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# Comparative Institutional Choice Analysis for Audit Regulation: Evaluating the Sarbanes-Oxley Act of 2002

Micah Bible

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DATE COMPLETED APRIL 27, 2005

**COMPARATIVE INSTITUTIONAL CHOICE ANALYSIS FOR AUDIT  
REGULATION: EVALUATING THE SARBANES-OXLEY ACT OF 2002**

**A project submitted in partial fulfillment of the requirements for the degree of  
Bachelors of Arts in College Scholars in the College of Arts and Sciences of the  
University of Tennessee, Knoxville**

**Charles Micah Bible**

**May 2005**

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## **Abstract**

The Sarbanes-Oxley Act of 2002 is a broad federal corporate governance regulation. With the Act, Congress reforms the process of financial statement disclosure by enacting new rules for the behavior of corporate management, corporate audit committees, and independent auditors. Scholars of law, public policy, and accounting debate the appropriateness and effectiveness of federal corporate governance reform. This paper combines participant-centered and rule-centered comparative institutional choice frameworks to discuss the institutional choices made during corporate governance regulation. The participant-centered model examines majoritarian and minoritarian influence during policy initiation. The rule-centered model compares the capacity and competence of Congress, the SEC, and the federal judiciary during policy formulation. This paper uses the example of regulating non-audit services provided by auditors to demonstrate comparative institutional choice as a tool for selecting the optimal institutional vehicle.

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## Introduction

Scholars from a variety of disciplines have engaged to debate the efficacy and appropriateness of the Sarbanes-Oxley Act of 2002 (H.R. 3763) since it was passed by the United States Congress and signed into law by President Bush on July 30, 2002. The social goal of the Sarbanes-Oxley Act of 2002 (SOX) is to “protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”<sup>1</sup>

While many agree about the necessity of a social goal to “protect investors” in the midst of corporate frauds that were widespread in 2002, many also raise questions about the institution best suited to reform the audit profession. Much of the debate focuses on the speed and force with which Congress took charge of audit regulation in the midst of widespread corporate fraud.<sup>2</sup> Did Congress move too fast to effectively regulate a federal level? Is it appropriate for members of the American Institute of Certified Public Accountants (AICPA), a private organization comprised of accountants, to continue regulating the behavior of auditors? Should the federal judiciary make a ruling on audit reform? To answer these questions, it is important for one to fully understand the stakes of the participants, the social goal they pursue, and the institutions available to pursue it.

Comparative institutional choice analysis provides a framework for gathering information about institutions and policy results. Neil Komesar describes the importance of institutional choice analysis in his book, Imperfect Alternatives as follows:

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<sup>1</sup> See The Sarbanes-Oxley Act. Pub. L. 107-204. 30 July 2002. Stat. 745.

<sup>2</sup> See William Ide, “Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight,” *Mercer Law Review*, 54 (2003): 829; see also Larry E. Ribstein, “Bubble Laws,” *Houston Law Review*, 40 (2003): 88-89; see also U.S. Chamber of Commerce, “U.S. Chamber of Commerce on Swift Conference Action, Corporate Reform Impacts Not Well Understood,” <http://www.uschamber.com/press/releases/2002/july/02-120.htm> .

Goal choice and institutional choice are both essential for law and public policy. They are inextricably related. On the one hand institutional performance and, therefore, institutional choice cannot be assessed except against the benchmark of some social goal or set of goals. On the other, because in the abstract any goal can be consistent with a wide range of public policies, the decision as to who decides [on the specifics of the policy] determines how a goal shapes public policy. It is institutional choice that connects goals with their legal or public policy results.<sup>3</sup>

Discussions limited to social goals have generated useful public policy analysis. This paper strives to demonstrate that successfully protecting investors by regulating auditing depends as much upon the capacity, competency, and impartiality of the institution charged with the task as it does upon the goal. Donald Schwartz notes that “federal influence on corporate governance could be enhanced either through action by Congress, the regulatory agencies, or the courts.”<sup>4</sup> The body of this paper utilizes a comparative institutional choice analysis of the decision-making processes and allocations of responsibility found within Congress, the SEC, and the federal judiciary to understand how regulation of financial statement issuances is initiated, and how selection of the optimal institution is possible in light of a clearly defined regulatory objective.

Comparative institutional choice analysis offers a number of advantages over analysis of a single institution. The foremost is a framework that captures the significant and controversial decision about who will shape the contours of the law. With a singular

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<sup>3</sup> See Neil Komesar, *Imperfect Alternatives*. (Chicago: The University of Chicago Press), 1994, 5.

<sup>4</sup> See Mark J. Roe, “Delaware’s Competition,” *Harvard Law Review*, 117 (2003): 598-99; See also Donald E. Schwartz, “Federalism and Corporate Governance,” *Ohio State Law Journal*, 45 (1984): 571.



institutional focus, this decision is treated superficially or, at best, analyzed in terms of the attributes of only one institution.<sup>5</sup> A comparative framework for institutional choice, on the other hand, makes a parallel comparison of how the institutional decision is made for each institutional alternative. Participant-centered comparative institutional choice compares the costs and benefits of participant action in each of the available institutions. This comparison enhances the understanding of previous institutional choices, and predicts future institutional choices.

The second most significant advantage of comparative institutional choice analysis over single institutional analysis is that it flushes out the institutional strengths and weaknesses that lead to good and bad policy outcomes. The economic theory of public policy highlights resource allocation efficiency as the overriding determinant of policy success. Some analysts have argued against the social goal of efficient resource allocation, preferring to measure a policy's success with concepts such as Rawlsian justice or Lockean protection of property. By focusing solely on normative and descriptive arguments about social goals, policy analysts fail to link social goals to policy results.<sup>6</sup> Sometimes bad policies emerge from good social goals. The attributes of the institution chosen to regulate often affect policy results as much as the qualities of the goal that is pursued. The rule-centered framework for comparative institutional choice describes the abilities of several institutions to regulate a clearly defined rule in a given area of the law. In this way, rule-centered institutional choice connects social goals, no matter what they are, to policy outcomes, and assists policy analysts in deciding which institution is optimal for a specific rule.

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<sup>5</sup> See Neil Komesar, *supra* note 3, 4-5.

<sup>6</sup> *Ibid.*

Finally, comparative institutional choice fortifies policy analysis against the notion that institutional choice is intuitively obvious. The intuitive approach undermines the importance of observing variations of ability among institutional alternatives. Institutional alternatives are often intuitively dismissed by a parade of horrors because they are not consistent with the analyst's policy position. Comparative institutional choice, on the other hand, emphasizes the argument that any social goal is consistent with a wide range of public policies from a variety of institutions. Choosing the best institution often means choosing from a list of imperfect alternatives.<sup>7</sup>

Although both the participant-centered and the rule-centered approach to comparative institutional choice are designed to operate individually, this paper combines them to form a multi-step comparative institutional choice analysis. The combined framework provides more insight because it allows the analyst to investigate institutional choice at two stages of policy development: initiation and regulation. It is proposed that the participant-centered approach is most useful during initiation, when the participation of mass actors determines which institution is preferred. The institution chosen by policy initiators, however, is not necessarily the optimal one for regulation. Rule-centered comparisons are more effective in determining the optimal institution to create the proposed rule.

Congress mandated broad reform in many different areas of corporate governance with SOX. The efficacy of the law is most forcefully discussed by focusing on the sections reforming the process of auditing financial disclosures. Because investors rely heavily on financial statement information for economic decision-making, regulating financial statement audits is central to achieving the goal of protecting investors. With

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<sup>7</sup> See Neil Komesar, *supra* note 4, 22-23.

comparative institutional choice, an economic analysis of audit-related rules is enriched and suggestions for future regulatory action in a variety of areas are thoughtfully constructed.<sup>8</sup>

Focusing on how institutions interact with and control financial statement auditors establishes the framework for analyzing participant-centered factors involved in initiating audit regulation. This paper focuses on one area of corporate governance reform addressed by SOX: regulation of non-audit services provided by auditors (found in Section 201 of SOX). References to particular sections of SOX are made to create a context for comparative purposes, not to critique the Sarbanes-Oxley Act.

