to tax all public companies in order to support its operations, it is able to operate free of the normal constraints on government agencies.

To be sure, the Sarbanes-Oxley Act placed the PCAOB under the general oversight and control of the SEC, which has the authority to appoint the members of the board, to remove them "for cause," to approve the board's regulations and annual budget, and—significantly—to assign other responsibilities to the board. While on its face this degree of authority would appear significant, a fuller consideration of the sources of the board's independence and the SEC's institutional interests suggests that under the current arrangement real and sustained control is likely to be illusory.

Through the annual appropriations process, Congress balances agency requests for funds against other priorities, and thus exercises practical control over the scope of agency activities by limiting agency resources. In addition, congressional committees with jurisdiction over particular areas of government activity conduct annual reviews of agency operations and effectiveness, and these oversight functions also place practical limits on the scope of agency activities. No similar structures exist for the PCAOB. Since it does not rely on congressional appropriations for its funding, there is little regular oversight of the board through the appropriations process, and as a private company that operates as a kind of subsidiary of the SEC there is no occasion for Congress to review the board's activities through regular oversight hearings. In its two years of operations, the board seems to have had only one oversight hearing—in a House subcommittee in June 2004.

Moreover, unlike other SROs, the PCAOB is not subject to any control by the industry it regulates. Indeed, as noted above, Congress designed the PCAOB so that it

would be insulated from influence by the accounting profession. When an industry SRO is composed of and funded by members of the industry, there is an informal mechanism of control: the regulated industry, with an interest in reducing unnecessary expenditures, keeps a close watch on how much its SRO spends, and this in turn places an informal restriction on the regulatory reach of the agency. The members of the industry who serve on the governing board of the SRO—generally in part-time roles—are constantly in touch with others in the industry and receive critical commentary and feedback about the quality of the SRO's work. These informal elements of control over an SRO are missing in the case of the PCAOB. A majority of its board may not by law be members of the accounting profession, and since the board serves full-time, its members are isolated from day-to-day contact with accountants and auditors. Finally, and perhaps most important, the PCAOB is not funded by the industry it regulates, so the accounting profession has no financial incentive to pay attention to the organization's spending.

PCAOB Spending

Indeed, although it is too early to tell whether the PCAOB will expand its regulatory activities beyond what Congress intended, there are already indications that the organization is taking full advantage of its independence from the normal funding sources of government agencies and SROs. For an apt comparison, consider the National Association of Securities Dealers (NASD), another SRO that conducts investigations, inspections, and enforcement. The NASD regulates 5,200 brokerage firms, with 96,000 branch offices and 664,000 registered securities representatives. In 2004, it performed its regulatory functions with a staff of 2,000 and a budget of approximately $400 million—$200,000 per employee and $76,000 per regulated entity.

In contrast, the PCAOB is already operating at a rate of expenditure that is twice that of the NASD. The PCAOB's 2004 budget was $103 million, with which it regulated approximately 1,400 registered auditing firms. Although at first glance this seems roughly comparable to the NASD's rate of expenditure, it is not. The PCAOB began 2004 with fewer than 126 employees; by June 2004 its staff had grown to 200, and it ended 2004 with 262 employees. This suggests that the organization had an average of about 200 employees during 2004, and if so its cost per employee was over $500,000. In addition, while there are almost 1,400 accounting firms registered with the PCAOB, only eight are large enough to have as many as 100 public company clients and thus to require inspections every year. This means that the board could have spent $10 million for regulating and inspecting each of these eight firms and still had an additional $20 million left over to regulate and inspect all the others—500 of which have fewer than five public company clients.

This pattern seems to have continued into 2005. The PCAOB's 2005 budget calls for expenditures of $136 million, a 35-percent increase over 2004. The budget indicates that the organization began 2005 with 262 employees and expects to end the year with 450. If so, this suggests that the PCAOB will have an average employment in 2005 of approximately 350 employees, or $388,000 per employee—almost twice what the NASD spends per employee—and well over $13 million for each of the eight accounting firms that have more than 100 public company clients.

These costs will be almost entirely paid by public companies, according to a formula in which fees are levied in accordance with the ratio that a company's market capitalization bears to the market capitalization of all public companies. In 2003, 8,424 public companies paid approximately $51 million to support the PCAOB during its first year of operations, with four companies paying $1 million. The board's budget for 2005 will almost triple the 2005 cost for all public companies.

These costs do not, incidentally, exhaust the cost burdens that the PCAOB imposes on the economy. Other costs will come from its regulations, inspections, and investigations, which will require substantial expenditures by regulated accounting firms, and will necessarily be passed through to audit clients. In addition, regulation itself—by imposing costs on the members of a regulated industry—almost always acts as a bar to entry by competitors. The high costs to accounting firms of PCAOB regulation are likely to prevent smaller firms from growing large enough to challenge the four majors, reducing the rate competition that could result in lower audit costs for public companies.

SEC Control?

Late in December 2004, the SEC acted to reduce the PCAOB's budget for 2005 by 11 percent, from $153 million to $136 million. Although this might be considered evidence of SEC control over the PCAOB's spending, it is neither an example of SEC control in this case nor a harbinger of tight control in the future. It is common in Washington for agencies to overestimate their needs when they prepare their funding requests for Congress. This

gives Congress a chance to make some cuts and look parsimonious, while the agencies receive an overall increase. As the following description shows, this is likely to have been what happened in the minuet between the PCAOB and the SEC.

