Ethical Guidance and Constraint Under the Sarbanes-Oxley Act of 2002

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This article discusses two key features of the Sarbanes-Oxley Act, which was enacted in 2002 to restore integrity and public confidence to the financial markets. The law was passed in response to the horrendous corporate disasters that had occurred, including Enron, Worldcom, Adelphia, and Tyco. The implementation of effective business ethics became essential and the new law required the publication of corporate codes of ethics. It did not mandate their content. This paper suggests specific sections for inclusion in the general guidelines to encompass the ethical dimensions of the Act. It analyzes the compliance by the corporations in their public filings since Sarbanes-Oxley became law. The revelation of the size of the audit and accounting fees paid to Arthur Andersen by Enron and similar fees paid in other current financial debacles lead to another key requirement of Sarbanes-Oxley: mandatory auditor rotation. Here, however, Sarbanes-Oxley did not go far enough. The law required rotation only of the lead auditor within a firm. This paper submits that it should have required rotation of audit firms instead. The positions of the public companies, the American Institute of Certified Public Accountants, the Government Accountability Office, and accounting journals are explored as to the rotation of auditor firms regarding audit-partner rotation within a firm. The paper concludes that Sarbanes-Oxley should be expanded to require audit-firm rotation. This expansion is necessary to reinforce the independence of the public accountant, both in fact and appearance, and to restore competition within the accounting profession, which will benefit the investing public. It is up to the Security and Exchange Commission and the Public Company Accounting Oversight Board and, ultimately, Congress to make this expansion a reality.

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This article is dedicated to the memory of the Distinguished Professor of Law Emeritus at New York University, Homer Kripke. He wrote that the newly adopted Generally Accepted Auditing Standards (GAAS) "impose a responsibility on the auditors *with an attitude of professional skepticism* to detect and report errors and irregularities leading to *misleading financial statements, sometimes called management fraud*; and to report them to the audit committee" (Homer Kripke, "Reflections on the FASB's Conceptual Framework for Accounting and on Auditing," *Journal of Accounting, Auditing & Finance,* Winter 1989, p. 63). The author gratefully acknowledges the research assistance of Eric Weissmann, University of Rochester (2010).

Keywords: *Accounting, Arthur Andersen, ethics education, corporate governance, auditor rotation, audit-firm rotation, codes of ethics, Sarbanes-Oxley, auditing, Enron*

> Ethical virtue is acquired by habituation . . . for it is by our actions with other men in transactions that we are in the process of becoming just or unjust. . . . "Just" means that which is lawful or that which is fair, while "unjust" means that which is unlawful or that which is unfair.
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> —Aristotle selected works, translated by Apostle and Gerson (1991, p. 448, 473).

1. Introduction

Five years have passed since Congress enacted the Sarbanes-Oxley Act of 2002 (alternately, the "Act" or "Sarbanes-Oxley"). The Act constituted a daring effort to legislate morality, with the goal of restoring integrity to and public confidence in the financial markets. Sarbanes-Oxley was a direct response to the corporate scandals of Enron and WorldCom—immediately followed by Adelphia and Tyco, the collapse of the once-venerated accounting firm of Arthur Andersen, and the mistreatment of employees and investors by flagrantly unethical business practices.

Sarbanes-Oxley contains a variety of provisions regarding business ethics. The two that have particular potential to deter unethical business practices and that accordingly are the principal focus of this article are, first, the requirement that corporations develop codes of ethics for senior financial officers that include, among other things, enforcement mechanisms (Section 406) and, second, the requirement that outside auditors be rotated on a regular basis (Sections 203 and 207).[1] I find these requirements to be of greatest interest because, collectively, they regulate corporations from both within and without.

The Code of Ethics requirement provides a blueprint for internal corporate governance: one that formally delineates standards of acceptable conduct for all of a corporation's officers, directors, and employees, including its internal accountants. The auditor rotation requirement is designed to have a similar effect by ensuring that outside auditors are genuinely independent from—and therefore free to criticize and question the business practices of—the corporations that they are called upon to audit.[2] These two requirements are directly responsive to some of the principal ills that contributed to the scandals of the late 1990s: unethical

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1. There are a number of other requirements in the Act pertaining to ethics, such as Section 303 ("improper influence on conduct of audits"); Section 306 ("insider trades during pension fund blackout periods"); and Section 307 ("rules of professional responsibility for attorneys"); but they are beyond the scope of this article. See Sarbanes-Oxley Act (2002).

2. The demise of Enron, and the rapid and related demise of its outside auditor, Arthur Andersen, stand as an unfortunate testament to how the integrity of both an auditor and the corporation that it is auditing can be compromised when the circumstances permit the independence of the auditor to be called into question.

corporate cultures, regulated by "gatekeepers" whose careers and finances were so entwined with their accounts as to compromise, utterly, their professionalism, independence, and objectivity.

Sarbanes-Oxley has no shortage of critics. Most of them focus heavily, if not exclusively, on the out-of-pocket costs of compliance, which they posit is an unfair burden for American businesses.[3] Substantively, however, the general perception is that the Act has made inroads against unethical practices (Nocera [2005]).[4] I would submit that the latter advantage is far more important, in the long run, than the former disadvantage. Thus, as shown below, the principal thesis set forth in this article is that, while Sarbanes-Oxley has made favorable inroads in the amorphous area of achieving a healthy corporate culture, at least in part through its requirements regarding codes of ethics, its efforts to ensure vigilant external oversight is a different situation entirely. In limiting the rotation requirement to audit partners within an audit firm, rather than requiring the rotation of the firm in its entirety, my view is that Sarbanes-Oxley does not go far enough. For the reasons stated below, I believe that a much more effective method of achieving this goal is to expand these provisions so that they mandate audit-*firm* rotation, rather than simply the rotation of the lead, or engagement, partner within a firm.

My positive impression of the salutary effect of the code of ethics requirement is based, in large measure, on a survey that I conducted of the information that is publicly available about the codes of ethics of thirty-nine randomly selected corporations. The results of this survey indicated satisfactory compliance by the vast majority of these corporations with both the spirit and the letter of Section 406. For example, 92 percent of the corporations in the survey had adopted codes of ethics that not only satisfied the basic elements set by the Sarbanes-Oxley Act, but also reflected that careful thought and attention was consistently paid to the particular ethical conundrums of our times. Also, all of the codes of ethics within the survey contained enforcement mechanisms and, in particular, penalty provisions that appear to be strong enough to attract attention from corporate insiders and thereby to deter unethical conduct or, alternatively, ensure punishment of those who choose not to comply.

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3. The principal criticism of the Act regards the cost of compliance for corporations. Typical of the criticism are the comments expressed by Stephen M. Bainbridge, a law professor at UCLA Law School, "They rushed this legislation through without any effort to figure out what it was going to cost. And the costs have been higher than anybody thought." See Sarbanes-Oxley Act (2002).

4. Among other things, the article quotes SEC Commissioner Harvey J. Goldschmidt as saying, "I think that Sarbanes-Oxley has been a great success in terms of the effect it has had on improved corporate governance. There is no question it has been a great piece of legislation, and anybody who says otherwise is talking like a darn fool." See also O'Hara (2006), stating, "Institutional investor advisory firm Glass, Lewis & Co. estimates that by the time the books are closed for 2005, more than 1,200 of the country's approximately 15,000 public companies will have announced accounting restatements—a record. There were 619 restatements in 2004. In 2001, the year before Sarbanes-Oxley passed, there were 270."

My skepticism regarding the adequacy of the auditor rotation requirement is based on a reading of historical data, rather than an empirical study of the efficacy of the auditor rotation requirement. There is an eminently practical reason for the difference in approach—that is, the rotation requirement has not existed long enough to be subject to empirical review. The requirement provides for rotation every five years, yet the Sarbanes-Oxley Act is only five years old. While it is possible that some auditor rotation has taken place already, such rotation could not be reliably related to the Sarbanes-Oxley mandate and certainly could not be analyzed as being representative of that requirement's effectiveness.