Before institutional choice analysis is described in detail, the first section of this paper discusses the role of auditors in financial statement disclosure. Section II explains institutional choice in the context of audit regulation and identifies the premises of the participation-centered and rule-centered models of institutional choice analysis. Section III describes the combined framework of the institutional choice analysis in the context of audit reform. Section IV provides an example of comparative institutional choice analysis for audit services regulation. A conclusion on the optimal institutional choice for audit reform and future research ideas are offered in Section V to add another perspective to the debate over SOX appropriateness and efficacy.

## **I. The Audit Function**

A description of the audit function is provided to focus this discussion on the most important aspects of a complex profession. These aspects are: that auditors act as independent evaluators of accounting information that is transmitted from businesses to

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<sup>8</sup> See Komesar, *supra* note 3, 7.

investors and creditors, that the goals of the audit procedure have been uniquely defined by the AICPA, and that, despite their focus on examining informational evidence, auditors face ethical decisions.

The audit of financial statements is an assurance service provided by certified public accountants for economic decision makers. Decision makers include purchasers and sellers of goods and services, business managers, investors, and creditors. For each of these parties, relevant, reliable information is critical to making decisions that take advantage of opportunities presented by a competitive market.<sup>9</sup> The SEC requires all registered public companies to follow prescribed guidelines on the issuance of financial statements to ensure that such information is provided to investors.

Three actors are involved in the issuance of financial statements: corporate management, the audit committee, and the independent auditor. Management produces financial statements, the audit committee oversees the financial reporting, and auditors opine on the fairness of the financial assertions made by management in the financial statements.

The demand for complex, remote information begets the audit practice. Transactions in market economies are numerous and complicated, and most decision makers are not able to collect and summarize key information. Information professionals, such as auditors, transform complex information into straightforward reports for decision makers.

Because investment decisions often result in the commitment of significant economic resources, decision makers demand trustworthy information.<sup>10</sup> Auditors test the

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<sup>9</sup> See Louwers , et al., *Auditing and Assurance Services*, (New York: McGraw Hill, 2005), 2-4.

<sup>10</sup> See Louwers , et al., *supra* note 8, 7.

accounting information that is generated by management and report an opinion to the public on the fairness of the information. According to Ernst and Young CEO James Turley, independent auditors “audit the company’s financial statements to test management’s assertions as to the accuracy and fair presentation of the financial statements before they are issued.”<sup>11</sup> To do this, auditors acquire specialized knowledge of the Generally Accepted Accounting Principles (GAAP) developed by the Financial Accounting Standards Board (FASB) and Statements on Auditing Standards issued by American Institute of Certified Public Accountants (AICPA). The FASB is independent of the accounting profession, the AICPA is comprised of accounting professionals. Both are monitored by the SEC, which has delegated rulemaking authority to the organized accounting profession under the Exchange Act of 1934.<sup>12</sup> The cornerstone of the public’s trust that an auditor has used his best judgment to make audit choices is the auditor’s independence.<sup>13</sup>

The concept of auditor independence develops over time. Auditor independence in the 20<sup>th</sup> century began as a state-of-mind in which the auditor would take the perspective of the business owner. In the 1930’s, auditors abandoned the practice of taking on the interests of owners, and independence came to mean neutrality of interest. For the next seven decades, neutrality was implemented by commitment to AICPA

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<sup>11</sup> See James Turley. The Senate Housing, Banking and Urban Affairs Committee, “Sarbanes-Oxley Act Impact International Convergence,” Sept. 9, 2004. [http://web.lexis-nexis.com/congcomp/document?\\_m=95941568976c918d867a2b5bab556010&\\_docnum=1&wchp=dGLbVlz-zSkSA&\\_md5=bec867439bdea319cc8d1b198bad1000](http://web.lexis-nexis.com/congcomp/document?_m=95941568976c918d867a2b5bab556010&_docnum=1&wchp=dGLbVlz-zSkSA&_md5=bec867439bdea319cc8d1b198bad1000).

<sup>12</sup> See Louwers , et al., supra note 8; see also Anne M. Khademian, “The Securities and Exchange Commission: A Small Regulatory Agency with a Gargantuan Challenge,” *Public Administration Review*, 62 (2002): 5.

<sup>13</sup> See Deborah Lindberg, “Before and After Enron: CPA’s Views on Auditor Independence,” *The CPA Journal*, (2004): 36.

standards.<sup>14</sup> The private sector Independence Standards Board was, until SOX, the AICPA-sponsored, authoritative source of audit independence standards.

Auditor independence is linked to investor protection because it promotes reliable information and efficient markets. This paper is not concerned with whether the provisions created by the AICPA are better than those created by Congress in SOX, but with whether Congress is the optimal institution for setting independence standards.

Independence does not require the auditor to be completely free from all influence. The independent auditor need only be free from factors that rise to the level of compromising the ability to make unbiased audit decisions. For example, management pays the auditor's fee, so complete independence is impossible.<sup>15</sup> As independence develops from a state-of-mind into a commitment to standards, the concepts of independence in fact and independence in appearance are the auditors' guide for deciding which factors compromise their independence.

Independent in fact means that the auditor can make independent audit decisions even if there is a perceived lack of independence or if the auditor is placed in a potentially compromising position.<sup>16</sup> For example, an auditor who is independent in fact will continue to make objective assessments of GAAP fairness even when client management has pressured him to conceal a fraud.

Even when an auditor is independent in fact, the public may not believe that the auditor is independent. Appearing to lack independence creates skepticism over the value of the audit opinion. For instance, an auditor that holds stock in the company she audits appears to lack independence even though she may perform the audit with complete

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<sup>14</sup> See Robert Colson, "CPA Independence, Present and Future," *The CPA Journal*, (2004): 80.

<sup>15</sup> See Lindberg, *supra* note 13: 36.

<sup>16</sup> See Lindberg, *supra* note 13: 38.

independence in fact. Because investors have no way to evaluate independence in fact, appearing independent is as important to the auditor's credibility as is acting independent. The Auditing Standards Board of the AICPA addresses independence in appearance by directing the auditor to consider whether a "reasonable investor knowing all the facts and circumstances" would believe that a particular factor would compromise the auditor's independence.<sup>17</sup>

## II. Institutional Choice

Institutional choice is a decision-making process in which politicians, legislators, judges, interest groups, and the public consider the abilities of the various regulatory bodies that can legislate, promulgate, or order a proposed rule.<sup>18</sup> Comparative institutional choice is more useful than single institutional choice because it focuses on the controversial decision of who decides, flushes out institutional strengths and weaknesses, and dismisses the notion that institutional choice is intuitive. Comparative institutional choice analysis requires a framework that compares parallel attributes across institutions and detects variations in institutional ability in a variety of circumstances because institutions come in a diversity of shapes and sizes, each uniquely complex.<sup>19</sup> Parallel attributes include: the benefits and costs of participant action, institutional capacity, institutional competence, and institutional impartiality. The participants studied in this paper are the actors involved in issuing financial disclosures: corporate executives, audit committees, and independent auditors, and the general investing public. The institutions analyzed in this paper are Congress, the SEC, and the federal judiciary.

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<sup>17</sup> See Independence Standards Board, "A Framework for Auditor Independence," Discussion Memorandum 00-1, Feb. 2000, <http://www.cpaindependence.org>.

