Powered by More Than GAAS: Section 10A of the Private Securities Litigation Reform Act Takes the Accounting Profession for a New Ride

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NOTE

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SECTION 10A OF THE PRIVATE SECURITIES
LITIGATION REFORM ACT TAKES THE
ACCOUNTING PROFESSION FOR A NEW RIDE

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I. INTRODUCTION

Congress, in overriding a presidential veto,1 enacted the Private Securities Litigation Reform Act of 19952 ("Reform Act") which represented a comprehensive revision of the federal securities laws governing private securities litigation. The Reform Act was designed to restructure the private securities litigation system by balancing two competing interests: deterring and remedying securities fraud and "assuring that the litigation process is not used for abusive purposes and does not unfairly target defendants who are guilty of no wrongdoing."3

1. See 141 CONG. REC. H15214 (daily ed. Dec. 20, 1995) (President Clinton's veto message). Although the Reform Act received overwhelming support in the House vote to override the presidential veto (319-100), see id. at H15223, the Senate narrowly met the necessary two-thirds vote to override the veto (68-30), see id. at S19180 (daily ed. Dec. 22, 1995).
The Reform Act drew strong support from the American Institute of Certified Public Accountants ("AICPA") and was seen as a victory for the Certified Public Accountant ("CPA") responsible for auditing the financial statements of a public company. This support reflected years of harsh treatment experienced by "deep-pocket" defendants in private securities litigation. For the independent auditor, one such "deep-pocket" defendant, this resulted in a legislative compromise, exchanging proportionate liability for a statutory obligation to act as a "whistleblower" and report illegal acts committed by the company to the Securities and Exchange Commission ("SEC"). The accountant's victory, therefore, has come with a substantial price, as the auditor will be required to expend additional time and resources in identifying, evaluating, and reporting illegal acts. Such a policing role is likely to have a chilling effect on the relationship between auditors and their publicly held clients.

Congressional scrutiny of the auditing profession has existed, in some form, for the past twenty years. In fact, efforts in the area of private securities litigation initially focused on the independent auditor and the revision of accounting and auditing requirements relating to the detection and disclosure of financial irregularities in publicly held companies. This scrutiny was precipitated by a series of large-scale business failures and disclosures of management fraud that occurred shortly after independent auditors had issued unqualified audit opinions.

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6. The terms "accountant" and "auditor" are used interchangeably throughout this Note.
7. See Edward Brodsky, The Auditor's New Duty to Blow the Whistle on Its Client, N.Y. L.J., June 12, 1996, at 3 ("One of the main attractions in the [Reform] Act for accountants . . . was Congress's substitution of a proportionate liability standard for the previous joint and several liability that auditors . . . faced in securities litigation.").
9. The auditor may issue one of four types of opinions at the conclusion of an audit. These include (1) an unqualified opinion ("standard" or "clean audit" opinion); (2) a qualified opinion; (3) an adverse opinion; or (4) a disclaimer of opinion. See CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 58, § 508 (American Inst. of
on the reliability of the company's financial statements.\textsuperscript{10} Indeed, the impetus underlying much of Congress's scrutiny resulted from the massive federal bailout of the savings and loan ("S&L") industry that occurred in the 1980s.\textsuperscript{11} During these hearings, both the legislature and the public attributed these business failures, in part, to deficiencies in the audit process. The criticism was aimed at the independent auditors who should have detected and prevented fraudulent financial reporting by their clients' management or, alternatively, should have recognized and warned against the existence of certain risk factors predictive of a company's ultimate failure.\textsuperscript{12}