Nevertheless, accepting history as a guide, I analyzed the series of accounting failures that plagued Arthur Andersen up until the ultimate scandal—Enron—caused the accounting firm's demise. The list was long, with many names that were readily recognizable, such as Sunbeam, Waste Management, WorldCom, and Qwest, and other names that were not nationally known but were no less important to the particular investors, employees, directors, and officers who were involved. This survey revealed that there was *no* commonality among the names of the individual partners associated with each respective scandal. Nevertheless, the accusations in each case were strikingly the same: misstatements on financial statements, failures to comply with generally accepted accounting principles, deliberate destruction of records, and so on. Were the current Sarbanes-Oxley requirement of auditor rotation to have been imposed on Arthur Andersen in those years, it is reasonable to conclude that its principal effect, at least in many cases, may have been simply to swap the troubled accounts among partners who already were engaging in accounting improprieties elsewhere.

Putting aside the risk of a systemic unethical culture, under any system of internal partner rotation, newly appointed audit partners would have practical, financial, and legal incentives to acquiesce in existing patterns of improprieties perpetuated by their predecessor partners—especially when the opposite course may lead to client resistance, financial losses, reputational harm for the newly appointed partner's own firm and—potentially—complete individual and institutional ruin. In contrast, historical examples set forth below suggest that newly appointed auditing firms would have exactly the opposite incentives. Were they to inherit accounts rife with accounting improprieties, there is reason to believe that they would be motivated, from the perspective of both self-preservation and natural competitiveness, if nothing else, to disclose and attempt to correct these historical problems. The ultimate incentive, which may prove to be the *sine qua non*, is that a failure to do so could expose them to the disastrous possibility of being deemed to have embraced these historical problems and to become accountable for them as their own.

This analysis, along with other findings set forth below, supports my opinion that, even if partner rotation takes place in the upcoming years strictly in compliance with Sections 203 and 207, such rotation is not likely to be sufficient to satisfy the underlying goal of genuine auditor independence. To the contrary, the principal effect of audit-partner rotation may be merely to increase the number of individual partners named in each of the resulting lawsuits, administrative proceedings, and civil and criminal sanctions.

2. Section 406: The Code of Ethics

One of the principal challenges corporations have faced in handling ethical matters is that ethics historically have not been taught in this country in any sort of systematic, formalized, or reliable way. A survey conducted by *BusinessWeek* as late as 2003, even as the recent wave of corporate scandals was breaking, showed that there continues to be a general acceptance of the concept that ethics cannot be formally taught, especially at higher levels of education.[5]

Commentators have long bemoaned that "[e]thics are not taught in the home, the school or the college system" (Banerjee [2005], p. 9). At the undergraduate level, for example, accounting majors historically have not been required to take ethics courses.[6] In 1988, a study conducted by the Association for the Advancement of Collegiate Schools of Business (AACSB), the organization responsible for accrediting business school programs, found that only one-third of its members required their students to take an ethics course as a mandatory part of the curriculum (Stewart [2004]). In 1993, a separate study reported in the *Journal of Business Ethics* established that only about three hours were devoted to the topic within accounting courses.[7]

In 2002, in response to the onset of corporate scandals, a number of educators launched a campaign for mandatory education in ethics, at least in the context of formal business and accounting curricula. These actions were spearheaded by Diane Swanson, a professor of business at Kansas State University, and Bill Frederick, a retired ethics specialist from the University of Pittsburgh, under the name of Campaign AACSB. Their goal, which was to persuade that association to require a stand-alone ethics course as a condition of accreditation, was endorsed by more than 200 professors and practitioners, as well as two professional associations (Swanson & Frederick [2005]).

Their efforts were ultimately unsuccessful, in that the AACSB did not change its accreditation standards (Swanson & Frederick [2005]). It should come as little surprise, therefore, that an informal survey conducted in 2003 by the

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5. According to the Reader Survey Results, "[T]he vast majority of readers think ethics are better taught someplace other than B-school, with 75% saying the best values are taught at home by parents, while 8% chose elementary or secondary school, and only 4% chose B-School" (2003, p. 2).

6. According to Haas, "Several surveys conducted in the late 1980s found little integration of ethics into the accounting curriculum" (2005, pp. 66–68).

7. According to Haas, "A 1993 study [Frances McNair and Edward E. Milam, "Ethics in Accounting Education: What Is Really Being Done," *Journal of Business Ethics*, October 1993] reported that the average time covering ethics in an accounting course was a little over three hours" (2005, p. 67).

AACSB found that only 35 percent of its member schools required students to take an ethics course, a percent that was virtually unchanged from the results of the study it had conducted fifteen years before (Stewart [2004]).

Even without an accreditation mandate, however, either Campaign AACSB or the collective impact of the corporate scandals, or a combination of such factors, may be starting to affect business and accounting programs. Notably, in 2004, a survey of ethics requirements within master of business administration (MBA) programs was conducted by the Task Force on Business Ethics Education, an organization born out of Campaign AACSB (Swanson & Frederick [2005], at 2). The survey reviewed curriculum requirements related to ethics for each of the thirty top MBA programs in the United States as ranked by *BusinessWeek*, using each university's Web site and online catalogue as a data source, with telephone confirmation of the offerings (Business Ethics Education Initiative [2005]). The results showed that 43 percent of the surveyed programs required a course in business ethics in 2004, which was an improvement on the 35 percent figure found by the AACSB in the previous fifteen years (Stewart [2004]; Business Ethics Education Initiative [2005]).[8] Ten of the thirty schools in the Task Force study required a separate course on ethics, either alone or in combination with a related topic such as business law or public policy (Stewart [2004]; Business Ethics Education Initiative [2005]).[9] Three of them required a module or segment on ethics as part of a larger series of events or seminars, but not a full-credit course (Stewart [2004]; Business Ethics Education Initiative [2005]).[10] Still, seventeen schools among the top thirty business schools had no required foundational ethics courses in 2004 (Stewart [2004]; Business Ethics Education Initiative [2005]).[11]

Although the trend appears to be favorable, it is reasonable at this point to assume that most people have received or will receive little to no formal education in ethics, but for the most elemental lessons of kindergarten:

> Most of what I really need to know about how to live, and what to do, and how to be, I learned in kindergarten. Wisdom was not at the top of the graduate school mountain, but there in the sandbox. These are the things

8. Even outside of the top thirty schools on this list, ethics requirements are starting to emerge. For example, the College of Business at the University of Missouri-Columbia requires its accounting students to elect at least one course in philosophy, ethics, or logic (University of Missouri Undergraduate Catalog [2004–06], p. 194).

9. These schools are New York University, Harvard University, University of Virginia, University of California-Berkley, University of North Carolina, Notre Dame University, Carnegie Mellon University, University of Pennsylvania, Georgetown University, and University of Michigan.

10. These schools are Stanford University, University of Maryland, and Purdue University.

11. These schools are Columbia University, Duke University, University of Chicago, Yale University, University of Rochester, University of Texas-Austin, Massachusetts Institute of Technology, Northwestern University, Dartmouth College, Cornell University, University of California-Los Angeles, University of South Carolina, Indiana University, Emory University, Washington University, Vanderbilt University, and Babson College.

I learned: share everything, play fair, don't hit people, put things back where you found them, clean up your own mess, don't take things that aren't yours, say you're sorry when you hurt somebody, wash your hands before you eat (Fulghum [1986]).

As we move toward written codes of ethics, in hopes that they will function as tolerable substitutes for the instincts and understanding that might have been inbred by years of formal training, it is appropriate to examine their underlying ethical bases. Contemporary ethical beliefs have evolved from "Utilitarian," "Deontological," and "Virtue" ethics. Utilitarianism is the moral philosophy that asserts that an act or practice is right if it leads to the greatest possible balance of good consequences (Donaldson, Werhane, & Cording [2002]; Capaldi [2004]; Dershowitz [2004]).[12] This concept of utilitarianism can then be divided between "rule utilitarianism," which maintains that a rule or code is morally right if the consequences of adopting the rule or code are more favorable than unfavorable to everyone, as contrasted with "act utilitarianism," which maintains that the morality of the action (not a rule or code) is determined in relation to the favorable or unfavorable consequences that emerge from the action.[13] The second ethical category is deontological ethics, which assets that a variety of relationships among persons have a significance independent of consequences that may impose duties in a moralistic sense.[14] The third ethical category is virtue ethics or moral virtue, as developed by Aristotle, which emphasizes the moral character and behavior of the person. The social practices of business managers can be equated with the ethical virtue of self-restraint and control.[15]

The division between "act utilitarianism" and "rule utilitarianism" recognizes the obvious: that written rules, in isolation, are not enough.[16] Codes of

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12. According to Donaldson, Werhane, and Cording, "Bentham and Mill thought that utilitarianism was a revolutionary theory, both because it accurately reflected human motivation and because it had clear application to the political and social problems of their day. If one could measure the benefit or harm of any action, rule, or law, they believed, one could sort out good and bad social and political legislation as well as good and bad individual actions" (2002, p. 4).