<sup>18</sup> See Joan MacLeod Heminway, "Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives," *Fordham Journal of Corporate and Financial Law*, (2005) "pending".

<sup>19</sup> See Neil Komesar, *supra* note 4, 7.

Institutional choice needs to be explained more thoroughly in the context of audit regulation because SOX is a landmark growth of federal participation in the regulation of auditing and disclosing financial statements. The Act is certain to increase the participation of federal courts in corporate governance by creating new areas of federal jurisdiction. Congress passed specific rules in SOX that define corporate executives' liability, define audit committee duties, and regulate non-audit services provided by auditors. In addition, Congress created a new institution, the Public Company Accounting and Oversight Board (PCAOB), to take sole responsibility for setting audit standards. For auditors, the creation PCAOB abruptly ends decades of self-regulation through the AICPA. Joan MacLeod Heminway describes the enactment of SOX as "a forceful, preemptive use of institutional choice on the part of Congress."<sup>20</sup>

Although SOX represents a new era in the development of the concept of independence, this paper does not question the creation of new audit standards or PCAOB. The focus of this analysis is on the process by which regulatory reform comes to a particular institution's agenda, and the abilities of institutional alternatives to create the desired regulation. As such, the setting of this analysis is during the six-months when the public became aware of frauds at Enron, Worldcom, and Xerox, and rule proponents had not yet made an institutional choice. The analysis compares institutional factors that led to specific developments during the initiation and formulation of SOX. In the future, the PCAOB should be included as an alternative institutional choice. At this point, however, the PCAOB is maturing, and a body of literature on its abilities is not available.

Without a cohesive framework, the three-part analysis becomes confusing, the comparison of parallel factors becomes more difficult, and the variations between

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<sup>20</sup> Joan MacLeod Heminway, *supra* note 18: 5.



institutions, which are often very close in ability, become indistinguishable<sup>21</sup>. This paper combines the participant-centered model found in Neil Komesar's book, Imperfect Alternatives, with the rule-centered framework found in Joan MacLeod Heminway's article "Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives."<sup>22</sup>

Komesar's participant-centered approach is designed to be "portable"; it can detect "variations in institutional ability across the wide and varied landscape of law and public policy."<sup>23</sup> Like the rule-centered model, it is comparative. The comparative approach is preferred because it provides details about variations of institutional ability that are essential for deciding which institution is optimal for a given area of regulation. The primary difference between the participant-centered approach and the rule-centered approach is the starting point for the analysis. Participant-centered institutional choice "identifies the actions of participants as the factor that in general best accounts for the variation in how institutions function."<sup>24</sup> Komesar treats political and adjudicative rulemaking like a market of buyers and sellers. The participant-centered approach focuses on how actors will alter their participation based on the costs and benefits of their action or inaction. The avid participation of small groups or apathy of large groups can create institutional biases. Studying these biases in the context of audit regulations is useful for making and predicting institutional choices.

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<sup>21</sup> See Neil Komesar, *supra* note 4, 4-5.

<sup>22</sup> See Joan MacLeod Heminway, *supra* note 18.

<sup>23</sup> See Neil Komesar, *supra* note 4, 6-13.

<sup>24</sup> *Ibid.*, 7.

Heminway's rule-centered approach begins by focusing on a clearly defined rule to assess institutional strengths and weaknesses relative to that rule.<sup>25</sup> The rule-centered model is best applied when there is a consensus about the need to regulate. In this way, Heminway's model is an extension of Komesar's. Komesar's model seeks to understand the actions of participants who bring issues to rulemaking institutions' agendas and evaluate the responses of those institutions. He describes how the factors affecting the initiation of rulemaking also affect policy outcomes. Heminway's model provides the tools for comparing institutional alternatives once the issue has been raised and choosing the optimal institution. She deals with the specific institutional abilities that enhance or worsen policy outcomes.

### **III. The Combined Framework for Comparative Institutional Choice Analysis**

This paper proposes that comparative institutional choice is improved by combining the participant-centered and rule-centered models. The combined framework uses each model for the stage of policy development that it is best suited to describe. The participant-centered model discusses policy initiation. The rule-centered model is used to compare institutional capacity and competence during policy formulation.

The multi-step approach of the combined framework has advantages over the use of only the participant-centered or rule-centered model. Because public policy is created in multiple steps, the factors that influence institutional choice decisions vary in importance depending on when the analyst uses a given model. For instance, while the high cost of legal information is a critical factor when a rule proponent is at the stage of initiating regulation, it is not as important as judicial expertise for determining whether the resulting policy achieves resource allocation efficiency. Standing alone, the

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<sup>25</sup> See Joan MacLeod Heminway, *supra* note 18: 6.

participant-centered and rule-centered models are limited in their ability to track variations of important factors through multiple steps. When combined, the participant-centered and rule-centered models reinforce each other's weaknesses.

In Imperfect Alternatives, Komesar acknowledges that "the strengths and weaknesses of one institution versus another vary from one set of circumstances to another."<sup>26</sup> The participant model, however, limits its comparative investigation of such circumstances to factors that inhibit or promote participation from certain massive groups. These factors mainly determine how and where policy is initiated. Constraining analysis to participant factors results in a policy analysis that offers little information on the inherent abilities of legislatures, agencies, or courts. Although an emphasis on participants isolates the ways in which various institutions respond to participants, it ignores the ways in which other inherent institutional abilities, such as authority, shape the resulting policy. As the area of proposed regulation becomes more complex, inherent institutional abilities become more important. This premise is ostensible given the creation of expert regulatory agencies such as the SEC.

The rule-centered approach increases the scope of institutional choice analysis to provide parallel comparison of inherent institutional abilities that is not limited to participant interaction. To do this, it must replace an emphasis on participants with an emphasis on well-defined rules. The rule-centered approach treats institutional bias as one of many institutional attributes that varies depending on the specifics of the proposed rule. Biases, however, refer to how an institution treats groups of people, not rules. Congress, for instance, might be said to exhibit a bias to domestic producers when they increase tariffs on imports. The federal courts on the other hand are designed to operate

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<sup>26</sup> See Neil Komesar, *supra* note 4.

with less bias because domestic manufacturing lobbies cannot influence judges' decisions. The rule-centered model's analysis of bias is based on the premise that certain groups of people are linked to certain types of rule proposals. In reality, particular groups of participants initiate rules in areas they traditionally ignore as perceived stakes increase.<sup>27</sup> As such, the rule-centered model is less skillful at comparing institutional behavior variances due to biases and participant stakes.

A second limitation of the rule-centered model is comparison of instances in which a proposed rule has already been clearly defined. A clearly defined rule is usually developed by an institution after an initial institutional choice is made. For this reason, this paper focuses on participant factors to understand policy initiation, and proceeds to discussing inherent institutional abilities during a second stage: policy formulation. Once participant and rule-centered factors are compared among Congress, the SEC, the federal judiciary, an example of audit regulation is presented to exhibit the multi-step combined framework.

#### **A. The Participant Factors that Affect Policy Initiation**

In the context of regulating the issuance of audited financial statements, the participants are: investors, corporate executives, auditors, audit committees, legislators, judges, officials in the SEC, and members of self-regulating organizations like the AICPA. This list of participants illustrates the complexity of institutional choice. To make comparison simpler, Komesar emphasizes the “activities of consumers, producers, voters, lobbyists, and litigants”<sup>28</sup>. In the context of this paper, these five groups can be condensed into two: investors, who are consumers, voters, and potential plaintiffs, and

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<sup>27</sup> See Neil Komesar, *supra* note 4, 79-85.