The board approved the initial PCAOB budget for 2005, $153 million, in October 2004. As noted above, less than two months later, the SEC cut the board's budget back to $136 million. But the board did not appear concerned. In a statement at the end of December, it noted a very fortunate turn of events: the board had discovered in the interim that employee recruitment had been slower than anticipated during 2004, and thus that the PCAOB would have fewer employees throughout 2005 than the original, higher budget had anticipated. Voila! The board now needed only $136 million to perform its mission for 2005. Since the board is supposed to be made up of financial experts, one would have assumed that at the time the original budget was approved in October someone would have noticed that recruitment was not proceeding at the anticipated pace. The obvious conclusion is that the PCAOB, in time-honored Washington fashion, had overestimated its financial needs so that the SEC could make a cut without actually constraining the organization's growth.

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Another reason that the SEC's action on the PCAOB's budget should not be taken seriously is that Congress has authorized the SEC to assign additional responsibilities to the PCAOB. For a regulatory agency like the SEC, this provides extraordinary flexibility. Each year, the SEC has to go before Congress and seek more funding for its operations. In this sense, the PCAOB is an answer to the agency's prayers. Since the PCAOB has a funding pipeline directly to all public companies, with no congressional appropriators involved, it will be easy for the SEC to offload projects and assignments onto the PCAOB—not to mention nonperforming employees—saving its appropriated funds for higher priority projects. Needless to say, under these circumstances, the SEC will not be interested in cutting the PCAOB's budget if the organization is in effect supplementing the SEC's own funding.

Intra-government politics also makes it unlikely that the SEC will want to do much to rein in or control the spending of the PCAOB. If it should do so, and if in the future another Enron should creep out of the shadows, the PCAOB will certainly defend itself by pointing to the SEC's budget cuts, just as the SEC was able to blame lack of funding by Congress and the administration for its failure to detect and prevent the Enron fraud. Apart from the minor face-saving cut we saw in the PCAOB's 2005 budget, we should not expect to see the SEC tightly controlling the PCAOB's growth in the future.

Regulatory Reach

Although the growth in its spending is the most visible consequence of the PCAOB's insulation from any real control, in the absence of any funding limitations there is little to stop the expansion of its regulatory purposes and activities. This is such a common phenomenon in Washington that it has a name: "mission creep." It is a rare government agency that does not see compelling reasons to enlarge its jurisdiction and expand its mission, and there is no reason to believe that the PCAOB will be different in this respect. In addition, because it is insulated from influence by the industry it is supposed to regulate, the PCAOB is not subject to the informal limitations on mission creep that other SROs experience.

As outlined in the Sarbanes-Oxley Act, the PCAOB has an enormously broad mandate. Among other things, it is to register all accounting firms that audit public companies; set rules for auditing, quality control, and independence of auditing firms; conduct on-site inspections; carry out investigations; conduct disciplinary proceedings; and impose appropriate penalties. These authorities are very broadly stated. How many on-site inspections are sufficient, and how extensive should they be? Some of the larger accounting firms have global operations. Will each office be inspected each year? Will there be standards for training staff and examinations or requirements for continuing education? Is there any natural limit on the scope of an "investigation"? Like independent counsel investigations, the board's investigations and the inspections may never come to an end; there are always stones left unturned. Ordinarily, this process is kept in check by the relatively small increments in which new money is handed out by Congress, or by complaints from the regulated industry that must pay the bills in the case of an SRO. But the

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The irony here is that we never needed a PCAOB. Scholars and commentators on accounting have noted for the last twenty years that financial statements based on Generally Accepted Accounting Principles (GAAP) are becoming less and less useful as a means of financial disclosure. This is because, increasingly, companies are generating revenues through the use of intangible assets—patents, know-how, computer software, brands, employee skills, and contractual relationships with suppliers and customers—that cannot be effectively valued for purposes of GAAP reporting. In establishing an agency specifically for the purpose of the auditing of GAAP financial statements, Congress was fighting the last war. The problems associated with GAAP are not—as Congress seemed to think—problems of accuracy; they are problems of adequacy. The Enrons of the future will not be discovered through better auditing, but through comparisons of cash flows and industry-wide metrics that disclose key performance indicators—neither of which is brought to light through either GAAP accounting or the audit process.

What Is to Be Done?

Congress must take steps to gain control of the PCAOB. The simplest and most effective method would be to fold it into the SEC. This could be done immediately, with the board then serving as an advisory body on the development of rules and standards for auditing. But at the outside, the board should be terminated within five years, the term of the board's members. In that period, it should be possible for the board to have made all the rules and established all the standards necessary to govern the business of auditing. Once that work is complete, the PCAOB should cease to exist, and enforcement of its regulations should rest with the SEC, which could of course update the rules as changing conditions warranted. This would put regulatory authority back where it belongs—in a legitimate agency of the U.S. government—and would subject that authority to an appropriations process and a regular system of congressional oversight.