13. According to Dershowitz, "'Rule Utilitarianism' is a formulation of utilitarianism which maintains that a behavioral code or rule is morally right if the consequences of adopting that rule are more favorable than unfavorable to everyone. It is contrasted with 'act utilitarianism' which maintains that the morality of each action is to be determined in relation to the favorable or unfavorable consequences that emerge from that action" (2004, p. 242).

14. According to Heath and Schneewind, "Deontology is ethical reasoning that creates principles of moral imperatives based on duty and universal rules that one is obliged to follow regardless of the consequences. A voluntary action of an autonomous individual based on the right reason that is a good and free act of the will" (1997, pp. 50, 62–65); see also Donaldson, Werhane, and Cording (2002).

15. See Apostle and Gerson, "Since virtues are of two kinds, intellectual and ethical, an intellectual virtue originates and grows mostly by teaching, and in view of this it requires experience and time, whereas an ethical virtue is acquired by habituation (ethos) . . . Hence virtues arise in us neither by nature nor contrary to nature; but by our nature we can receive them and perfect them by habituation" (1991, p. 44); see also Donaldson, Werhane, and Cording (2002).

16. This concept is embedded, in a slightly different context, in the U.S. Sentencing Guidelines, set forth at www.ussc.gov.

conduct may assist in the establishment of levels of competence, standards of performance, and guidance for decision making, but they do not provide actual solutions to individual problems (Sack [2002]; Gibson & Goering [2001]). Thus, there must be systems in place to translate the written rules into action (Sack [2002]). In the particular concept here, namely, written codes of ethics for corporate conduct, these systems should include the following: (1) communication of the rules to all employees of the corporation; (2) formal education of employees in ethical decision making; and (3) methods of enforcement (Sack [2002]).

The best proof that written codes of values, in isolation, are not enough lies in the fact that such codes proliferated among Fortune 1000 companies in the mid to late 1990s—just as the actions were being taken that produced the wave of scandals (Weaver, Trevino, & Cochran [1999]).[17]

Mindful of this problem, the Sarbanes-Oxley Act attempts to ensure that codes of ethics are more than window-dressing.[18] The Act does so largely by empowering the Securities and Exchange Commission (SEC) to enact such rules and regulations that the SEC deems necessary to put teeth into the requirements pertaining to the issuance of such codes:

> The Commission shall issue rules to require each issuer, together with periodic reports required pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reason therefore, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officers and comptroller or principal accounting officer, or persons performing similar functions (Section 406, see Appendix A).
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> The Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronics means, by any issuer of any change in or waiver of the code of ethics for senior financial officers (Section 406, see Appendix A).

The SEC rose to this difficult challenge by inviting comments from corporations, professional associations, accountants, law firms, analysts, consultants, academics, investors, and others about the amount and types of disclosures that should be required The response came in the form of more than 200 comment letters. Investors generally supported the objectives and some proposed additional

17. The Weaver, Trevino, and Cochran (1999) study established that, although there was a high degree of corporate adoption of ethics policies at that time, there was a wide variability in the extent to which these policies were implemented. The authors conclude that the vast majority of firms were committed to the lower cost and symbolic side of ethics activities, and accordingly the codes in the study mostly were symbolic recitals of preexisting corporate structure or processes.

18. The Code of Ethics (Section 406) can be found in Appendix A and the regulations for the section can be found in Appendices B, C, D, and E.

disclosures. Other commentators thought that more disclosure was required than was necessary to achieve the change of the Act and suggested changes to the proposals (SEC [2003b]).

The result is what the SEC describes as a "disclosure-based regulatory scheme."[19] As the SEC explains in its comments on the final rules, it limited its mandates to what corporations should make public, rather than mandating what their written codes should say:

> [T]he rules do not specify every detail that the company must address in its code of ethics, or prescribe any specific language that the code of ethics must include. They further do not specify the procedures that the company should develop, or the types of sanctions that the company should impose, to ensure compliance with its code of ethics (SEC [2003b], p. 16).

Consistent with the philosophy of corporate individuality, the SEC did not set forth a model code of ethics. It did, however, provide corporations with general guidelines as to some of the ethical issues that their individually written codes should address. A blueprint of specific sections to be included in a specimen code follows:

> Sections on accuracy and retention of business records; company property; fraud and theft; payments and gifts to third parties; privacy; confidential information; computer resources and computer security; intellectual property; inside information; conflict of interest; family members and close personal relationships; ownership in other businesses; corporate activities; outside employment, affiliations or activities; gifts, gratuities and entertainment; fair dealing; relationships with suppliers or service providers; consultants and agents; antitrust and unfair competition; relationships with government agencies and outside organizations; selling to government institutions; political contributions and activities; personal involvement and the political action committees; government procurement; responding to government and other inquiries; tax violations; and any other area that is unique to the company (Chief Security Offices [2004]).

Similarly, without delving into details, the rules make clear that every code should contain an enforcement mechanism that includes both "severe penalties for violations" and a formal procedure for waivers of compliance:

> [E]ach code should provide severe penalties for violations of the code and a procedure to report violations with complete confidentiality, including anonymity (SEC [2003b], p. 16).

19. According to the SEC, "We continue to believe that ethics codes do, and should, vary from company to company and that decisions as to the specific provisions of the code, compliance procedures and disciplinary measures for ethical breaches are best left to the company. Such an approach is consistent with our disclosure-based regulatory scheme" (2003b, p. 16).

An analysis of the public filings and Internet disclosures of thirty-nine randomly selected corporations shows that, for the most part, corporations have responded admirably to the code of ethics requirements of Sarbanes-Oxley.[20] None of their codes reflected a merely token effort; to the contrary, the codes reflected a substantial amount of work, effort and thought.

The Code of Corporate Conduct of ITT Industries, for example, is thirty pages long, followed by an addendum (see Appendix F, Code 29). The Rayonier Inc. Standard of Ethics and Code of Corporate Conduct is twenty-four pages long, with an introduction by the chairman, president and chief executive officer (CEO) (see Appendix F, Code 31). The Hovnanian Enterprises, Inc. Code of Ethics is a detailed twenty pages, beginning with a table of contents and ending with an acknowledgment certificate form to be executed by each employee (see Appendix F, Code 28). Fannie Mae, also known as the Federal National Mortgage Association, apparently appreciated the philosophical underpinnings of its Code of Business Conduct; that code opens with a quote from Henry David Thoreau.[21]

In accordance with both the Act and the SEC's rules, 92 percent of the corporations in this study had disclosed in their annual reports or Form 10-Ks that their codes of ethics or conduct were publicly available on their Web sites.[22] A review of their Web sites then confirmed that these disclosures were correct; the codes were there, and were easy to find.

Moreover, the codes themselves tended to address the principal ethical issues of our times. An analysis of thirty-six such codes shows that they collectively addressed thirty-one different categories of ethical conduct. Appendix G identifies these categories and reviews what percent of the codes address each of them.

Notably, all of the codes studied had sections pertaining to the "Accuracy and Retention of Business Records," which was the fatal flaw to the financial reports of Enron, Worldcom, and Tyco and which destroyed Arthur Andersen. All of them had sections specifically describing the obligations of the CEO, chief financial officer, and other financial officers, which also appears to be a direct response to these recent corporate scandals. In addition, 83 percent of the codes had detailed sections regarding conflicts of interest and 75 percent had provided corporate protection for whistle-blowers (see Appendix G).

Some codes warn employees to avoid speculation or the appearance of speculation: topics that are peculiarly modern-day ethical conundrums. The

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20. Appendix F identifies the thirty-nine corporations that were the subject of this study.

21. Appendix F, Code 24, stating, "It is truly enough said that a corporation has no conscience. But a corporation of conscientious individuals is a corporation with a conscience" (Thoreau [1906]).

22. Of the three corporations that did not reference their codes of ethics in the public filings, they still disclosed them in full on their Web sites. Thus, while they may not have complied exactly with the technical requirement regarding the public filings, they were in compliance with the fundamentally more important requirement of public disclosure of their codes of ethics.

