

No. 08-861

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IN THE  
*Supreme Court of the United States*

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FREE ENTERPRISE FUND AND  
BECKSTEAD AND WATTS, LLP,  
*Petitioners,*

*v.*

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD  
AND UNITED STATES OF AMERICA,  
*Respondents.*

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**On Writ Of Certiorari To The  
United States Court Of Appeals  
For The District Of Columbia Circuit**

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**BRIEF FOR  
THE CENTER FOR AUDIT QUALITY  
AS *AMICUS CURIAE*  
SUPPORTING RESPONDENT  
PUBLIC COMPANY ACCOUNTING  
OVERSIGHT BOARD**

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PUBLIC COMPANY ACCOUNTING  
OVERSIGHT BOARD**

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The Center for Audit Quality (“CAQ”) respectfully submits this *amicus curiae* brief on behalf of itself and its members in support of Respondent Public Company Accounting Oversight Board (“PCAOB” or the “Board”).\*

**INTEREST OF *AMICUS CURIAE***

The CAQ is a public policy organization that seeks to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change, rooted in the audit and accounting profession’s core values of integrity, objectivity, honesty, and trust. Any U.S. accounting firm registered with the PCAOB may join the CAQ. The CAQ is affiliated with the American Institute of Certified Public Accountants (“AICPA”), and has approximately 700 U.S. public company

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\* Pursuant to this Court’s Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than the Center for Audit Quality, its counsel, and its members made a monetary contribution to the preparation or submission of this brief. Letters consenting to the filing of this brief by all parties have been submitted to the Clerk.



auditing firms as members, representing tens of thousands of professionals dedicated to audit quality.

The CAQ seeks to improve the reliability of public company audits and to enhance their relevance for investors, particularly in this time of growing financial complexity and globalization. The CAQ is dedicated to helping increase public confidence in the auditing process and to maintaining high standards in the accounting profession. To fulfill its mission, the CAQ offers recommendations to policymakers, issues technical support for public company auditing professionals, and participates in the public discussion about financial reporting.

Accordingly, the CAQ has a keen interest in cases, such as this one, concerning the regulation of auditors and the audit process, and their broader impact on investors and the capital markets. This brief does not address the constitutional questions raised by Petitioners, but rather provides context to help the Court understand the PCAOB's role in achieving the goals Congress embodied in the Sarbanes-Oxley Act, from the perspective of the profession the PCAOB regulates.

### **STATEMENT**

Congress passed the Sarbanes-Oxley Act of 2002 (the "Act"), Pub. L. 107-204, 116 Stat. 745, in response to scandals that exposed serious weaknesses in the financial reporting required by publicly held companies. *See Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 537 F.3d 667, 669 (D.C. Cir. 2008). The Act has many provisions focused on enhancing the accuracy and reliability of financial statements, including a requirement for management certifications relating to financial

statements, new disclosures and audit procedures related to internal controls, and an enhanced role for audit committees. *See, e.g.*, 15 U.S.C. §§ 7241, 7262, 78f. The centerpiece of the legislation is the creation of the Public Company Accounting Oversight Board.

Prior to the adoption of the Act, regulation of the audit profession was decentralized. Beginning with the Securities Act of 1933, Congress enacted a series of laws that required public companies to have financial statements audited by independent accountants; but the Securities and Exchange Commission (“SEC”) chose not to exercise formal power to regulate the methods used to audit financial statements included in SEC-mandated filings. Instead, the SEC generally looked to the states, which in turn often adopted the AICPA’s guidance.

The passage of the Sarbanes-Oxley Act in 2002 created a new paradigm for audit regulation, which relies heavily on the newly created PCAOB. The Act directs the PCAOB, under the oversight of the SEC, to regulate public company auditors and audit processes. The Act empowers the PCAOB, again subject to the oversight of the SEC, to register public accounting firms, establish auditing and ethics standards, conduct inspections and investigations of registered firms, and impose sanctions on registered firms and their personnel. *See* 15 U.S.C. §§ 7211(c), 7219(c), (d); *see also Free Enter. Fund*, 537 F.3d at 669.

Since January 2003, the PCAOB has registered more than 1,870 accounting firms; established auditing and ethics standards; conducted hundreds of inspections of registered firms; and imposed

disciplinary sanctions on firms and individuals. *See* 2008 PCAOB Annual Report at 7, 9 (2009).

### **SUMMARY OF ARGUMENT**

Congress structured the PCAOB to ensure that the regulation of the profession is undertaken on an informed basis, but is not subject solely to the viewpoint of the profession. This structure enables the Board to reflect best practices in the profession and to serve the interests of the public.