Prior to the passage of section 10A of the Reform Act, Congress left the accounting profession with the responsibility of promulgating auditing standards. However, on the heels of both the massive federal bailout of S&L institutions and the resulting financial burden placed on the taxpayers, Congress quickly lost patience with the accounting profession. In particular, Congress believed that better detection of corporate fraud and earlier notification by the auditor to the SEC would have significant-

\begin{footnotes}
\item[12] See 141 CONG. REC. H14049 (daily ed. Dec. 6, 1995) ("I am of the view . . . that had [these audit requirements] been in effect in America, Charles Keating could have been stopped in his tracks cold. Because in the Keating case, the auditors had the goods. And instead of reporting the fraud, they simply shrunk away.") (statement of then Rep. Wyden)); 141 CONG. REC. H2846-47 (daily ed. March 8, 1995) (statement of Rep. Wyden); see also Joseph I. Goldstein & Catherine Dixon, New Teeth for the Public's Watchdog: The Expanded Role of the Independent Accountant in Detecting, Preventing, and Reporting Financial Fraud, 44 BUS. LAW. 439, 441 (1989).
\end{footnotes}
ly reduced the losses absorbed by both the federal government and the taxpayer.13

The immediate by-product of section 10A is the auditor’s assumption of a role analogous to that of a detective, charged with the responsibility to “ferret out fraud”14 and other illegal acts. Moreover, the auditor has a concomitant duty to report to the SEC those instances of management fraud that have a material effect on the company’s financial statements.

Although the accounting profession currently has standards that address the auditor’s responsibility with respect to fraud and illegal acts,15 the auditor is not trained to function as a “fraud detective.” Consequently, section 10A misses the mark in that the auditor has minimal experience with this new requirement and it provides the auditor with little, if any, guidance in carrying out these enhanced audit responsibilities. This will force the auditor to expend additional resources in satisfying the requirements of section 10A, resulting in a reduction in audit procedures performed in other areas or a significant increase in audit fees. However, given the client’s anticipated reluctance to absorb this additional expense and the narrow timeframe already faced by the auditor in issuing the audit opinion, section 10A will likely have a negative impact on the overall quality of audits and create tension in the auditor-client relationship.

Part II of this Note analyzes the statutory text of section 10A and identifies certain issues with respect to the enhanced audit procedures and reporting requirements that now confront the auditor. Part III examines the role of the independent accountant in the audit of an issuer’s financial statements, as defined in the accountant’s professional literature and as perceived by both Congress and the public. Part IV sets forth the auditor’s existing responsibilities with respect to illegal acts, related parties, and a going concern evaluation. Part V provides an historical

13. See Auditor Responsibility Hearing, supra note 8, at 1-6. The estimates for the ultimate cost of the S&L bailout have ranged from $500 billion to $700 billion. See, e.g., Reuters, Cost of S&L Bailout May Reach $600 Billion, CHRISTIAN SCIENCE MONITOR, Oct. 1, 1990, at 9.

The Government Accounting Office, in a 1989 study of 11 failed S&Ls, found that in more than half of those cases, “CPA’s did not adequately audit and/or report the S&Ls’ financial or internal control problems in accordance with professional standards.” U.S. GEN. ACCOUNTING OFFICE, CPA AUDIT QUALITY: FAILURES OF CPA AUDITS TO IDENTIFY AND REPORT SIGNIFICANT SAVINGS AND LOANS PROBLEMS I (1989). The report further found that before these 11 S&Ls failed, their most recent audit reports showed a positive net worth of $44 million; yet, less than 18 months later when these institutions failed, they had a combined negative net worth of $1.5 billion. See id.

14. Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 454 (7th Cir. 1982).

15. See infra Part IV.
overview of the Reform Act from its inception with respect to audit and reporting requirements. Part VI assesses the implications of section 10A of the Reform Act on both the audit engagement and the users of audited financial statements. Part VII addresses recent efforts undertaken by the accounting profession to enhance its ability to detect fraud during an audit. Part VIII concludes with a discussion of whether section 10A of the Reform Act will meet its prescribed objectives, namely, more accurate financial reporting and more timely reporting of management fraud and illegal acts to the SEC.