Dow Jones & Company Code of Conduct, for example, contains provisions encouraging employees to be long-term investors in the company's stock and prohibiting them from the short selling of any securities (see Appendix F, Code 21).

Other codes reveal sensitivity to avoiding abuses by directors of the types that have aggravated the recent wave of scandals. For example, Curtiss-Wright Corporation requires its directors to certify that they have read and understand their Corporate Governance Guidelines; to certify that they have not been involved, during the past twelve months, in any situation that violates the Guidelines; and, further, to certify that they are not aware that any Curtiss-Wright director, officer, or employee is involved, or during the past twelve months has been involved in any situations that violate the Guidelines (see Appendix F, Code 20).

It is particularly notable that most of the codes in the survey included a range of potential penalties for code violations.[23] For example, 81 percent provided for a variety of disciplinary penalties as a consequence of noncompliance, including reprimand, censure, suspension, and termination. Forty-two percent provided penalties of civil or criminal liability for noncompliance (see Appendix G).

First Republic Bank has a typical code of ethics (see Appendix F, Code 7), which subjects violators of the code to the following disciplinary measures:

- Warning and/or reprimand
- Probation
- Suspension
- Salary reduction
- Bonus reduction or elimination
- Demotion
- Termination

23. Notably, these penalty provisions for violations of codes of ethics are not the only penalty provisions set forth within the scope of the Sarbanes-Oxley Act. In addition to these provisions, in Title VIII Corporate and Criminal Fraud Accountability imposes, under Section 802, criminal penalties for altering documents; Section 803 provides for nonchargeable debts if incurred in violation of securities fraud laws; and Section 807 imposes criminal penalties for defrauding shareholders of publicly traded companies. Title IX White Collar Crime Penalty Enhancements under Section 903 imposes criminal penalties for mail and wire fraud; Section 904 provides for criminal penalties for violations of the Employee Retirement Income Security Act of 1974; Section 905 amends the sentencing guidelines relating to certain white-collar offenses; and Section 906 imposes corporate responsibility for financial reports. Also in Title XI Corporate Fraud and Accountability under Section 1102 imposes fines and/or imprisonment for tampering with records or otherwise impeding an official proceeding; Section 1103 gives the SEC authority for a temporary freeze; Section 1104 amends the Federal Sentencing Guidelines Section 1105 increases the penalties under the Securities Exchange Act of 1934; and Section 1107 imposes fines and/or imprisonment for retaliation against informants. See Sarbanes-Oxley Act (2002), Title VIII—Sections 802, 803, 807; Title IX—Section 903, 904, 905, 906; Title XI—Section 1102, 1103, 1104, 1105, 1107.

In addition, violations of legal and regulatory requirements might carry their own civil and criminal penalties, including fines and imprisonment (see Appendix F, Code 7).

While the codes that I surveyed were largely satisfactory, especially considering that they are relatively new, I nevertheless believe that many of them can, and should, go further. In my opinion, it would be appropriate if each code contained a letter from the CEO, emphasizing the importance of compliance and understanding by all of the employees and directors.[24] Similarly, I believe that every director and every employee, from the chairman of the board to the mail clerk, should be required to sign a certification confirming that they have received the code and will comply with it.[25] In the same vein, it is my opinion that any waiver of compliance should require the express approval of the Audit Committee, ideally requested and given before the noncompliant action takes place, and the waiver should be disclosed in all appropriate public filings. I believe that such changes, and others that may become apparent over time, are likely to increase the effectiveness of the codes and further the goals of ensuring that the codes rise above the merely symbolic role that they once were limited to serving.

In this regard, when enough time passes to produce reliable and consistent data, a study should be done of the actual efficacy of the written codes of ethics mandated by Section 406 of Sarbanes-Oxley, perhaps through a focus on the measurable fact of the penalties that actually are imposed within corporations for code violations. But at this point, in the relative infancy of the Act, the prognosis generally seems good with regard to the code of ethics requirements. Corporations appear to be making more than token efforts to establish appropriate codes; to make them readily available to employees, shareholders, and others; and to stand ready to enforce them against violators if, and unfortunately when, that time comes.

3. Sections 203 and 207: Audit-Partner Rotation

Just as the discussion of written codes of ethics underscored concerns about ensuring efficacy rather than symbolism, the same concern will be manifest in the ensuing discussion of the audit rotation requirements. Here, though, my assessment is far less optimistic. My opinion is that the Sarbanes-Oxley requirement of audit-partner rotation is too narrow to protect the public from audits in appearance only. Although I cannot support my assessment with empirical evidence at this time, due to the fact that the rotation requirement is only five years old, the following discussion should demonstrate why I believe that Sarbanes-

24. Only 22 percent of the codes surveyed contained introductions from CEOs.

25. Only 31 percent of the codes surveyed contained requirements for acknowledgment signatures.

Oxley must be expanded to require mandatory rotation of audit *firms*, not just the named partners within ongoing audit firms.[26]

The natural starting point for this discussion is a review of why auditor independence is essential to ensuring ethical corporate behavior. As stated by the SEC, independent auditors function as "'gatekeepers' to the public securities markets."[27] Professor John C. Coffee, of Columbia Law School, describes their role as follows:

> Securities markets have long employed "gatekeepers" – independent professionals who pledge their reputational capital – to protect the interests of dispersed investors who cannot easily take collective action. The clearest examples of such reputational intermediaries are auditor and securities analysts, who in different ways verify or assess corporate disclosures in order to advise investors (Coffee [2004]).

The accounting profession has long recognized that auditor independence is essential to achieving the essential goals of being objective and avoiding conflicts of interest.[28] Thus, the Code of Professional Conduct of the American Institute of Certified Public Accountants (AICPA) consists of two sections. The first section includes six principles, which provide the professional behavior and framework for the Rules of Professional Conduct (Duska & Duska [2003], pp. 75–77). Specifically, principle IV on Objectivity and Independence provides that "[a] member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services." This principle has been recognized as perhaps the most important of all the principles in the AICPA Code (Duska & Duska [2003], p. 85).

Further, the AICPA Code contains a section on the rules and the bylaws requiring its members to adhere to its Rules of Professional Conduct. The rules section consists of five sections of which the first is "Independence, Integrity and Objectivity" (Duska & Duska [2003], p. 93). The independence rule (Rule 101) states, "[a] member in public practice shall be independent in the

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26. In the years that have passed since the enactment of Sarbanes-Oxley, the sufficiency of the audit-partner rotation requirement has provoked continuous dispute and controversy. Compare the following Op Ed Article published in the *Wall Street Journal* by Ernst &Young Chairman Jim Turley (February 4,2002), stating that mandatory audit-firm rotation "would likely reduce audit quality in both the early and late years of an audit term," with the article in the *Accounting Horizon* by Eugene A. Imhoff (2003), supporting audit-firm rotation on grounds that "[r]otating CPA firms every three years could be the single most effective change for enhancing independence." Other commentators on this controversial subject limit their conclusions to the innocuous finding that "increased auditor tenure does not lead to reduced audit and earnings quality.... However, our results also do not imply that forcing firms to remain with the same auditors would improve earnings quality or audit quality" (Myers, Myers, & Omer [2003]).

27. See Securities Act Release No. 7870 (June 30, 2000). Chief Justice Warren Burger opted for the more colorful term "public watchdog" to express this same concept (Duska & Duska [2003]).

28. In this respect, the audit rotation requirements stand as complementary counterparts—but not mere derivatives—of the Code of Ethics requirements described in Section 2 of this article.

performance of professional services as required by standards promulgated by bodies designated by Council" (Duska & Duska [2003], p. 93). These bodies include the state board of accountancy, Certified Public Accountants (CPA) society, the SEC, U.S. Department of Law, and the AICPA SEC Practice Section (Centers of Public Company Audit Firms). A positive explanation of "independence" as freedom from conflicting interests to the responsibilities of the accountant is negatively interpreted by examples of impairment to "independence" by direct or material indirect financial interest in or with the client; loans to or from the client, or its officers, directors, or principal stockholders; and connection with the client as a promoter, underwriter, voting trustee, director, officer, employee, or manager (Duska & Duska [2003], p. 93). Similarly, the conflict of interest rule (Rule 102) states, "In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others" (Duska & Duska [2003], pp. 95–96).

Against that backdrop, the audit-partner rotation requirement currently found within the Act reads as follows:

> It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (have primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit service for that issuer in each of the 5 previous fiscal years of that issuer (see Appendix H).