Although only a few years have passed since the passage of the Sarbanes-Oxley Act, the evidence demonstrates that regulation by the PCAOB has led to substantial progress in meeting Congress's goals of improving audit quality and increasing investor confidence.

PCAOB inspections have improved audit quality in a number of ways. These inspections provide an independent review of audit quality, have focused firms on remediating audit issues identified during the inspections, and have provided transparency to audit committees and investors.

Moreover, the PCAOB's oversight of the profession brings with it stability and predictability that is beneficial to both the investing public and the audit profession. The profession appreciates the benefits that a tough but fair, well-informed and appropriately focused regulator can bring to audit quality, and recognizes that an entity charged with audit regulation provides corresponding benefits to investors.

No profession or industry seeks regulation with open arms, and the CAQ and its members have had and will continue to have views that diverge from the PCAOB on various matters. Nevertheless, the

establishment of the PCAOB has generally been seen by auditors as a net positive for the profession, capital markets, and investors. Were the Court to strike down the PCAOB, all of these benefits—expert, focused regulation; improved audit quality through a system of inspections emphasizing remediation; and stability of the regulatory regime—would be cast aside.

## **ARGUMENT**

### **I. CONGRESS STRUCTURED THE PCAOB TO PERFORM ITS DUTIES EFFECTIVELY.**

Congress carefully structured the PCAOB's membership. The Board has five members, who are to be appointed "from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public." 15 U.S.C. § 7211(e)(1). Significantly, "[t]wo members, and only 2 members, of the Board shall be or have been certified public accountants." *Id.* § 7211(e)(2). Congress chose this balanced membership to serve two goals: first, the PCAOB's authority over the profession and auditing principles was designed to be exercised and informed by individuals who are knowledgeable about the performance of audits; and second, the viewpoint of the profession will not dominate the Board's analysis of any issue.

This structure was intended to ensure that the highly technical regulation of auditing practice is conducted on an informed basis. Generally, the Board has three broad functions: adopting auditing, quality control, ethics and independence standards related to the preparation of audit reports; inspecting registered firms; and investigating registered firms

and their personnel. *Id.* § 7211(c)(2)-(4). By ensuring that accounting professionals have a significant but not dominant role on the Board, Congress intended that audit-relevant experience would be brought to bear to guide the Board's operations. And by placing these functions in a focused and expert entity, Congress intended to ensure that these powers would be exercised in a manner that protects the investing public and accurately reflects professional standards.

The PCAOB's overall structure reflects a further Congressional determination that, in order to secure these benefits, the Board—while operating under the oversight of the SEC—had to be a private body for certain purposes. *Id.* § 7211(b). In such significant areas as budgeting and hiring staff, Congress decided that expert regulation would be best placed in a private entity. *Id.* § 7211(c)(7). In particular, Congress directed that the Board be able to pay its staff “at a level that is comparable to *private sector* self-regulatory, accounting, [or] technical” salaries. *Id.* § 7211(f)(4) (emphasis added).

Although these goals could conceivably be pursued through other structures, Congress chose to design the PCAOB in this manner. Changing the structure would inevitably result in a change to the focus and expertise of the Board as carefully created by Congress, and to the make-up of the Board and its staff.

## **II. AUDIT QUALITY AND INVESTOR CONFIDENCE HAVE IMPROVED SINCE THE CREATION OF THE PCAOB.**

One of the Act's main goals is to increase investor confidence in U.S. capital markets by strengthening financial reporting. *See, e.g.,*

*Sarbanes-Oxley at Four: Protecting Investors and Strengthening the Markets, Hearing Before the H. Comm. on Fin. Servs.*, 109th Cong. 44-45 (2006) (Statement of Rep. Michael G. Oxley, Chairman, House Comm. on Fin. Servs.).

As with any major piece of ground-breaking legislation, various provisions of the Act have come under criticism, but “[r]egulators, public companies, audit firms, and investors generally agree that the Sarbanes-Oxley Act of 2002 has had a positive and significant impact on investor protection and confidence.” Government Accountability Office, GAO-06-361, *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, cover page (2006). Indeed, the Act has been described as a “godsend” to investors, producing “major benefits” including “more reliable corporate financial statements.” David Henry, “Not Everyone Hates SarbOx,” *Business Week*, Jan. 29, 2007.

Although its critics complain that the PCAOB is not “an efficient, convenient, or ultimately useful means of regulating the accounting industry,” Cato Br. at 10, the evidence of the PCAOB at work is to the contrary: Investor confidence has increased since the establishment of the PCAOB and the implementation of other Sarbanes-Oxley reforms, and the PCAOB’s inspection process has contributed to improved audit quality.