II. AN ANALYSIS OF THE STATUTORY PROVISIONS OF SECTION 10A

The Reform Act's statutory audit requirements were codified by adding section 10A to the Securities Exchange Act of 1934 ("Securities Exchange Act"). The Reform Act divides the auditor's responsibilities

§ 78j-1. Audit Requirements
(a) In general
Each audit required pursuant to this chapter of the financial statements of an issuer by an independent public accountant shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—
(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;
(2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and
(3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.
(b) Required response to audit discoveries
(1) Investigation and report to management
If, in the course of conducting an audit pursuant to this chapter to which subsection (a) of this section applies, the independent public accountant detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the accountant shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—
(A)(i) determine whether it is likely that an illegal act has occurred; and
(ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and
(B) as soon as practicable, inform the appropriate level of management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such accountant in the course of the audit, unless the illegal act is
(2) Response to failure to take remedial action

If, after determining that the audit committee of the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the accountant in the course of the audit of such accountant, the independent public accountant concludes that—

(A) the illegal act has a material effect on the financial statements of the issuer;

(B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

(C) the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement;

the independent public accountant shall, as soon as practicable, directly report its conclusions to the board of directors.

(3) Notice to Commission; response to failure to notify

An issuer whose board of directors receives a report under paragraph (2) shall inform the Commission by notice not later than 1 business day after the receipt of such report and shall furnish the independent public accountant making such report with a copy of the notice furnished to the Commission. If the independent public accountant fails to receive a copy of the notice before the expiration of the required 1-business-day period, the independent accountant shall—

(A) resign from the engagement; or

(B) furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice.

(4) Report after resignation

If an independent public accountant resigns from an engagement under paragraph (3)(A), the accountant shall, not later than 1 business day following the failure by the issuer to notify the Commission under paragraph (3), furnish to the Commission a copy of the accountant's report (or the documentation of any oral report given).

(c) Auditor liability limitation

No independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b) of this section, including any rule promulgated pursuant thereto.

(d) Civil penalties in cease-and-desist proceedings

If the Commission finds, after notice and opportunity for hearing in a proceeding instituted pursuant to section 78u-3 of this title, that an independent public accountant has willfully violated paragraph (3) or (4) of subsection (b) of this section, the Commission may, in addition to entering an order under section 78u-3 of this title, impose a civil penalty against the independent public accountant and any other person that the Commission finds was a cause of such violation. The determination to impose a civil penalty and the amount of the penalty shall be governed by the standards set forth in section 78u-2 of this title.

(c) Preservation of existing authority

Except as provided in subsection (d) of this section, nothing in this section shall
into two main categories: procedures for conducting the audit and required responses to audit discoveries. With respect to the former, audits of an issuer’s financial statements by an independent public accountant must include

1. procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;
2. procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure [in the financial statements]; and
3. an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.17

Auditors of public companies are already required to perform such procedures under generally accepted auditing standards.18 Given the history of business failures and investor losses accompanied by unqualified or “clean” audit opinions, courts are likely to severely scrutinize the auditor’s responsibilities where such losses were attributable to management fraud.

While section 10A codifies much of what was already required in the professional literature,19 its effect may nonetheless prove to be quite significant in future litigation affecting the accountant. By creating certain statutory duties, it was the intention of Congress to force the auditor to take his role in the identification and reporting of fraud more seriously.20

be held to limit or otherwise affect the authority of the Commission under this chapter.
(f) “Illegal act” defined

As used in this section, the term “illegal act” means an act or omission that violates any law, or any rule or regulation having the force of law.

Id.

17. Id. § 78j-1(a)(1)-(3).
18. See Statement on Auditing Standards, supra note 9, No. 53, § 316; No. 54, § 317; No. 45, § 334; No. 59, § 341.
19. See Andrea R. Andrews & Gilbert Simonetti, Jr., Tort Reform Revolution, J. ACCT., Sept. 1996, at 53, 55; Phillips & Miller, supra note 3, at 1062; Andrew J. Pincus, The Reform Act: What CPAs Should Know, J. ACCT., Sept. 1996, at 55, 58. In legislation proposed before the enactment of section 10A of the Reform Act, Congress intended the auditor’s statutory duties to also include separate tests and a report on the company’s internal control structure (policies and procedures established to provide reasonable assurance that the financial statements are accurately and fairly presented). See infra Part V.
Although section 10A directs auditors to discharge these responsibilities in accordance with generally accepted auditing standards ("GAAS"), it specifically authorizes that such standards "may be modified or supplemented from time to time by the [SEC]." While the House Conference Report indicates that the SEC should not exercise this authority "until after it has determined that the private sector is unable or unwilling to do so on a timely basis," the express congressional authority to supplement auditing standards may enhance the SEC's influence over the development of those standards by the accounting profession.