This provision requires the "lead" and "concurring" partners to rotate after five years and, upon rotation, be subject to a five-year "time-out" period. The terms "lead partner" and "concurring partner" have specified meanings. The "lead partner" has the primary responsibility for the audit. The "concurring partner" performs a second level of review to provide additional assurance that the financial statements are in conformity with general accounting principles and generally accepted auditing standards and rules promulgated by the Commission or the Public Company Accounting Oversight Board (PCAOB), which is a review board created by Congress in conjunction with the passage of Sarbanes-Oxley.[29]

The problem is that this provision does not require the rotation of audit firms, only partners within a firm. It technically would be satisfied with a token change of the name of the lead partner—even though the lead partner in practice may continue unchanged for years, or even decades. It therefore is ripe for abuse, especially by large and stratified accounting firms.

Historical evidence makes the weakness of this requirement all too clear. First, one need look no further than the history of Arthur Andersen to appreciate

29. The Commission exempted firms with fewer than five audit clients and fewer than ten partners. This exemption was codified in the Act with the safeguard that the PCAOB would conduct a review of the accounting firm's engagements at least once every three years. See SEC (2003a, IIC.1).

that auditor rotation would serve no purpose when it takes place with an "unethical corporate culture that repeatedly permits unethical practices." In the years leading up to the catastrophic Enron scandal, Arthur Andersen was plagued with a series of comparable, but unrelated, accounting scandals. There was no overlap among the engagement partners involved in each case, although there was a marked similarity among the allegations of improper behavior. Thus, the inevitable and unfortunate inference is that the Sarbanes-Oxley auditor rotation requirement would have offered no protection for the investors in Arthur Andersen's clients during those years. The argument can be made that its principal effect would merely have been to increase the number of partners named in the resulting lawsuits and administrative proceedings.

In the Enron scandal, the engagement partner at Arthur Andersen—and the individual held accountable as the principal decision maker—was David B. Duncan.[30] The scandals at Arthur Andersen that preceded Enron, and the principal partners involved in each one, include the following:

- Baptist Foundation of America: In November 1999, this nonprofit charity based in Arizona declared bankruptcy, with debts of approximately $640 million. In response to investor allegations of accounting improprieties, including the nondisclosure of possible fraudulent activity, Arthur Andersen ultimately paid a $217 million settlement. The senior partner from Arthur Andersen was Jay Steven Ozer.[31]
- Sunbeam: This Florida-based home appliance company was accused by the SEC of multiple fraudulent accounting statements, including artificially boosting quarterly net income, accelerating sales from later periods into the present quarter, and other methods of improperly inflating revenue. In August 2002, a federal judge approved a settlement of an investor lawsuit that, among other things, required Arthur Andersen to pay $110 million. The engagement partner from Arthur Andersen was Phillip E. Harlow.[32]
- Waste Management: This accounting scandal lead to the first antifraud injunction issued against an accounting firm in twenty years. In 2001 and 2002, in response to accounting practices that were alleged to be extremely improper, Arthur Andersen paid a $7 million fine as well as an approximately $75 million settlement to Waste Management shareholders. The engagement partners from Arthur Andersen were Robert F. Allgyer, Edward G. Maier, and Walter Cervaschi.[33]
- WorldCom: Also in 2002, reports surfaced of enormous misstatements in financial statements filed from 1999 through 2002 by this telecommunications

30. *In re* Enron Securities Litig., 235 F. Supp. 2d 549.
31. *In re* Enron Securities Litig., 235 F. Supp. 2d 549, 676, n.111.
32. *In re* Enron Securities Litig., 235 F. Supp. 2d at 675, n.110.
33. *In re* Arthur Andersen Exchange Act Release No. 34-4444, 2001 WL 687561 (June 19, 2001). See the SEC Litigation Release, at http://www.sec.gov/litigation/litreleases/lr17039.htm.

giant based in Clinton Mississippi. Lawsuits filed by both investors and the SEC led to the imposition of a civil penalty in the astonishing sum of $2,250,000,000, among other sanctions. The engagement partners from Arthur Anderson were Mark Schoppet (2000) and Melvin Dick (2001) (Worldcom [2003]).

- Qwest: In 2002, the SEC accused Qwest Communications International Inc. of making false representations on its financial statements from 1999 through 2002, leading to the fraudulent recognition of approximately $43.8 billion of spurious revenue and the fraudulent exclusion of $231 million in expenses. At the time, the Colorado-based company was one of the largest telecommunications and Internet services companies in the United States (SEC [2003c]). A securities fraud class action in U.S. District Court in Colorado has reportedly produced a partial settlement of $400 million (Hevesi [2006]). As recently as April 18, 2006, New York State Comptroller Alan Hevesi filed a securities fraud lawsuit against Qwest and Arthur Andersen for $250 million to recoup losses suffered by the State Common Retirement Fund (Hevesi [2006]). The lead audit partner from Arthur Andersen was Mark Iwan (SEC [2005a]).[34]

In contrast to this walk of shame for the accounting profession—a walk that continues for much longer than a few examples set forth here—this author finds hope in an unexpected reaction: an SEC lawsuit against three Arthur Andersen auditors for fraud in connection with the year 2000 audit of American Tissue, Inc., a manufacturer of tissue and paper products. The lawsuit was brought against Arthur Andersen partner Fred Gold, along with audit manager John D. Parson and senior accountant Brendan P. McDonald. The SEC charged all three executives with failing to exercise due professional care in issuing an unqualified audit report on the company's fiscal 2000 financial statements (SEC [2005b]).[35]

The good news, relatively speaking, lies in the following allegations in the SEC's complaint:

> [I]n July 2001, when the defendants learned their fiscal 2000 American Tissue audit had been selected for a peer review by another accounting firm, they intentionally altered audit work papers in an attempt to conceal the failures of their audit work. In September 2001, when the defendants learned that another accounting firm had discovered that the company had overvalued inventory and would have to restate financial results for fiscal 2000, they destroyed documents and e-mails in a further attempt to conceal their audit failures (SEC [2005b]).

34. The SEC release states that Iwan agreed to a settlement that imposed a suspension from appearing or practicing before the Commission as an accountant.

35. The SEC release states that two of these auditors agreed to settlements that impose injunctions, civil penalties, and suspensions from appearing or practicing before the Commission as accountants.

These allegations, if true, support the argument that audit-firm rotation would be a more effective method of ensuring auditor independence than auditor rotation within a single firm. They suggest that partners within an audit firm are far more likely to second-guess their actions when they anticipate review by a competitor than when they anticipate review by one of their own partners. Review by a competitor has particular value because, under ordinary circumstances, it would seem that a competitor would have both a financial and a legal incentive to disclose and correct, rather than conceal, any accounting irregularities inherited from a predecessor company. The history of Arthur Andersen, however, suggests that the reverse would be true for audit-partner rotation within a single accounting firm.

A second reason for doubting the efficacy of the auditor rotation requirement—as distinguished from an audit-firm rotation requirement is that the auditor rotation requirement is little more than a minor extension of a previous rotation requirement that had been established by the accounting profession. That provision, established by the AICPA's SEC Practice Section (now known as the Center of Public Company Audit Firms or the Center for Audit Quality), recommended that the lead partner rotate off the engagement of SEC registrants after seven years, with a two year "time-out" period.[36]

That previous requirement was in effect during the accounting scandals that led to the creation of Sarbanes-Oxley. These accounting scandals therefore stand as unfortunate, yet convincing, evidence that this requirement was not stringent enough to be effective. Because the new rotation requirement embodied within Sarbanes-Oxley is substantially similar, with only a slight alteration of the original time periods, it is hard to see how this requirement could be sufficient to achieve its goals.

A third reason for questioning the auditor rotation requirement is that the accounting profession professed lukewarm support for the limited rotation requirement. That fact ironically stands as a testament to the requirement's weakness.

The AICPA submitted comments on the proposed requirement to the SEC in a sixty-two-page letter on January 9, 2003. The letter agreed with and supported the objectives of the Congress and the SEC in requiring partner rotation. It pointed out that the AICPA had required lead audit-partner rotation for the past twenty-five years. It recognized the importance of a "fresh set of eyes," but maintained that the benefit must be balanced with the cost of continuity and "institutional knowledge" (AICPA [2003]).