<sup>28</sup> *Ibid.*, 7.

the actors involved in the issuance of financial statements (corporate executives, audit committees, and auditors), who are suppliers, lobbyists, and potential defendants. The official actors in the rulemaking process - legislators, members of the SEC, and judges - play a secondary role in policy initiation. Although analyzing the behavior of individual judges and members of Congress can provide insight into institutional comparison during rulemaking, the activity of massive groups of actors have a stronger affect on institutional behavior when rulemaking is being initiated.<sup>29</sup>

The participant-centered comparative institutional choice model analyzes the activities of mass actors through the Two-Force Model, a theory that broadens the scope of Interest Group Theory of Politics (IGTP). According to the IGTP, concentrated minority interest groups have greater access to and influence over the regulatory process than majority groups. Komesar argues that IGTP “places almost exclusive emphasis on overrepresentation of concentrated interests, usually at the expense of larger, less organized groups.”<sup>30</sup> Although the republican principle exhibited by the United States’ government guards against wanton ruling passions of numerical majorities, majorities gain strength and even overcome minorities as the factors used by the IGTP to describe minority dominance are reversed. That is, as issues become less complex, majority stakes increase per capita, and low cost information becomes widely available, majority interests can exert a countervailing force on minority interests.<sup>31</sup> The Two Force Model allows analysts to examine the tradeoff between the minoritarian interest of business lobbyist and the majoritarian influence of the investing public.

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<sup>29</sup> Ibid.

<sup>30</sup> Ibid., 54.

<sup>31</sup> Ibid., 70.

Institutional choice analysts, whether assessing participation in Congress, the SEC, or the federal courts, must begin their comparison with how each institution deals with skewed distribution of stakes, in which one interest has higher per capita stakes and fewer members. If an institution gives favor or denies recognition to a group in the presence of skewed distribution of stakes, a bias exists. Komesar identifies minoritarian biases as occurrences when “a concentrated high per capita minority prevails...even though the total social costs imposed on the majority are greater than the total social benefits gained by the successful minority.”<sup>32</sup> Majoritarian bias, on the other hand, is an instance in which the majority has their way even though the total social impact on the majority is less than the impact on the minority.

Description of the participant-centered factors that detect variations in institutional performance is not complete without a discussion of goal choice. Komesar points out that “the normative implications of the two-force model and, therefore, characterizations like majoritarian or minoritarian bias can (but do not necessarily) vary with the choice of goal.”<sup>33</sup> If the chosen goal is resource allocation efficiency, then minoritarian biases threaten to exploit the majority. With a different goal, such as the protection of private property rights from the government, minoritarian biases are less threatening.<sup>34</sup>

The comparative institutional choice analyst must ask: what is the appropriate social goal for audit regulation? Protecting investors by improving the reliability of financial disclosures has been the explicit goal of securities and disclosure regulation since the Exchange Act of 1934. The Sarbanes-Oxley Act of 2002 reiterates this goal.

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<sup>32</sup> See Neil Komesar, *supra* note 4, 76.

<sup>33</sup> *Ibid.*, 80

<sup>34</sup> *Ibid.*, 79-80.

Protection here refers to guarding investor capital against fraudulent disclosures. In a sense, the Exchange Act and the Sarbanes-Oxley Act protect investors, a majoritarian group, from corporations, a minoritarian group. But investor protection is not the ultimate goal of audit regulation. If it were, a strong majoritarian dominance would lead to overzealous regulation that unnecessarily saps corporate resources. Maintaining efficient markets by ensuring consistent transparency of information is the ultimate goal of audit regulation. Market efficiency is akin to resource allocation efficiency. Corporations should be forced only to provide levels of disclosure that are not so expensive that the total cost to corporations outweighs the total benefit to users of financial statements. A major challenge to all institutions, therefore, is determining how investors and creditors use audited disclosures and whether audit regulation is an effective means maintaining efficient markets. Not only must an institution know about investors' use of disclosures, but it should be able to reasonably infer how much overall benefit certain types of audit regulations contribute to efficient markets. This paper does not draw conclusions on how audit regulations contribute to efficient markets. Instead, it seeks to compare the factors that explain why certain institutions are better or worse at drawing such conclusions.

**B. Comparing the Participant-Centered Factors among Congress, the SEC, and the Federal Judiciary**

When comparing Congress, the SEC, and the federal judiciary, the policy analyst must consider how each institution reacts to majoritarian and minoritarian influence in light of regulating auditors with the goal of maintaining efficient markets. First, the compared framework defines who can participate and the degree of their influence. Then participation costs are compared among institutions to predict which institution actors prefer.

## 1. Two Forces of Influence

Compared to the SEC and the federal courts, Congress is, by electoral design, more susceptible to majoritarian influence. Majoritarian influences, though less likely to create biases than their minoritarian counterpart, are exerted on Congress by voters. As such, Congress is expected to be more sensitive to majority interests when elections are imminent. The media plays a role in this phenomenon by providing cheap and accessible information to otherwise dormant majorities.<sup>35</sup> Without extensive media coverage of a politicized issue near an election, Congress tends to exhibit minoritarian biases more often in the context of audit regulation. The American Bar Association, Chamber of Commerce, Business Roundtable, AICPA, and the Big Four accounting firms have been historically successful at influencing Congress. The SEC also lobbies Congress to draft legislation that falls outside of the agency's explicit authority but has impacts on the SEC's regulatory goals nonetheless. The Chairman of the SEC influences Congress by speaking about issues that the agency would like to be regulated. The courts influence Congress by judicial review and case selection.

The SEC is less affected by majoritarian influences than Congress because agency members are not elected. Congress can pass on majoritarian biases to the SEC by changing the agency's funding or exerting political pressure on agency members.<sup>36</sup> This makes the SEC more susceptible to majoritarian influence than the federal courts. Minorities exert greater influence on the SEC than majorities. Minority groups do not influence the SEC to the same degree as they do Congress. Minority interests influence the SEC in two ways. They exert influence directly by sending members of regulated

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<sup>35</sup> See Neil Komesar, *supra* note 4, 73.

<sup>36</sup> See Joan MacLeod Heminway, *supra* note 18: 77.



industries to consult with the SEC (controlling information) and indirectly through Congress.<sup>37</sup> Just prior to the exposure of fraud at Enron, business interest groups lobbied Congress and blocked rules from the SEC that were aimed at prohibiting auditors from providing non-audit services. The federal courts can influence the SEC by creating rules in areas of agency authority and review agency actions. Both these methods of influence are limited by the federal courts deference to agency decisions.<sup>38</sup>

In general, the federal courts are not greatly influenced by majoritarian or minoritarian interests.<sup>39</sup> With the exception of bribes, the public can exert very little influence over the action of the courts except by filing suits. Likewise, Congress and the SEC do not exert much influence over the judiciary. Congress can influence the federal court system by legislatively defining court jurisdiction in certain matters, exercising its right to approve judicial appointments, and controlling the budget for court resources.<sup>40</sup> The influence of Congress over the judiciary is counterbalanced by judiciary's power to review Congressional action. The SEC influences the court by exercising its authority to bring action in federal courts. According to Heminway, this power enables the SEC to "push the boundaries of ill-defined areas of the law in directions that suit its own parochial regulatory interest."<sup>41</sup>

## **2. The Costs of Participation**

Given the complexities of modern political action in democracies, assuming dominance by concentrated minorities in Congress and the SEC has become second

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<sup>37</sup> See Joan MacLeod Heminway, *supra* note 18: 73.

<sup>38</sup> *Ibid.*: 76.

<sup>39</sup> *Ibid.*: 82.

<sup>40</sup> *Ibid.*: 80-81.

<sup>41</sup> *Ibid.*: 81.

nature.<sup>42</sup> This section provides only general analysis about the participation of minoritarian and majoritarian groups. The details of these groups' behavior in the context of audit regulation are born out by the example of comparative institutional choice in section IV.