**A. Investors have more confidence in U.S. capital markets.**

As then SEC Chairman Christopher Cox recognized in 2006, “[w]e have come a long way since 2002. Investor confidence has recovered. There is greater corporate accountability. Financial reporting

is more reliable and transparent. Auditor oversight is significantly improved.” *Sarbanes-Oxley at Four: Protecting Investors and Strengthening the Markets*, 109th Cong. 56 (testimony of Christopher Cox, Chairman, SEC). All of these benefits are directly traceable, at least in part, to the actions of the PCAOB.

A national survey of investors conducted by the CAQ in 2007 found that 84 percent of investors “have confidence in the U.S. capital markets,” and 80 percent of investors have confidence in “the financial information provided by public companies.” Press Release, Center for Audit Quality, Center for Audit Quality Survey Finds Majority of Nation’s Investors Support Sarbanes-Oxley, Believe Rules Mandated by Act Should Not Be Eased (July 28, 2007) (“July 2007 Press Release”), available at [http://www.thecaq.org/newsroom/release\\_07282007.htm](http://www.thecaq.org/newsroom/release_07282007.htm).<sup>1</sup> Sixty percent of investors surveyed said “they have more confidence in audited financial information released by publicly traded U.S. companies than they used to.” Center for Audit Quality Research Summary for Telephone

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<sup>1</sup> The CAQ engages in regular telephone and internet surveys of stakeholders in the audit process, including investors and audit committee members. In particular, the CAQ conducted telephone surveys of approximately 1,000 investors in July 2007, July 2008, and September 2009. The CAQ also conducted an internet survey of audit committee members in March 2008. These surveys help the CAQ to promote informed dialogue about issues of importance to the U.S. capital markets for the benefit of investors, the public company auditing profession and the markets as a whole.

Survey conducted July 17-23, 2007 at 1 (“2007 Research”), available at <http://www.thecaq.org/events/sox/researchsummary.pdf>.

This increased confidence can be traced specifically to the work of the PCAOB, whose involvement 76 percent of investors agreed has been effective, and 28 percent of investors described as “*very positive.*” 2007 Research at 2. Seventy-nine percent of investors surveyed attributed bolstered confidence in public companies’ financial information to “changes brought about by the Sarbanes-Oxley Act,” and two-thirds of investors “would be concerned by any easing of rules mandated by the Sarbanes-Oxley Act.” July 2007 Press Release.

Even as the general decline in U.S. capital markets was taking hold, a survey of investors conducted by the CAQ in July 2008 showed that 70 percent of investors surveyed “expressed confidence” in U.S. markets. Press Release, Center for Audit Quality, Investor Confidence in U.S. Capital Markets Declines Due To Energy Costs, Weak Dollar and Home Foreclosures (July 30, 2008), available at [http://www.thecaq.org/newsroom/release\\_07302008.htm](http://www.thecaq.org/newsroom/release_07302008.htm). A survey of investors completed in September 2009 shows that investor confidence has stabilized, with 73 percent of investors expressing confidence in U.S. capital markets, a slight increase over 2008. Press Release, Center for Audit Quality, Investor Confidence in U.S. Capital Markets Stabilizes Despite Economic Turmoil (September 30, 2009), available at [http://www.thecaq.org/newsroom/release\\_09302009.htm](http://www.thecaq.org/newsroom/release_09302009.htm). The decrease in investor confidence since 2007 is not surprising given the market upheaval, but the number of positive responses demonstrates that a supermajority of U.S.



investors have confidence in the U.S. markets as appropriately regulated.

These surveys demonstrate that investors view themselves as “benefit[ing] from the stronger internal controls, greater transparency, and elevated accountability that have resulted from this new law.” Committee on Capital Markets Regulation Interim Report at xiii (2006). And the increased investor confidence supports the conclusion that the Act is working, and that the PCAOB’s vital role in the administration of that law has been successful.<sup>2</sup>

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<sup>2</sup> Critics assert that the Act imposes unnecessary costs on the American economy. *See, e.g.*, Cato Br. at 24. Most of this criticism, however, centers on Section 404, which sets forth internal control reporting requirements—requirements imposed directly by Congress. In any event, “[m]any believe that the SOX 404 ‘is working,’” and “[t]he academic research provides important support for these conclusions.” Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding The Impact of SOX 404*, 29 *Cardozo L. Rev.* 703, 715 (2007) (citations omitted). As then SEC Chairman Cox recognized, “it is wrong to conflate the implementation problems of 404 with the entirety of the Sarbanes-Oxley Act. While it’s a handy whipping boy, overall the law has had important positive effects. It may fairly be credited with correcting the most serious problems that beset our markets just a few years ago. It has played a significant role in restoring integrity to our markets.” Remarks to the U.S. Chamber of Commerce’s First Annual Capital Markets Summit: Securing America’s Competitiveness (Mar. 14, 2007).