Most notable about the letter was that it stressed the AICPA's objections to audit-firm rotation—the very concept that I believe is critically needed and conspicuously absent from the requirements of Sarbanes-Oxley. The letter stated

36. See AICPA (1978, pp. 1–5). While the prior lead partner-rotation requirements specified a seven-year period prior to rotation, the original rotation requirements developed by the SECPS specified a five-year rotation period.

that "audit firm rotation has significant costs that far outweigh the potential benefits." The costs cited were increase in audit failures, increased start-up costs, increased difficulties in timely reporting, loss of institutional knowledge, opportunity to disguise voluntary rotations, reduced incentives to improve efficiency and audit quality, and a sharp increase in time and resources dedicated to proposal process (AICPA [2003]).

There are many possible reasons to explain the AICPA's vehement objections to audit-firm rotation, and some of them likely are based in political, financial, and economic realities. It is common knowledge, for example, that the AICPA is heavily represented by members of the Big Four accounting firms and, as a result, are necessarily sensitive to protecting the interests of those firms. This mutually dependent relationship was affirmatively acknowledged in 2003 by Charles Bowsher, a former partner at Arthur Andersen who served as comptroller general of the United States for fifteen years and also as chairman of the PCAOB. In an interview with the editor-in-chief of the *CPA Journal* about the AICPA's reaction to the Sarbanes-Oxley Act, he stated:

> I'm not sure if the AICPA is leading the Big Four or the other way around. The morale of all CPAs about their profession has sunk so low over the last two years, and to a great extent it is because the leaders of the big firms and the AICPA have undertaken initiatives that turned out to be disastrous. The AICPA has become a big public relations and lobbying machine. It does a good job with some of its education programming, but its involvement with auditing and professional standards setting has become de-emphasized (Morris [2003]).[37]

Although the membership of the AICPA consists mostly of mid-size and small accounting firms, which vastly outnumber the Big Four, this membership does not appear to be represented proportionately in the leadership of the organization or to have a proportionate influence upon AICPA policy or concerns. The officers, directors, and committee chairs of the AICPA are predominantly partners of the Big Four firms, and their views tend to be reflected within official positions taken by the association on issues of professional consequence.[38]

The fourth and final reason for questioning the merits of auditor rotation lies in a report prepared by the Government Accountability Office (GAO) that, ironically, is viewed by many as a primary reason why auditor rotation was selected over audit-firm rotation in the first place. That report was prepared and submitted by the GAO pursuant to Section 207(b) on November 21, 2003, after obtaining and reviewing comments from seventy-four public accounting firms having ten

37. According to the interview, "The AICPA and the Big Four have become a hardball lobbying coalition with enormous amounts of money. Some of their efforts have come at enormous costs to their prestige, and now, because the results are perceived as contributing to the recent financial disaster of several large public companies, many in Washington are having second thoughts" (Morris [2003]).

38. See AICPA Web site (2005), "Committee Volunteers," http://www.aicpa.org.

or more SEC clients, 201 chief financial officers of Fortune 1000 public companies, and 191 of their audit committee chairs (GAO [2003]). The report strongly favored the adoption of the limited audit-partner rotation requirement, instead of the more substantial audit-firm rotation requirement. Yet the GAO was subject to criticism for placing undue emphasis from the outset—even before conducting the survey that ultimately led to the report—on the costs and fees relating to audit-firm rotation (GAO [2003]). As one commentator stated, the elimination of future losses by shareholders and employees, along with the restoration of public confidence in the market, deserve greater attention and consideration than the concern for the initial year audit and support costs and increased marketing expenses of the public accounting firms (Mason [2004], R7, R10).

It is beyond dispute that the responses of the largest entities surveyed by the GAO were largely negative with regard to mandatory firm rotation. About 79 percent of the auditing firms and public companies that responded to the survey expressed concern that mandatory firm rotation would increase risks, while increasing costs. Specifically, some predicted that changing firms would substantially increase the risk of audit failure in the early years for the new auditor (GAO [2004]).[39] Others predicted that mandatory rotation would not relieve the lead partner of the pressure of dealing with material financial reporting issues or retention of the client (GAO [2004]).[40] Still others predicted audit-firm rotation would result in more costly audits (GAO [2004]).[41]

Nevertheless, even the GAO acknowledged that these results were not surprising. The Big Four accounting firms that audit 90 percent of the companies listed on the New York Stock Exchange, and the management of the large public companies, were the predominant source of answers to the questionnaires (Mason [2004], R11). This resulted in those with vested economic self-interest controlling the result.

Importantly, however, mandatory audit-firm rotation is still on the table. As even the GAO concluded in endorsing audit-partner rotation, the SEC and the PCAOB should monitor and evaluate the effectiveness of the Act's partner-rotation requirements for several years and then decided whether to pursue the topic of mandatory firm rotation (GAO [2003]). This conclusion probably reflected, at least in part, the concerns raised by a minority of respondents, which happen to echo my personal concerns expressed above. For example, some responses acknowledged that mandatory firm rotation had the potential to increase

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39. According to GAO "The primary reason we oppose mandatory rotation of auditing firms is that it would lower audit quality and thereby injure the public interest" (GAO [2004], p. 132).

40. "I believe that the issue that results in audit failures and the drive for auditor rotation are caused by individuals or firm cultures. No amount of regulation is going to control human behavior or address unethical acts" (GAO [2004], p. 116).

41. "Unfortunately, for small firms (under $75,000,000) in revenue the concept ignores the efficiency involved in changing firms from both the client and firm perspective. The difference and bigger issue relates to the fact that for large firms, the audit client is most likely the only client the engagement partner has" (GAO [2004], p. 117).

competition among auditor firms, with the twin benefits of improving independence and lowering costs:

> Mandatory rotation will provide opportunities for certain firms other than the Big 4 to grow their public company practice especially for large public companies. This increased level of service to the public company market segment will enhance competition for talent and for the opportunity to serve these larger entities requiring services throughout the year (GAO [2004], p. 123).[42]

Other responses acknowledged that the *perception* held by individual investors of auditor's independence substantially increased under mandatory auditor rotation (Mason [2004], R7).

Starting in late 2008, six years after the adoption of Sarbanes-Oxley and one year after the audit-partner rotation requirement will have taken effect, careful research should be conducted by the SEC, the PCAOB, and various academic, association, and private research organizations to assess whether Sections 203 and 207 are proving effective in protecting the independence of outside auditors. These studies will present many practical obstacles, because it likely will be difficult to secure genuine cooperation and accurate disclosures from within private corporations and auditing firms who have substantial vested interests in validating the adequacy of the limited audit-partner rotation requirements. Nevertheless, certain objective benchmarks may be of use in assessing the efficacy of the requirements, such as whether there is any recognizable change in audit practices or disclosures following a change in lead partners, as compared with the types of changes that commonly occur following a change in audit firms under other circumstances. Over time, other measurable benchmarks may include whether the original lead partners are simply reinstated at the end of the five-year time-out periods, giving rise to an inquiry into whether such partners had remained, for all practical purposes, in charge during the interim period despite nomenclature to the contrary.

A less empirical, but perhaps far more reliable, method of assessing the efficacy of the rotation requirement will be simply to read the newspapers over the next few years. If the rotation requirement proves to be too limited, and if corporations and outside auditors have not learned from the past, then accounting scandals are likely to continue to occur. If that happens, then Congress will be well advised immediately to take the actions recommended herein, with regard to expanding the rotation requirements of Sarbanes-Oxley to include audit-firm rotation. There would be no need to wait for years to pass and empirical research to be conducted; the failure of the audit-partner rotation provisions would be readily apparent in the faces of those individuals who are harmed by unchecked, unethical business practices.

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42. "The Sarbanes-Oxley Act of 2002 and the recently issued SEC rules on strengthening auditor independence, along with vigilant audit committees, are major steps in restoring the investors' trust and confidence in the capital markets. These positive actions must be given time to work and rebuild investors' confidence" (GAO [2003b], p. 123).

4. Conclusion

The Sarbanes-Oxley Act has provided an excellent start to ensure that the accounting disasters of recent years will not be repeated. Some of the key provisions of the Act, such as the Code of Ethics requirements, appear to have struck their mark and to have begun making improvements. The efficacy of other provisions, such as the audit-partner rotation requirements, are destined, in my opinion, to fall short, but should improve considerably with the substitution of a requirement for audit-firm rotation. Accordingly, every effort should be made by government decision makers to resist industry pressures to scale back these provisions. To the contrary, all efforts should be made to allow these provisions to be as effective as possible and, if they prove ineffective, to expand them.