Comparative analysis of the benefits and costs of participation in political processes focuses on factors that cause variation in the degree to which the few dominate the many. Political results are rarely caused by battles in which the largest group wins simply because of their numbers. Although voting gives majority groups a potential edge, this potential is rarely realized without special circumstances. Free riders are the primary challenge to overcoming minority dominance is in terms of both benefits and costs. On the benefit side, distribution of per capita stakes is the key factor for predicting political inaction. On the cost side, the cost of information is the foremost factor leading to free riders.

The likelihood of political inaction by majority groups can be predicted by observing two aspects of the distribution of per capita stakes. First, higher average per capita stakes among members of the majority make it more likely it is that the majority group will incur the basic expenses to understand their position.<sup>43</sup> Majority groups characterized by very low per capita stakes get away with free riding because free riders are difficult to isolate among a large, uninterested group. Even when a majority group's average per capita stakes are relatively low compared to a minority group, an increase in stakes will wake a dormant majority. Second, greater heterogeneity among majority groups increases the likelihood that small, high per capita stakes subgroups will take

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<sup>42</sup> See Neil Komesar, *supra* note 4, 68.

<sup>43</sup> *Ibid.*, 68-70.

action on behalf of the majority.<sup>44</sup> The existence of pockets of high-benefit subgroups is indicated by skewness and variation of per capita stakes among majority groups.

Costs work in tandem with benefits to determine the likelihood of political inaction by majority groups. The cost of information increases as issues become more complex and extensive. Information costs include: identifying a basic interest in an issue, acquiring knowledge about the issue, recognizing one's political position, organizing collective action, and becoming sophisticated with the various channels of political influence. Without pockets of high-benefit subgroups to stimulate action, it is unlikely that a majority groups will expend resources to understand issues and organize for political action.<sup>45</sup> Even with catalytic subgroups, majority groups are unlikely to identify their basic interest in an issue when average per capita stakes are low. In sum, political action by majority groups becomes more likely as average per capita stakes increase, issues become simpler, and pockets of catalytic high-benefit subgroups develop.

Concentrated minority interest groups, on the other hand, are characterized by substantial per capita stakes. They have an incentive to understand issues, organize for political action, and develop sophistication with the various channels of political influence. These groups form lobbies, contribute to campaigns, and manipulate the media to influence Congress and the SEC. The cost of overcoming free riding for minority interest groups is mitigated by closeness of members (in terms of stakes and identified political position), benefits of action, and obviousness of free riding due to smaller numbers.

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<sup>44</sup> Ibid., 82-83.

<sup>45</sup> Ibid., 73.

Participation in the federal judiciary is also understood in terms of distribution of stakes and the cost of information. In the courts, the benefits and costs realized by plaintiffs and defendants are analyzed. Litigants are characterized by uniform low stakes (resembling two dispersed majorities), uniform high stakes (resembling two concentrated minorities), and skewed distribution (resembling a trade-off between minority and majority). No matter the distribution of benefits, the cost of information in the federal judiciary is high due to institutional formalities and complexity in the judicial process. Litigation of almost any issue requires a lawyer to speak the language of the court and deal with the mechanics of litigation with sophistication. Understanding and using judicial rulings is also costly for participants.

When both sides of an issue have uniform low stakes, neither is likely to litigate because of the cost. Potential plaintiffs and defendants in this case are both widely dispersed, increasing the probability of inaction.<sup>46</sup> Various instances of non-point pollution, where both victims and polluters are widespread provide a familiar example of highly dispersed, uniform low stakes.

When stakes are uniformly high between potential plaintiffs and potential defendants, litigation is more likely but action is not a foregone conclusion. High-stakes parties tend to utilize cheaper market alternatives to avoid litigation. High-stakes adversaries are sophisticated enough to work out differences by negotiating contractual relationships or settlements outside of court.<sup>47</sup> For instance, if Coca Cola threatened to sue Pepsi for stealing and using their patented secret recipe, lawyers from each side are

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<sup>46</sup> See Neil Komesar, *supra* note 4, 128.

<sup>47</sup> *Ibid.*, 129.

more likely to recognize that settling outside of court is cheaper and design a settlement that pleases both parties.

The probability of litigation in cases of skewed distribution of stakes depends upon which side is dispersed and which side is concentrated. Class actions increase the likelihood of litigation when stakes are dispersed among plaintiffs and concentrated among defendants. In this scenario, class actions reduce per capita litigation expense for plaintiffs by pooling resources. If stakes are extremely dispersed among a very large group of potential plaintiffs, preventing catalytic subgroups, litigation is less likely because potential plaintiffs do not recognize the injury or availability of class action recovery. When stakes are dispersed among many defendants and concentrated among plaintiffs, on the contrary, litigation becomes less likely because of the prohibitive cost of suing many defendants. Class action rules do not cater to suits from concentrated plaintiffs against dispersed defendants because controlling thousands of defendants is costly and awkward.<sup>48</sup>

As the preceding general analysis shows, variations in distribution of stakes and information costs among majority and minority groups determine participant action during policy initiation. In general, majoritarian groups with low per capita stakes are dominated by concentrated minoritarian interest groups. Minorities have more to gain by meeting the costs of policy initiation. Majorities become more active as stakes increase and information costs decrease. This trend is more evident in Congress and the SEC in the federal judiciary because political institutions are geared to meet voter and interest group needs. Courts are less accessible because they require expensive legal interpreters and operate at remote locations.

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<sup>48</sup> Ibid., 131.

It is by becoming sophisticated with the channels of influence that concentrated interest groups transform influence into bias. High per capita stakes curtails free riding among members of minoritarian groups. The cost of political organization is less daunting to minoritarian groups because, once a threshold cost is borne, marginal cost is unaffected. Minority groups that are already organized, such as corporations and professional organizations, have a lobbying and fundraising advantage.<sup>49</sup> A majoritarian bias, on the other hand, results from voting. Congress caters the most to active majorities, the SEC receives indirect influence from Congresses' majority biases, and the federal courts only offer advantages to majorities with class actions.

### **C. Rule-centered Factors that Affect Policy Formulation**

The abilities of Congress, the SEC, and the federal judiciary to make clearly defined audit regulation are assessed by comparing the institutions' capacity and competence. This section elaborates on the rule-centered factors by defining these attributes.

#### **1. Institutional Capacity**

Institutional capacity is a measure of the legislative power of Congress, the regulatory authority of the SEC, and the jurisdiction of the federal courts. The concept of capacity is primarily used to eliminate institutions that do not have the power to make a particular type of rule, not to determine which institution will optimally formulate a rule. The following three paragraphs describe the power of Congress, the SEC, and the federal judiciary to make rules that control the behavior of the auditors.

In general, Congress has functional rulemaking authority as the legislative branch of government. The Commerce Clause of the Constitution gives Congress power to

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<sup>49</sup> Ibid., 72.

investigate, delegate, and regulate foreign and interstate commerce.<sup>50</sup> About disclosure laws, Robert Thompson and Hillary Sale note that “disclosure has become the most important method to regulate corporate managers, and disclosure has been predominantly a federal, rather than a state, methodology.”<sup>51</sup> Although states have traditionally dominated the rulemaking process for duties and liabilities of corporate executives and boards, Congress is paying more attention to corporate executives and members of corporate boards, such as audit committees. Thompson and Sale argue that federal litigation over the fiduciary duty of board members is increasingly popular because of several practical advantages of the federal courts. These authors also note that increasing use of the federal courts for shareholder litigation in the 20<sup>th</sup> century makes the federal legislature increasingly aware their power over disclosure rules.<sup>52</sup>

The SEC’s authority over audit regulation is not derived from the Constitution.<sup>53</sup> The nature and scope of the SEC’s power is set by Congress and is subject to Congressional override. Its authority is subsidiary to Congress, but it is active as a corporate regulator. The Exchange Act of 1934 created the SEC to administer, interpret, and enforce securities laws within the Act. The most notable area of SEC regulation in corporate governance is proxy regulation, but the Exchange Act also allows the agency to promulgate disclosure provisions to protect investors.<sup>54</sup> By regulating disclosures, the SEC controls the behavior of corporate management, audit committees, and auditors.