Even where criticisms over Section 404 are raised, it is often acknowledged that the Act on the whole improved corporate governance. “The vast majority

[Footnote continued on next page]

**B. The PCAOB inspection process improves audit quality.**

Under the Act, the PCAOB is tasked with carrying out inspections of registered accounting firms. 15 U.S.C. § 7214(a). The largest registered firms—those with more than 100 issuer clients—are inspected annually, and smaller registered firms are inspected once every three years. *Id.* § 7214(b).

The PCAOB’s inspections are “designed to identify auditing problems at an early stage and focus firms on correcting them.” *Sarbanes-Oxley at Four: Protecting Investors and Strengthening Markets*, 109th Cong. 71 (testimony of Mark W. Olson, Chairman, PCAOB). PCAOB inspections “begin by looking at the professional environment in which audits are performed and focus on the influences—both good and bad—on a firm’s audit practice. . . . PCAOB inspections are also risk-based, in that they focus on the aspects of audits that present the greatest risk.” *Id.* The PCAOB’s inspections are viewed as independent and reflecting a high degree of actual audit experience. Clive Lennox & Jeffrey Pittman, *Auditing the Auditors:*

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[Footnote continued from previous page]  
of the Act’s provisions are: positive; easy to understand; improving corporate governance; cost effective; and consistent with the objective of reducing financial fraud.” American Electronics Association, *Sarbanes-Oxley Section 404: The ‘Section’ of Unintended Consequences and its Impact on Small Business* 1 (Feb. 2005), available at <http://www.acanet.org/governmentaffairs/AeASOXPa perFinal021005.asp>.

*Evidence on the Recent Reforms to the External Monitoring of Audit Firms* 3 (October 2008) (explaining that the PCAOB is independently funded and employs inspectors without current ties to audit firms); *see also* 2008 PCAOB Annual Report at 5 (explaining that inspection team leaders for inspections of the largest firms average 27 years of relevant experience and other PCAOB inspectors average 15 years of relevant experience).

PCAOB inspections also increase audit quality by focusing on *remediation* of any quality issues identified. Congress decided in the Sarbanes-Oxley Act that quality control criticisms identified during an inspection remain non-public for a year after they are identified. 15 U.S.C. § 7214(g)(2). If those criticisms are not addressed to the PCAOB's satisfaction within the year period, they are then publicly reported. *Id.* This provides registered firms "additional incentive to correct problems." *Sarbanes-Oxley at Four: Protecting Investors and Strengthening Markets*, 109th Cong. 72 (testimony of Mark W. Olson, Chairman, PCAOB).

In 2008, the PCAOB made determinations concerning quality control remediation efforts related to 162 inspection reports. 2008 PCAOB Annual Report at 12. With respect to 117 of those reports, the PCAOB determined that the firm had implemented remediation steps to the PCAOB's satisfaction, and thus, per the congressional plan, did not make that section of the report public. *Id.* Mark Olson, then Chairman of the PCAOB, recognized that registered firms undertook remediation efforts as a result of inspections, explaining that "[w]hen firms approach inspections with a cooperative attitude, the PCAOB has been

able to achieve significant real-time improvements, often even before an inspection is concluded.” *Sarbanes-Oxley at Four: Protecting Investors and Strengthening Markets*, 109th Cong. 72.

The U.S. Treasury Department’s Advisory Committee on the Audit Profession noted in its final report that it “heard of many positive developments within the auditing profession in recent years and of a generally positive impact the [PCAOB] has had on audits.” U.S. Treasury Department, Advisory Committee on the Auditing Profession, Final Report at II:1 (Oct. 6, 2008) (Co-Chair’s Statement). Indeed, research suggests that audit quality has improved in the post-Sarbanes-Oxley Act era. See Lennox & Pittman, *Auditing the Auditors* at 25; Gerald J. Lobo & Jian Zhou, *Did Conservatism in Financial Reporting Increase After the Sarbanes-Oxley Act? Initial Evidence*, 20 *Accounting Horizons* 57 (2006); Daniel A. Cohen, Aiyesha Dey & Thomas Z. Lys, *Real and Accrual-Based Earnings Management in the Pre- and Post-Sarbanes Oxley Periods* (June 2007).