APPENDIX A

Title IV—Enhanced Financial Disclosures
Section 406. Code of Ethics for Senior Financial Officers

(a) Code of Ethics Disclosure—The Commission shall issue rules to require each issuer, together with periodic reports required pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reason therefore, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officers and comptroller or principal accounting officer, or persons performing similar functions.

(b) Changes in Codes of Ethics—The Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.

(c) Definitions—In this section, the term "code of ethics" means such standards as are reasonably necessary to promote—
   (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
   (2) full, fair, accurate, timely, and understandable disclosures in the periodic reports required to be filed by the issuer; and
   (3) compliance with applicable governmental rules and regulations.

(d) Deadline for Rulemaking—The Commission shall—
   (1) propose rules to implement this section, no later than 90 days after the date of enactment of this Act, and
   (2) issue final rules to implement this section, not later than 180 days after that date of enactment.

APPENDIX B

Reg. S229.406 (Item 406) Code of Ethics

(a) Disclose whether the registrant has adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the registrant has not adopted such a code of ethics, explain why it has not done so.

(b) For purposes of this Item 406, the term *code of ethics* means written standards that are reasonably designed to deter wrongdoing and to promote:
   (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
   (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
   (3) Compliance with applicable governmental laws, rules and regulations;
   (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
   (5) Accountability for adherence to the code.

(c) The registrant must:
   (1) File with the Commission a copy of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as an exhibit to its annual report.
   (2) Post the text of such code of ethics on its Internet website and disclose, in its annual report, its Internet address and the fact that it has posted such code of ethics on its Internet website; or
   (3) Undertake in its annual report filed with the Commission to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.

(d) If the registrant intends to satisfy the disclosure requirement under Item 10 of Form 8-K regarding an amendment to, or a waiver from, a provision of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and that relates to any element of the code of ethics definition enumerated in paragraph (b) of this Item by posting such information on its Internet website, disclose the registrant's Internet address and such intention.

Instructions to Item 406

(1) A registrant may have separate codes of ethics for different types of officers. Furthermore, a *code of ethics* within the meaning of paragraph (b) of this Item may be a portion of a broader document that addresses additional topics or that applies to more persons than those specified in paragraph (a). In satisfying the requirements of paragraph (c), a registrant need only file, post or provide the portions of a broader document that constitutes a *code of ethics* as defined in paragraph (b) and that apply to the persons specified in paragraph (a).

(2) If a registrant elects to satisfy paragraph (c) of this Item by posting its code of ethics on its website pursuant to paragraph (c)(2), the code of ethics must remain accessible on its website for as long as the registrant remains subject to the requirements of this Item and chooses to comply with this Item by posting its code on its website pursuant to paragraph (c)(2).

APPENDIX C

Part 249.220f—Forms, Securities Exchange Act of 1934
Item 16B of Form 20-F Code of Ethics

(a) Disclose whether the registrant has adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the registrant has not adopted such a code of ethics, explain why it has not done so.

(b) For purposes of this Item 16B, the term "code of ethics" means written standards that are reasonably designed to deter wrongdoing and to promote:
   (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
   (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
   (3) Compliance with applicable governmental laws, rules and regulations;
   (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
   (5) Accountability for adherence to the code.

(c) The registrant must:
   (1) File with the Commission a copy of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as an exhibit to its annual report;
   (2) Post the text of such code of ethics on its Internet website and disclose, in its annual report, its Internet address and the fact that it has posted such code of ethics on its Internet website; or
   (3) Undertake in its annual report filed with the Commission to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.

(d) The registrant must briefly describe the nature of any amendment to a provision of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and that relates to any element of the code of ethics definition enumerated in Item 16B(b), which has occurred during the registrant's most recently completed fiscal year.

(e) If the registrant has granted a waiver, including an implicit waiver, from a provision of the code of ethics to one of the officers or persons described in Item 16B(a) that relates to one or more of the items set forth in Item 16B(b) during the registrant's most recently completed fiscal year, the registrant must briefly describe the nature of the waiver, the name of the person to whom the waiver was granted, and the date of the waiver.

Instructions to Item 16B

1. Item 16B applies only to annual reports, and does not apply to registration statements, on Form 20-F.
2. A registrant may have separate codes of ethics for different types of officers. Furthermore, a "code of ethics" within the meaning of paragraph (b) of this Item may be a portion of a broader document that addresses additional topics or that applies to more persons than those specified in paragraph (a). In satisfying the requirements of paragraph (c), a registrant need only file, post or provide the portions of a broader document that constitutes a "code of ethics" as defined in paragraph (b) and that apply to the persons specified in paragraph (a).
3. If a registrant elects to satisfy paragraph (c) of this Item by posting its code of ethics on its website pursuant to paragraph (c)(2), the code of ethics must remain accessible on its website for as long as the registrant remains subject to the requirements of this Item and chooses to comply with this Item by posting its code on its website pursuant to paragraph (c)(2).
4. Not Applicable
5. The registrant does not need to provide any information pursuant to paragraph (d) and (e) of this Item if it discloses the required information on its Internet website within five business days following the date of the amendment or waiver and the registrant has disclosed in its most recently filed annual report its Internet address and intention to provide disclosure in this manner. If the registrant elects to disclose the information required by paragraph (d) and (e) through its website, such information must remain available on the website for at least a 12-month period. Following the 12-month period, the registrant must retain the information for a period of not less than five years.

   Upon request, the registrant must furnish to the Commission or its staff a copy of any or all information retained pursuant to this requirement.
6. The registrant does not need to disclose technical, administrative or other non-substantive amendments to its code of ethics.
7. For purposes of this Item 16B:
   a. The term "waiver" means the approval by the registrant of a material departure from a provision of the code of ethics; and
   b. The term "implicit waiver" means the registrant's failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer, as defined in Rule 3b-7 (S240.3b-7 of this chapter), of the registrant.

APPENDIX D

Part 249.240f—Forms, Securities Exchange Act of 1934
Notes to Paragraph (8) of General Instruction B

9. (a) Disclose whether the registrant has adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the registrant has not adopted such a code of ethics, explain why it has not done so.

(b) For purposes of this paragraph (9) of General Instruction B, designed to deter wrongdoing and to promote:
   (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
   (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
   (3) Compliance with applicable governmental laws, rules and regulations;
   (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
   (5) Accountability for adherence to the code.

(c) The registrant must:
   (1) File with the Commission a copy of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as an exhibit to its annual report;
   (2) Post the text of such code of ethics on its Internet website and disclose, in its annual report, its Internet address and the fact that it has posted such a code of ethics on its Internet website; or
   (3) Undertake in its annual report filed with the Commission to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.

(d) The registrant must briefly describe the nature of any amendment to a provision of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and that relates to any element of the code of ethics definition enumerated in paragraph (9)(b) of General Instruction B, which has occurred during the registrant's most recently completed fiscal year. File a copy of the amendment as an exhibit to the annual statement.

(e) If the registrant has granted a waiver, including an implicit waiver, from a provision of the code of ethics to one of the officers or persons described in paragraph (9)(a) that relates to one or more of the items set forth in paragraph (9)(b) of General Instruction B during the registrant's most recently completed fiscal year, the registrant must briefly describe the nature of the waiver, the name of the person to whom the waiver was granted, and the date of the waiver.

APPENDIX E

Part 249.240f—Forms, Securities Exchange Act of 1934 Notes to Paragraph (9) of General Instruction B

1. Paragraph (9) of General Instruction B applies only to annual reports, and does not apply to registration statements, on Form 40-F.
2. A registrant may have separate codes of ethics for different types of officers. Furthermore, a "code of ethics" within the meaning of paragraph (9)(b) of this General Instruction may be a portion of a broader document that addresses additional topics or that applies to more persons than those specified in paragraph (9)(a). In satisfying the requirements of paragraph (9)(c), a registrant need only file, post or provide the portions of a broader document that constitutes a "code of ethics" as defined in paragraph (9)(b) and that apply to the persons specified in paragraph (9)(a).
3. If a registrant elects to satisfy paragraph (9)(c) of this General Instruction by posting its code of ethics on its website pursuant to paragraph (9)(c)(2), the code of ethics must remain accessible on its website for as long as the registrant remains subject to the requirements of this paragraph (9) of General Instruction B and chooses to comply with this paragraph (9) of General Instruction B by posting its code on its website pursuant to paragraph (9)(c)(2).