The Reform Act also alters the relationship between public companies and their auditors by requiring the latter to take specific action if they learn during an audit that a client may have committed an illegal act. In such cases, and regardless of the perceived impact or materialities and Finance).

Similar statutory action was recently taken when President Clinton signed a law that would codify accounting standards set by the Federal Accounting Standards Advisory Board. See Clinton Signs New Federal Agency Audit Bill, J. ACCT., Dec. 1996, at 13, 13 (noting that the Federal Financial Management Improvement Act of 1996 was passed in order to assure that all federal agencies implement and maintain financial management systems that comply with uniform federal accounting standards). This Act is intended to assist Congress in evaluating federal programs and agencies which are the financial responsibility of the federal government. See id.

21. See infra notes 61-63 and accompanying text.
23. H.R. CONF. REP. NO. 104-369, at 48 (1995). While never expressly stated, the SEC has long believed that it already had the authority to modify or promulgate auditing standards. See Financial Fraud Detection Hearing, supra note 20, at 74-75 (testimony of Richard C. Breeden, Chairman, SEC). This is consistent with the broad powers given to the SEC under the various federal laws. See VINCENT M. O'REILLY ET AL., MONTGOMERY'S AUDITING 35-36 (11th ed. 1990). As a general rule, the accounting profession has maintained that the SEC does not prescribe the audit procedures employed by independent public accountants in their audit of a company's financial statements. The SEC has traditionally relied on the public accounting profession to establish such auditing standards. See RONALD J. MURRAY ET AL., THE COOPERS & LYBRAND SEC MANUAL 23 (6th ed. 1993). The SEC's official position in this area has generally remained unchanged since 1940. See id. (noting that, in accordance with SEC Accounting Series Release 19, "[u]ntil experience should prove the contrary, we feel that [auditing standards promulgated by the accounting profession are] preferable"); see also Goldstein & Dixon, supra note 12, at 441 n.7. But see Auditor Responsibility Hearing, supra note 8, at 22 ("The [SEC] also has a significant statutory role to play in the process of setting auditing standards and in establishing reporting requirements which we believe should be pursued more actively." (statement of the Hon. Charles A. Bowsher, Comptroller General of the United States) (emphasis added)).
24. See infra Part VI.
25. Section 10A(f) of the Reform Act defines the term illegal act as "an act or omission that violates any law, or any rule or regulation having the force of law." 15 U.S.C. § 78j-1(f) (emphasis added). Illegal acts are specifically defined by the auditing standards as "violations of laws or governmental regulations" by the client on behalf of the entity and related to its business activities.
ty of the illegal act on the client’s financial statements, the auditor must

(i) determine whether it is likely that an illegal act has occurred; and
(ii) if so, determine and consider the possible effect of the illegal act
on the financial statements of the issuer, including any contingent
monetary effects, such as fines, penalties, and damages; and
(iii) as soon as practicable, inform the appropriate level of the
management of the issuer and assure that the audit committee of the
issuer, or the board of directors of the issuer in the absence of such
a committee, is adequately informed with respect to illegal acts that
have been detected or have otherwise come to the attention of such
accountant in the course of the audit, unless the illegal act is clearly
inconsequential.

At this point, management has the opportunity to take remedial action
without further reporting to the board of directors or to the SEC.

If the audit committee of the board of directors fails to take
appropriate action upon learning of illegal acts that are judged by the
auditor to have a material effect on the financial statements, the
Reform Act requires the auditor to report this information. Conversely,
this requirement is not currently mandated or contemplated under GAAS.
If, however, (i) the illegal act has a material effect on the issuer’s
financial statements; (ii) senior management has failed to take timely and
appropriate remedial action with respect to the illegal act; and (iii) the
failure to take remedial action is reasonably expected to warrant
departure from the standard audit report or the auditor’s resignation
from the audit engagement, then the auditor must report his conclusions
directly to the board of directors.

Once the auditors report to the board of directors that remedial
action has not been taken either by the audit committee or client

Statement on Auditing Standards, supra note 9, No. 54, § 317.02. The statutory and accounting
profession’s definitions of illegal acts appear to be consistent.