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<sup>50</sup> See Joan MacLeod Heminway, *supra* note 18: 19.

<sup>51</sup> See Robert B. Thompson and Hillary A. Sale, “Securities Fraud as Corporate Governance: Reflections upon Federalism,” *Vanderbilt Law Review*, 56 (2003): 859.

<sup>52</sup> *Ibid.*

<sup>53</sup> See Joan MacLeod Heminway, *supra* note 18: 21.

<sup>54</sup> *Ibid.*: 23.

The rule-making power of the federal judiciary over auditors is Constitutional. The courts can create or alter such rules in the context of cases under federal securities laws or interpretations of state law in cases of diversity jurisdiction.<sup>55</sup> In this way, courts are able to increase federalization of corporate governance laws by eliminating state provisions. Because corporations with securities traded on national markets are exempt from state class actions, litigants generally prefer to bring anti-fraud class actions to the federal court.<sup>56</sup> A number of such suits were filed following the exposure of fraud at Enron.

## 2. Institutional Competence

Analysts draw certain conclusions about institutional competence primarily by observing structure. Structural competencies are rooted in the separation of powers in the federal government. Institutions are most often more competent at tasks that they are designed to handle. Structural competence is discussed in terms of the deliberative, accessible, and representative features of institutions. Although analysts can draw conclusions by observing another type of competence, substantive competence, structural competency is more important. Substantive competence (expertise) is fleeting. It depends on the abilities of particular members of each institution at a given time. Talented members do not stay forever; structure is more permanent. Furthermore, substantive competence relies on anecdotal observations that tend to result in intuitive institutional choices that value tradition over institutional merit. For instance, because the SEC has a long history of regulating securities trading, the agency might be intuitively chosen based upon supposed substantive competence. If, hypothetically, the agency can not retain the

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<sup>55</sup> Ibid.: 27.

<sup>56</sup> See A.C. Pritchard, "Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998," *Washington University Law Quarterly*, 78 (2000): 435.



most talented employees because it is under funded the promise of expertise might not come to fruition. Over reliance on substantive competence is a rule-centered weakness that is eliminated from the combined framework.

There are several structural aspects of Congress that enable legislators to competently regulate auditors. In Congress, a deliberative, routine method of policy formulation is coupled with broad investigative powers that allow representatives to become fully informed. For issues of complexity, such as audit and financial disclosure reform, Congress uses special committees and relies on staff assistance to enhance overall understanding of policy issues. Representatives' knowledge is espoused in debates and applied in sessions of laborious bill amending. The involved nature of federal legislation, though it leads to thoroughness, can prove a detriment structural competence when rulemaking is slowed by too much deliberation.

Compared to the SEC and the federal judiciary, Congress provides unparalleled access to participants. Voting encourages legislators to aggressively pursue desires of influential groups. To ensure that this occurs, legislative action is public and open, which ensures accountability.<sup>57</sup>

Congress certainly derives some legitimacy from their structure because members form an assembly that is representative of the public.<sup>58</sup> Congress' ability to make rules in the public interest is only structurally limited by the existence of channels through which minority interest groups exert influence and create bias.

Like Congress, the SEC gains structural competence from a deliberative routine of regulation. The steps involved in promulgating federal agency rules are less varied,

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<sup>57</sup> See Joan MacLeod Heminway, *supra* note 18: 35.  
<sup>58</sup> See A.C. Pritchard, *supra* note 56: 433.

cumbersome, and involved than the federal legislative process.<sup>59</sup> The SEC even has the option of issuing interpretations and informal rules, making the agency's rulemaking more nimble.

The Administrative Procedures Act of 1946 requires agencies to provide notice of proposed rulemaking and access to the public for comments. The SEC is accessible, but not to the same extent as Congress. A design that is less responsive to voter opinion shields the SEC from the direct pressure of majoritarian biases, although Congress can indirectly pass biases to agencies.<sup>60</sup> The public can petition the SEC for rule adoption, alteration, and repeal, but this process is likely to be most useful to well organized minoritarian groups, and does not make the agency truly representative.

Because members of the SEC are appointed by the President and confirmed by the Senate, they are only indirectly representative. The SEC achieves further independence as the President cannot remove its leadership once appointed.<sup>61</sup> Independence is important to the SEC's structural competence because it allows the agency to develop viewpoints on public policy that are not influenced by the legislative or executive branch.

The structure of the federal courts affords judges more independence than members of Congress and the SEC, but results in rulemaking that is "less deliberative, less representative, and less accessible than that of either Congress or the SEC."<sup>62</sup> Marcel Kahan and Edward Rock support this characterization, noting that "judges are brought to the fore through the decentralized activities of private actors rather than on their own

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<sup>59</sup> See Joan MacLeod Heminway, *supra* note 18: 68.

<sup>60</sup> *Ibid.*: 73-74.

<sup>61</sup> *Ibid.*: 42.

<sup>62</sup> *Ibid.*: 52.

motion, [and] lack the power and staff to conduct investigations.”<sup>63</sup> Deliberation among federal judges is limited because they receive less input than Congress or the SEC, and their decisions are limited to the facts of individual cases. This means that judicial rules are made retrospectively in response to claims of participants. Congressional legislation and SEC promulgations, alternatively, are prospective e.g. made ex ante.<sup>64</sup> A structure that permits only retrospective rulemaking limits the competence of the judiciary because retrospective rules solve problems particular to a set of facts. Prospective rulemaking, on the other hand, lends itself to creating comprehensive regulation. The process of appeal is another structural variable that affects judicial deliberation. Judges at different levels of the appeals process resolve conflicts by different means. Supreme Court justices are the only judges who can deliberate to resolve conflicts in a uniform manner.<sup>65</sup>

Access to the federal courts during policy formulation is limited to individuals who bring suits. The federal judiciary only provides access to non-litigants under special circumstances, i.e. the allowance of amicus briefs.<sup>66</sup> Access to the judiciary is also limited by the size and complexity of its bureaucracy. If willing to bear the information costs, groups can gain access to judicial policy because rulings become public record.

Like members of the SEC, judges are indirectly representative because they are appointed by the President and approved by Congress. Judges, however, are appointed for life, making them far more independent than members of the SEC.<sup>67</sup> Almost total independence means that judges are far less accountable to the public. Instead, judges are

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<sup>63</sup> See Marcel Kahan and Edward Rock, "Our Corporate Federalism and the Shape of Corporate Law," University of Pennsylvania, Institute for Law & Economic Research Paper 04-12; New York University, Law and Economics Research Paper No. 04-020, (2004): 31, <http://ssrn.com/abstract=564685>.

<sup>64</sup> See Joan MacLeod Heminway, *supra* note 18: 54.

<sup>65</sup> *Ibid.*

<sup>66</sup> See *Ibid.*: 59.

<sup>67</sup> *Ibid.*: 55.

accountable to higher levels of appellate review. The actions of the Supreme Court, however, are not reviewable.

#### **IV. Comparative Institutional Choice Analysis for Regulating Non-audit Services Provided by Auditors**

After fraud was exposed at Enron, the government made a historical indictment of Anderson LLP, Enron's independent auditor. Anderson compromised independence of appearance by selling lucrative, non-audit consulting services to Enron. The nature of consulting, which is aimed at improving financial performance, conflicts with the objective, investigatory nature of auditing. Anderson did not maintain independence in fact because of the intense economic bond formed by lucrative consulting fees. Partners at Anderson overlooked fraud at Enron as an auditor to ensure that, as a consultant, they could continue to garner phenomenal revenues. Anderson was not indicted for violating fiduciary duty, however. Providing consulting services to audit clients was not illegal in 2000. They were indicted and convicted of obstruction of justice during an investigation of fraud at Enron. The combined framework begins by examining the stakes of investors and audit firms and describes a shift from dominance by the few to dominance by the many.