APPENDIX F

Corporate Codes of Ethics or Conduct

Annual Reports, 2004–05	No.
References a Code of Ethics or Code of Conduct	03
Contains a Code of Ethics or Code of Conduct	36
Total Corporations in the Study	39

Note: The annual reports included the Form 10-Ks.

List of Corporations

1. Arrow Electronics, Inc.—Annual Report references code in 10-K Finance Code of Ethics available on Web site.
2. British American Tobacco—Code of Corporate Governance and Standards of Business Conduct available on Web site; company noted that it is exempt from Sarbanes-Oxley, but does comply.

3. CommScope, Inc.—Annual Report references Code of Ethics and Business Code for senior corporate officers; Code of Ethics for senior corporate officers available on Web site.
4. Conagra Foods, Inc.—Annual Report references Code of Ethics for senior corporate officers; Code of Ethics for senior corporate officers available on Web site.
5. El Paso Electric Company—Code of Ethics not mentioned in Annual Report; Code of Ethics is available on Web site.
6. Exxon Mobil Corporation—Code of Ethics and Standards of Business Conduct referenced in 10-K; Code of Ethics and Standards of Business Conduct available on Web site.
7. First Republic Bank—Code of Ethics mentioned in 10-K; Code of Ethics and Corporate governance is available on Web site.
8. Friendly Ice Cream Corporation—Code of Ethics referenced in Annual Report; Code of Ethics is available on Web site.
9. Gannett Co. Inc.—Code of Ethics is mentioned in Annual Report; Code of Ethics is available on Web site.
10. IVAX Corporation—Code of Ethics is not mentioned in Annual Report; Code of Conduct is available on Web site.
11. Kellogg Company—Code of Ethics is referenced in Annual Report; Global Code of Ethics is available on Web site.
12. Kimco Realty Corporation—no reference to Code of Ethics in Annual Report; Code of Ethics is available on Web site.
13. Newmont Mining Corporation—reference to Code of Ethics in 10-K; Code of Ethics is integrated into Principles of Business Conduct and Ethics, which is available on Web site.
14. Ryder System, Inc.—reference to Business Code of Ethics in 10-K; Code of Ethics available on Web site.
15. Seagate Technology—reference to Code of Business Conduct and Ethics in 10-K; Code of Business Conduct and Ethics and International Integrity and Ethics in Worldwide Business Operations, applicable to the senior officers, is available on Web site.
16. The Sherwin-Williams Company—reference to Business Ethics Policy in 10-K; Business Ethics Policy available on Web site.
17. Sony Corporation—reference to Code of Ethics in 10-K; Code of Ethics is included in Code of Conduct, which is available on Web site.
18. Vodafone Group, Plc—Code of Ethics applicable to all officers referenced to in Annual Report; Code of Ethics available on Web site.
19. Amerada Hess—reference to Code of Business Conduct and Ethics in 10-K; Code of Business Conduct and Ethics is available on Web site.
20. Curtiss-Wright Corporation—no reference to any ethical code in Annual Report or in 10-K; Corporate governance guidelines available on Web site.
21. Dow Jones & Company—Annual Report references Code of Ethics; Code of Conduct and Code of Conduct for Directors are available on Web site.
22. Entergy Corporation—Code of Business Conduct and Ethics for Directors and Code of Business Conduct and Ethics for Employees (including provisions for corporate officers) is referenced to in 10-K; Code of Business Conduct and Ethics for Directors and Code of Business Conduct and Ethics for Employees is available on Web site.

23. Ethan Allen—reference to Code of Business Conduct and Ethics in 10-K; Code of Business Conduct and Ethics is available on Web site
24. Federal National Mortgage Association—Code of Ethics for corporate officers is referenced in 10-K; Code of Ethics for Directors and Code of Business Conduct and Ethics for Employees is available on Web site.
25. Genentech, Inc.—Code of Ethics applying to chief executive officer and financial officers referenced in 10-K; Code of Ethics applying to chief executive officer and financial officers available on Web site.
26. Gerber Scientific, Inc.—Financial Code of Ethics referenced in 10-K; Financial Code of Conduct and Ethics applicable to chief executive officer and senior financial officers available on Web site.
27. Hormel Foods Corporation—Code of Ethical Business Conduct referenced in Annual Report; Code of Ethical Business Conduct (covering directors, officers and employees) is available on Web site.
28. Hovnanian Enterprises, Inc.—Annual Report references Code of Ethics; Code of Ethics (applying to directors, officers and associates) is available on Web site.
29. ITT Industries—Annual Report references the Code of Ethics titled "Code of Corporate Conduct" and states that it applies to the chief executive officer and all financial officers; Code of Corporate Conduct available on Web site.
30. Perry Ellis International Inc.—Code of Ethics applying to all directors, officers, and employees referenced in 10-K.
31. Rayonier Inc.—Standards of Ethics and Code of Corporate Conduct are referenced in 10-K; Standards of Ethics and Code of Corporate Conduct are available on Web site.
32. SEI Investments Company—Annual Report references Code of Ethics for senior financial officers; Code of Ethics for senior financial officers available on Web site.
33. Schlumberger Limited—Code of Ethics referenced in 10-K; Code of Ethics for all officers, directors, and employees available on Web site.
34. Taubman Centers, Inc.—Annual Report references Code of Business Conduct and Ethics; Code of Business Conduct and Ethics available on Web site.
35. Toyota Motor Corporation—Toyota noted that it is exempt from Sarbanes-Oxley. It has independently chosen to adopt a Code of Ethics applying to all officers, in addition to their Code of Conduct and the company's Guiding Principles. The Code of Ethics is available by viewing Toyota's 20-F (foreign company equivalent of a 10-K).
36. Valmont Industries Inc.—Annual Report references a Code of Ethics applicable to the chief executive officer, chief financial officer, and controller; Code of Ethics for senior officers available on Web site.
37. Vishay Intertechnology, Inc.—Code of Business Conduct and Ethics and Code of Ethics applicable to chief executive officer and chief financial officer referenced in 10-K; Code of Ethics applicable to senior financial officers available on Web site.
38. Westar Energy, Inc.—no reference to Code of Ethics in Annual Report or in 10-K; Code of Business Conduct and Ethics available on Web site.
39. Winnebago Industries, Inc.—Code of Ethics for chief executive officer and other financial officers is referenced in 10-K; Code of Ethics for senior financial officers available on Web site.

APPENDIX G

36 Codes of Ethics or Conduct, 2004–05

Code Content	%
Accuracy and Retention of Business Records	100
Applicable to CEO, CFO, Financial Officers	100
Code Enforcement	92
Confidential Information	83
Conflict of Interest	83
Penalties for Noncompliance—Disciplinary up to Termination	81
Company Property	78
Family Members and Close Personal Relationships	78
Whistle-Blowers	75
Inside Information	69
Compliance with Laws	67
Privacy	58
Ownership in Other Businesses	58
Gifts, Gratuities, and Entertainment	58
Corporate Activities	50
Fair Dealing	44
Fraud and Theft	43
Penalties for Noncompliance—Civil and Criminal Liability	42
Payments and Gifts to Third Parties	39
Intellectual Property	37
Political Contributions and Activities	36
Outside Employment, Affiliations, or Activities	36
Acknowledgment Signature	31
Relationships with Suppliers or Service Providers	28
Antitrust and Unfair Competition	25
Responding to Government and Other Inquiries	25
Relationships with Government Agencies and Outside Organizations	22
Introductory Letter from CEO	22
Personal Involvement and the Political Action Committees	22
Selling to Government Institutions	19
Consultants and Agents	17
Computer Resources and Computer Security	14
Government Procurement	6

APPENDIX H

Title II - Auditor Independence

Section 203. Audit Partner Rotation

Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1) as amended by this Act, is amended by adding at the end of the following:

(j) Audit Partner Rotation - It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.

Section 207. Study of Mandatory Rotation of Registered Public Accounting Firms

(a) Study and Review Required - The Comptroller General of the United States shall conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms.
(b) Report Required - Not later than 1 year after the date of enactment of this Act, the Comptroller General shall submit a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the results of the study and review required by this section.
(c) Definitions - For purposes of this section, the term "mandatory rotation" refers to the imposition of a limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer.

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