26. The audit committee, distinct from the board of directors and client management, is
typically comprised of outside directors and is responsible for retaining the auditor and maintaining
a continual communication with the auditor regarding financial, operational, and compliance-related
issues that arise during the audit engagement. Such a communication is required under the auditing
standards. See Statement on Auditing Standards, supra note 9, No. 61, § 380; see also O’REILLY ET


28. While the Reform Act fails to specifically define this term, it is logical to assume that the
definition supplied in the accountant’s professional literature should be applied. See infra note 43.


30. See supra note 9 for a brief discussion of the elements of a standard audit report.

management, the company must inform the SEC within one business day, providing the auditor with a copy of such notice to the SEC. To encourage such early disclosure, the Reform Act specifically precludes any private action against the auditor for any finding, conclusion, or statement expressed in his report to the board of directors or the SEC. In order to enforce the auditor’s reporting duty, the SEC is authorized to impose civil penalties against an auditor who willfully violates these reporting obligations. It is unlikely, however, that a shareholder will be able to maintain a private cause of action against the auditor in a case where the requisite notification to the SEC is not made.

As noted, the Reform Act’s audit requirements represent, in large part, a statutory codification of existing auditing standards. The most significant impact of the Reform Act lies in the effect it has on the auditor’s duty to report illegal acts to the board of directors and the SEC. The new audit detection and disclosure provisions appear to make the independent auditor “adjuncts of the SEC’s Enforcement Divi-

32. See id. § 78j-1(b)(3).
33. See id. § 78j-1(b)(3)(A)-(B).
34. See id. § 78j-1(b)(4).
35. See id.
36. See id. § 78j-1(c).
38. Section 203 of the Reform Act specifically provides that “[n]othing in [the Reform Act] ... shall be deemed to create or ratify any implied private right of action.” Private Securities Litigation Reform Act § 203, 15 U.S.C. § 78j-1 Historical and Statutory Notes.
39. These enhanced reporting requirements were motivated by Congress’s strong belief that a substantial amount of the losses borne by the federal government in the S&L bailouts could have been prevented by earlier disclosure of such problems by the independent auditor to the SEC. See Auditor Responsibility Hearing, supra note 8, at 3-5.
sion," creating serious implications on the structure of the audit and the existing auditor-client relationship.41

III. THE ROLE OF THE CPA IN THE AUDIT OF A COMPANY’S FINANCIAL STATEMENTS

As a CPA and former securities auditor at a “Big Six” accounting firm,42 this Author recalls the difficulty encountered when attempting to explain the role of the CPA in the audit of a company’s financial statements. While many confuse this role with that of an auditor for the Internal Revenue Service (“IRS”), an equal number are confused over the purpose and scope of the audit. Specifically, there are conflicting views as to whether an accountant owes ultimate allegiance to the public or to his client’s management, as well as whether an audit can reasonably be expected to assure the public that the financial statements are accurate.43

While the limitations of an audit are well-known to auditors, this is not necessarily the case for the users44 of audited financial information. Often, the public operates under the mistaken assumption that the auditor

40. Phillips & Miller, supra note 3, at 1062.
41. See infra Part VI.
42. This phrase refers to the six largest accounting firms in the world and includes Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse. This may change, however, to the “Big Five” as Coopers & Lybrand and Price Waterhouse agreed to merge their worldwide practices, thus creating the world’s largest accounting firm. See Reed Abelson, Two of the Big Six in Accounting Plan to Form New No. 1, N.Y. TIMES, Sept. 19, 1997, at A1.
43. See H.R. REP. NO. 102-890, at 7 (1992). As evidence of this confusion, the accountants’ professional literature specifically caution against such accuracy. See O’REILLY ET AL., supra note 23, at 17 (“No audit provides complete assurance that the financial statements are free from material misstatement.”); see also Goldstein & Dixon, supra note 12, at 441 (noting that an audit is not designed to guarantee the reliability of corporate financial statements).