The participants in audit regulation initiation exemplify a skewed distribution of stakes. Audit related policy initiation is determined primarily by a dominant minoritarian interest group of accounting firms and their professional organizations. Investors, a typical dispersed stakes majority group, do not influence audit policy initiation. That is, until the Sarbanes-Oxley Act. William Carney notes that "the story of Sarbanes-Oxley lacks the usual indicia of interest group legislation. Perhaps the relevant interest group was Congress itself, which believed it was purchasing votes from many uninformed voters on

a highly visible issue.”<sup>68</sup> Carney’s tongue-in-cheek remark about Congress as an interest group is inspired by, but does not accurately describe, a sudden, dramatic shift from minority bias to majority bias within Congress.

Before fraud was exposed at Enron, Congress exhibited bias toward the accounting lobby. In 2000, SEC chairman Arthur Levitt proposed a rule to Congress that would prohibit auditors from performing non-audit services, such as consulting and information system design, for their audit clients.<sup>69</sup> Levitt’s concern was that audit firms used the audit function as “loss leader retained as a foot in the door for higher-fee consulting services.”<sup>70</sup> He argued that this would reduce audit quality, compromise auditor independence, and jeopardize the public’s interest in reliable financial statements. The AICPA and many audit firms objected to Levitt’s proposal to limit non-audit services. They lobbied Congress, arguing that the majority of non-audit services increase audit quality and benefit the economy. Some of the larger firms influenced key members of Congress with large financial contributions, a practice common among accounting firms, to increase political pressure on Levitt and the SEC.<sup>71</sup> Congress decided not to legislate the proposed rule. The SEC attempted to support the rule with a study on the degree to which non-audit fees were a part of accounting firms’ total revenue, but the largest accounting firms were not forthcoming with data or comments.<sup>72</sup> Without a countervailing majority group’s support, Levitt was unsuccessful. In the end, a market

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<sup>68</sup> See William J. Carney, “The Impact of Competition on Regulation: Introduction,” *Emory Law Journal*, 52 (2003): 1291.

<sup>69</sup> See Lawrence J. Abbot, et al., “Audit, Nonaudit, and Information Technology Fees: Some Empirical Evidence,” *Accounting and the Public Interest*, 3 (2003).

<sup>70</sup> See Arthur Levitt, “The Accountants Critical Eye,” Remarks delivered at the 24<sup>th</sup> Annual National Conference on Current SEC Developments, AICPA, Washington D.C. (1996), quoted in Lawrence Abbot, *supra* note 69.

<sup>71</sup> See Lawrence J. Abbot, et al., *supra* note 69: 5-9.

<sup>72</sup> *Ibid.*

approach was taken by the SEC: public companies were required to disclose the amounts paid to incumbent auditors for audit and non-audit fees, and investors decided if the auditor appeared satisfactorily independent. This is a case in which the SEC could not overcome the indirect influence from minoritarian biases within Congress, and was forced to create weaker rules because of direct pressure from interest groups.

After fraud at Enron was exposed in December of 2001, the general public became more likely to initiate audit policy because they perceived higher stakes and gained access to low cost information through the media. Although audit policy was just as complex after Enron as it was before, when even the SEC could not produce compelling evidence to support proposed audit regulation, the media simplified the issue for voters by amplifying the risk posed by compromised auditor independence to efficiency in securities markets. Indictment of Andersen, even though it was not for independence issues, confirmed the public suspicion that auditors were partly responsible for fraud. Larry Ribstein comments that “public perceptions of risk...played a particularly potent role in the enactment of the Sarbanes-Oxley Act.”<sup>73</sup> An initial institutional choice is expected, considering, as Troy Parades does, that “strong regulatory response to a wave of scandal appears to be consistent with historical practice.”<sup>74</sup> Returning to previous analysis of participant factors in Congress, the SEC, and the judiciary, one finds that Congress is far more likely to respond to majority interests because of electoral pressure. Participants are likely to initiate policy in Congress because they are more familiar with Congressmen and have greater access to Congressional policymaking.

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<sup>73</sup> See Larry E. Ribstein, *supra* note 2: 47.

<sup>74</sup> See Troy A. Parades, “The Future of the Mandatory Disclosure System: Foreword,” *Washington University of Law Quarterly*, 81 (2003): 232. Quoted in Joan MacLeod Heminway, *supra* note 18: 8.

Congressional factors alone do not warrant an intuitive institutional choice. When compared to Congress, the SEC is somewhat shielded from majorities. Even after Enron, the stakes of most of those in the majority were not high enough to motivate members to educate themselves on the processes of the agency. Catalytic subgroups within the majority, which had already covered threshold costs for lobbying Congress, made it even less likely that policy would be initiated in the SEC. The Consumers Union stimulated majority action and directed it toward initiation of policy in Congress.<sup>75</sup> Participants are not likely to initiate regulation of non-audit services in the federal courts immediately following Enron because class actions do not help a majority as large and dispersed as the general investing public.

Once Congress is aware that they are the publicly chosen institution for regulation of non-audit services, a second comparative institutional choice analysis is needed. Before formulating specific regulation, Congress should compare its capacity and structural competence to institutional alternatives e.g. the SEC and federal courts.

In terms of capacity, Congress derives its power to regulate auditors, and anything else commerce related, from the Commerce Clause. In 1934, however, Congress delegated responsibility for setting and enforcing accounting standards to the SEC. Although the agency is a subsidiary to Congress, its capacity for regulating auditors appears to be at least equal to Congress' because of the Legislature's deference to the SEC regarding audit regulation. The federal courts are eliminated from the analysis because they do not have jurisdiction. Although investors could file civil suits against audit firms before Sarbanes-Oxley, there was no federal regulation for auditors in regard

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<sup>75</sup> See Keith Perine, "Beleaguered Accounting Industry Faces Avalanche of Legislation," *CQ Weekly*, 16 March 2002, Finance sec.

to non-audit services. In terms of capacity, Congress is superior to the SEC because the legislature uses statute to establish and modify the agency's authority.

In making comparisons of structural competence, it is not appropriate to completely abandon participant-centered factors simply because the analysis is now focused on the step of policy formulation. To choose an optimal institution, Congress must consider how majoritarian biases limit deliberativeness, accessibility, and representativeness.<sup>76</sup> More importantly, legislators must consider the variations in degree to which biases limit structural competency between Congress and the SEC.

There are many critics of Congress' competence in regard to regulating auditors. Of those who do not make the mistake of intuitive institutional choice based on expertise, Lawrence A. Cunningham summarizes the appropriate criticisms of Congress' competence most succinctly; noting that the provisions of SOX are "based less on a calculated cost-benefit assessment of the likelihood of their effectiveness than a populist need to exhibit taking control."<sup>77</sup> Previous analysis concluded that Congress is generally more rigorous, deliberative, accessible, and representative than the SEC. Could limitations caused by majoritarian biases prove Cunningham correct? Or does majoritarian bias actually enhance certain structural competencies?

A majoritarian bias does not limit or enhance representation within Congress or the SEC. At the most, an influential majority reminds Congress of the importance of constituent representation. Reminding Congress of its representatives does not increase

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<sup>77</sup> See Lawrence A. Cunningham, "The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, and Other Ills," *Iowa Journal of Corporate Law*, 29 (2004): 280-81. Quoted in Joan MacLeod Heminway, *supra* note 18: 69.



the relative structural competence of Congress compared to the SEC, it merely counters minoritarian influences from interest groups with majoritarian influences from voters.