Significantly, audit committee members—to whom Congress gave an enhanced role in reviewing audit quality under the Act—have stated that audit quality has improved under the PCAOB. The CAQ conducted a survey of audit committee members in Spring 2008, and found that more than “three-quarters of audit committee members [surveyed] rate overall audit quality [as] ‘very good’ or ‘excellent.’” Press Release, Center for Audit Quality, Post-SOX Audit Quality Has Improved, Say Nation’s Audit Committee Members at 1 (Mar. 18, 2008), available at [http://www.thecaq.org/newsroom/release\\_03182008.htm](http://www.thecaq.org/newsroom/release_03182008.htm). Eighty-two percent of those surveyed

said that audit quality “has improved in recent years.” *Id.* Sixty percent of audit committee members agreed that the risk of financial inaccuracies in reported statements due to fraud declined after the passage of the Act. *Id.* Increased external auditor scrutiny played a role in the low risk of fraud and materially inaccurate statements. *Id.* In general, 65 percent of audit committee members surveyed “agreed that investors should have more confidence in the markets as a result of the 2002 law,” and 58 percent said changes resulting from the Sarbanes-Oxley Act “had a positive impact.” *Id.*

The publication of inspection reports also increases transparency of the audit process to audit committees and the investing public by providing insight into areas where the PCAOB identified weaknesses or deficiencies through inspection. This additional information, in turn, assists audit committees in their oversight of the registered firms.

By conducting thorough inspections, focusing on remediation, and helping to improve the function of audit committees, backed up by the ability to impose meaningful sanctions, the evidence demonstrates that the PCAOB has contributed to improved audit quality. *See, e.g.,* Mark W. Nelson, *Ameliorating Conflicts of Interest in Auditing: Effects of Recent Reforms on Auditors and their Clients*, at 10-11 (July 11, 2005) (noting that the PCAOB’s ability to conduct thorough inspections combined with the ability to levy significant sanctions “should encourage auditors to perform more effective audits”).

### **III. STABILITY AND PREDICTABILITY IN AUDIT REGULATION PROVIDE BENEFITS TO INVESTORS AND THE AUDITING PROFESSION.**

The Sarbanes-Oxley Act created the PCAOB to replace a system that had been criticized and in which Congress and the investing public had lost confidence. The PCAOB provides enhanced inspection and enforcement activities, along with greater clarity for auditors regarding rules to be followed in performing audits.

Since its establishment, then PCAOB Chairman Mark W. Olson explained, “[t]he Board has evolved from a start-up organization to a more steady state of operation.” Melissa Hoffman Lajara, *Q&A with PCAOB Chairman Mark W. Olson*, *The Trusted Professional: The Newspaper of the NYSSCPA*, May 15, 2008, available at <http://www.lucaonline.com/trustedprof/508a/tp4.htm>. Over time, the PCAOB “has built and continues to refine its supervisory oversight programs to assure that it fulfills its statutory duty of overseeing auditors of public companies in order to protect the interest of investors.” *Id.*

As the PCAOB continues to operate, and to develop its own rules of practice, the profession and the investing community will continue to benefit from its oversight. The profession recognizes that PCAOB standards and the close scrutiny of PCAOB inspections will drive auditor behavior with lasting effect across the profession. The PCAOB inspection process is generally viewed as an opportunity to improve audit quality, and to do so with the supervisory assistance of the PCAOB. A tough, but fair, expert, and independent regulator will continue

to help improve audit quality and to restore the confidence of the investing public.

Maintaining the PCAOB's oversight of the profession—and not dramatically changing the regulatory structure for the second time in less than a decade—will help to provide consistent and predictable regulation that can be relied upon both by auditors and by the investing public. As this Court has recognized, in the securities markets in particular, “uncertainty . . . can have ripple effects.” *Cent. Bank v. First Interstate Bank*, 511 U.S. 164, 189 (1994); see also generally, e.g., Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 *Duke L.J.* 945, 962 (1993) (increases in “uncertainty deter beneficial conduct and breed costly litigation”).

At a time of market and financial upheaval, overturning the established system of regulation will exacerbate investors' fears about the integrity of capital markets, and interfere with the ongoing work of regulation. Were the Court to find the PCAOB as established to be constitutionally impermissible, the uncertainty surrounding the effect of past regulations, and the question of what form future regulation would take, would have negative consequences for investors, the profession, and the markets generally.

**CONCLUSION**

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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