In the scope paragraph of the standard or unqualified audit opinion, it explicitly required that the auditor “plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement” and in the opinion paragraph that the financial statements are “present[ed] fairly, in all material respects . . . in conformity with generally accepted accounting principles.” Statement on Auditing Standards, supra note 9, No. 58, § 508.08(h) (emphasis added). This language is intended to indicate that the financial information presented by management and opined by the auditor is accurate within a range of acceptable limits. See id. No. 69, § 411.04.

The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for the fair presentation of the financial statements in accordance with generally accepted accounting principles. See id. No. 47, § 312.03.

44. This generally includes potential investors, lending institutions such as banks and insurance companies, regulatory agencies such as the SEC and New York Stock Exchange, and the management of the company.
is responsible for identifying and disclosing all instances of fraudulent financial reporting and illegal activities. This perception is magnified in cases where there is a business failure and both investors and creditors suffer substantial losses. The Supreme Court, however, has provided its own interpretation and definitively held that an independent auditor’s ultimate allegiance belongs to the public. In United States v. Arthur Young & Co., Chief Justice Burger described the auditor’s role as that of a “public watchdog”:

By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public. This “public watchdog” function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

This role of “public watchdog” has resulted in an exceptionally high standard for the independent auditor to meet, thus creating a role akin to that of a policeman. Often, this has led to an adversarial relationship between the auditor and client management and has impaired the auditor’s ability to learn of and report a company’s transactions to the public. In order to apply the Supreme Court’s interpretation of the auditor’s role, it is important to first understand the purpose of the audit of a company’s financial statements and the tools used by the auditor in carrying out his responsibilities.

In general, an audit involves an objective verification of the financial statements of an entity by obtaining and evaluating the

45. This misconception is commonly referred to as the “expectation gap.” For a general discussion of this topic, see O’Reilly et al., supra note 23, at 19. In 1988, the Auditing Standards Board of the AICPA issued nine new auditing standards in an effort to narrow the expectation gap and raise auditor performance and reporting standards. See id. at 20 (referring to Statement on Auditing Standards Nos. 52-61); see also Goldstein & Dixon, supra note 12, at 442 (“Public expectations of the independent auditor’s performance nevertheless appear to exceed the scope of those duties prescribed by law and professional standards governing the auditing function.”).

46. See supra note 11 and accompanying text.


48. Id. at 817-18.

49. Although this Note addresses the financial statement audit, see supra note 4, it is also common for the auditor to perform compliance (adherence to prescribed laws and regulations) and operational (adherence to the entity’s internal policies and procedures as well as recommendations for improving the current systems) audits. For a discussion of the various types of audits, see Donald H. Taylor & William Glezen, Auditing: Integrated Concepts and Procedures 4-5
underlying accounting records and other supporting evidence.\textsuperscript{50} The accounting profession, however, sets limitations on the objective of the audit.\textsuperscript{51} Given this formalistic definition and the use of ambiguous terminology such as "fairness" and "in all material respects,"\textsuperscript{52} it is easy to understand the frustration of both Congress and the investor in light of recent business failures.\textsuperscript{53}

The auditor plays an integral role in providing the capital markets with some form of assurance that business enterprises accurately and fairly report information that the investor perceives as credible.\textsuperscript{54} Without such investor confidence, the markets would suffer, the cost of capital formation would increase significantly, and the value of the auditor would diminish. It is vital, therefore, that the expectation gap that currently exists be narrowed. Equally important is that the public obtain a greater understanding of the scope and limitations of the audit. This problem is magnified in cases where accounting firms are forced to settle claims rather than engage in the difficult task of explaining the responsibilities of an auditor to a jury.\textsuperscript{55} A greater understanding begins with an examination of generally accepted accounting principles ("GAAP"), GAAS, and interpretations on GAAS, collectively termed Statements on Auditing Standards.\textsuperscript{56}


\textsuperscript{51} "The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which [the financial statements] present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles." Statement on Auditing Standards, supra note 9, No. 1, ¶ 110.01.

\textsuperscript{52} Id. No. 58, ¶ 508.08.

\textsuperscript{53} An important distinction to be made, and which is too often overlooked, is that the financial statements are the responsibility of the company and prepared by the company's management. See id. No. 1, ¶ 110.02. The auditor's responsibility, however, is confined to the expression of an opinion on such financial statements. See id. For a general discussion of these various opinions, see supra note 9.