Directly after Enron, countervailing between majoritarian and minoritarian interests led to partisan factions within Congress that limited deliberativeness. On one side, House Republicans Billy Tauzin, Richard Baker, and Michael Oxley advocated mild regulation of non-audit services to avoid “blanket[ing] market participants in a sea of red tape.”<sup>78</sup> Minority interest groups encouraged the limited measures offered by Republicans. House Democrats, alternatively, proposed bills with more sweeping reforms, including a longer list of prohibited non-audit services. The Democrats approached the issue of audit reform as an opportunity to expose their counterpart’s softness towards the accounting lobby, and they were backed by consumer advocacy groups.<sup>79</sup> Deliberation between partisan factions in Congress was limited by particularly contentious politicization of the issue of audit reform. Although Republicans succeeded in passing their bill in the House, a Democrat in the Senate, Paul Sarbanes, was ultimately successful in finalizing a more restrictive list of prohibited non-audit services when frauds at Worldcom and Xerox reignited majority pressure on Congress. Rather than extending deliberation to address the unique causes of the new frauds, Senate Republicans were forced to “get out of the way of the Senate measures.”<sup>80</sup>

In comparison, the SEC offered only one rule proposal that was largely ignored because of the popularity of audit reform as a political topic. The structure of the SEC is not designed to harness the power of majorities to the extent that Congress does. With

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<sup>78</sup> See Keith Perine, *supra* note 75.

<sup>79</sup> See Keith Perine, “Partisan Showdown This Summer Could Kill Chances for New Auditing Rules,” *CQ Weekly*, 27 April 2002, Finance Sec.

<sup>80</sup> See Keith Perine, “Tougher Accounting Legislation Resurrected in Senate,” *CQ Weekly*, 13 July 2002, Finance Sec.

political topics, voters are likely to recognize greater influence over elected officials than appointed officials. The SEC is accessible, but independent. Heated political debate further limited collaborative deliberation between the SEC and Congress. Leaders within SEC recognized majoritarian pressure and, realizing that they would not overcome it, lobbied Congress for a bigger budget so it could handle the enforcement of new legislation.<sup>81</sup> In the words of Joan MacLeod Heminway, “deliberation may be limited where politics drives the process.”<sup>82</sup>

Access, on the contrary, is enhanced in Congress by majoritarian biases. Minority interest groups, who are often invited to testify, and the general public enjoy greater access through Congressional hearings. The accounting firms were quite successful in limiting the regulatory reach of Oxley’s house bill (HR 3763), passed on April 4, 2002. If not for the exposure of accounting fraud at Worldcom and Xerox in July 2002, accounting lobbyists may have convinced Sarbanes to limit the regulatory reach of the Senate’s draft of HR 3763. Congress also increased access to members of the majority by reaching out to constituents for comment during campaigns. House minority leader Richard Gephardt D-MO said, “I had any number of people come up to me in neighborhood meetings and ask me ‘What are you in the government going to do about it?’”<sup>83</sup>

Access to the SEC is similarly enhanced to the extent that Congress uses the agency as an investigative collaborator. Throughout the process of legislative investigation Congress can ask the SEC to conduct studies of the issue. In preparing its own rule proposals in times of majoritarian influence, the SEC will likely receive more

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<sup>81</sup> Ibid.

<sup>82</sup> See Joan MacLeod Heminway, *supra* note 18: 34.

<sup>83</sup> See Keith Perine, *supra* note 80.

comments from minorities to countervail growing majority power than from majorities that favor increased influence over Congress.

## V. Conclusions

This ex post analysis of institutional choice concludes that majoritarian interests prefer Congress over the SEC and the federal courts for initiating policy reform in the midst of crises. With Sarbanes-Oxley, Congress did indeed make a preemptive institutional choice based solely on capacity. Comparison of structural competence suggests that the SEC is equipped to handle audit reforms, but that majority interests will most likely initiate audit reform in Congress because of the representative design. Had Congress performed an institutional choice comparison, it would become apparent that majoritarian biases limit deliberation. With more deliberation, it is likely that the SEC would have played a greater role in crafting Sarbanes-Oxley. SEC chairman Harvey Pitt was eager to propose and argue for audit reform with limited reach. The repeated occurrence of fraud, however, intensified majoritarian bias within Congress, and the SEC proposal was discarded.

The conclusion of this comparative analysis of the institutional choices leading to Sarbanes-Oxley is that majoritarian interests are likely to initiate audit reforms in Congress when perceived stakes increase and low cost information is provided by the media. Action from the general investing public is directed toward Congress by catalytic subgroups that have already covered the threshold costs of identifying stakes, organizing politically, and developing sophistication with channels of influence. In addition, Congress increases the likelihood that it will be chosen by reaching out to constituents

with politically charged issues during election years. The SEC and federal courts have far less control over policy initiation because they are not representative.

Maintaining efficient markets with optimal audit regulation is most likely to be the result of a collaborative, deliberative effort between Congress and the SEC. The very existence of the SEC suggests that Congress would want the agency to participate in formulating regulation that it must enforce. The agency certainly has the capacity and structural competencies required to regulate auditors. Sarbanes-Oxley, however, was formulated solely by Congress. Many critics of the SOX point to Congress' domination of policy formulation as cause of many problems with the substantive details of the Act.<sup>84</sup>

The combined framework explains Congress' preemptive decision as the result of a strong majoritarian bias created by escalating anxiety over repeated accounting frauds and intense electoral pressure. Analysis with the combined framework, however, is limited by flaws in its design. One of its major flaws is the assumption that, after comparative analysis, an institution would relinquish its authority during the step of policy formulation. For instance, after the investing public made resounding demands for Congress to fix the problems leading to fraud, legislators would be politically foolish to suggest the SEC is better for the task. In the presence of majoritarian bias, institutional choice should focus on the degree to which Congress allows agencies to participate. Considering that minority interests prevented a SEC proposal of audit reform that might have prevented fraud caused by compromised auditor independence in 2000, it is feasible to say that Congress limits agency participation in the presence of minoritarian bias as well.

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<sup>84</sup> See Joan MacLeod Heminway, *supra* note 18: 4-6.

## Future Research

Policy analysts are still gleaning the most valuable lessons from the Sarbanes-Oxley Act. In 2005, the New York Times reported that many corporate and accounting leaders are criticizing the cost of compliance with SOX.<sup>85</sup> The cost of compliance with Section 404, which requires internal control assessments, has, for some corporations, rivaled the cost of financial statement audits. Ignoring the cost of compliance costs is another flaw in the combined framework. Future analyses of factors that affect institutional choice should discuss costs of compliance (transition costs) because it is likely that institutional variations exist. Legal transition costs should also be included to identify the frictions associated with a change in legal regime. The creation of the PCAOB with the Sarbanes-Oxley Act would be a particularly fruitful starting point for comparative analysis of legal transition costs. Regardless of which framework is used for comparison, future research should include the PCAOB as evidence of its abilities become more widely available to determine whether the costs of increased bureaucracy offset the benefits of an independent public oversight board.

The effects of difficult institutional choices are present in every public policy. The economic analysis of law, though it recognizes such effects, does not enable the analyst to fully appreciate how alternative institutional choices lead to variations in policy outcome. Single institutional analysis leads to intuitive conclusions about why institutions were chosen to regulate a given area in the past, and why they should continue to do so in the future. It is by parallel comparison of imperfect institutional

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<sup>85</sup> See Jonathon D. Glater, "Here it Comes: The Sarbanes-Oxley Backlash," *New York Times*, 17 April 2005, Business section.

alternatives that the policy analyst absorbs the difficulties of institutional choice and constructs a more comprehensive framework for understanding policy outcomes.

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