\textsuperscript{54} See Auditor Responsibility Hearing, supra note 8, at 99 (statement of Donald L. Neebes, Chairman of the Auditing Standards Board of the AICPA).

\textsuperscript{55} See Securities Litigation Reform: Hearings Before the Subcomm. on Telecomms. and Fin. of the House Comm. on Energy and Commerce, 103d Cong. 191 (1994) [hereinafter Securities Litigation Reform Hearings] ("It is virtually impossible for [auditors] to explain our responsibilities effectively to a jury of our peers." (statement of J. Michael Cook, Chairman and Chief Executive Officer, Deloitte & Touche)).

\textsuperscript{56} The phrase "generally accepted" connotates the uniform acceptance and use of established accounting and auditing standards by all members of the accounting profession during all audit engagements.
GAAP constitutes the convention, rules, and procedures necessary to define accepted accounting practice at a particular time.57 The use of GAAP in the preparation of financial statements provides a standard by which financial presentations can be measured.58 In effect, it ensures that all financial statements are prepared under the same “rules,” thus allowing investors to make informed decisions based on comparable information. Although the SEC has the authority to promulgate GAAP, it has traditionally been the responsibility of the accounting profession,59 carried out under the authority of the AICPA’s Financial Accounting Standards Board.60

GAAS61 constitutes the minimum measures of the quality of the auditor’s performance.62 In general terms, these standards represent a measure of performance and quality set by a profession in recognition of the public’s interest and reliance on the professional’s work. GAAS broadly defines the nature and extent of the auditor’s responsibilities and provides guidance to the auditor in carrying out his duties. The responsibility for the promulgation of such auditing standards rests with the AICPA’s Auditing Standards Board, with general oversight performed by the SEC.63

While GAAS establishes specific standards to guide professional conduct, it is not to be considered a substitute for the auditor’s exercise of his own professional judgment. Clearly, GAAS cannot be expected to encompass all of the possible situations which naturally arise given today’s complex business transactions. It is therefore intended to provide a floor, below which the auditor should not perform, and to assist the auditor when making judgments regarding the audit.64

57. See Statement on Auditing Standards, supra note 9, No. 69, § 411.02.
58. See id.
59. See infra note 236.
60. See O’REILLY ET AL., supra note 23, at 20.
61. GAAS represents the ten broad auditing standards adopted by the AICPA in 1948. Interpretations of these original ten standards are set out in the Statements on Auditing Standards. See id. at 34-35. Throughout this Note, however, GAAS will refer collectively to GAAS and its interpretations, namely, the Statements on Auditing Standards.
62. See id. at 44-45.
63. See id. at 34-35.
64. See id. at 45.
IV. THE AUDITOR’S GENERAL RESPONSIBILITIES CONCERNING ILLEGAL ACTS, RELATED PARTIES, AND A GOING CONCERN EVALUATION

A. Illegal Acts

The auditor’s responsibilities with respect to illegal acts contribute more to the expectation gap than any other auditing standard. Specifically, the auditor has an affirmative duty to design the audit to provide reasonable assurance of detecting those illegal acts that have a direct and material effect on the company’s financial statements. This process begins with the auditor’s preliminary assessment of the risk that such illegal acts exist and whether these acts will cause a material misstatement. Although characteristics indicating the likelihood of such

65. The term "illegal act" is defined in the auditing standards as "violations of laws or governmental regulations." Statement on Auditing Standards, supra note 9, No. 54, § 317.02. For a comparison of this definition to that supplied under the Reform Act, see supra note 25.

Currently, the professional literature addresses the auditor’s responsibilities for errors and irregularities together. See Statement on Auditing Standards, supra note 9, No. 53, § 316. While errors are unintentional misstatements, irregularities are defined as intentional misstatements and generally include management fraud, e.g., fraudulent financial reporting, and theft or misappropriation of the company’s assets. See id. §§ 316.02–03. The auditor’s responsibility with respect to illegal acts is addressed separately. See id. No. 54, § 317. For a detailed analysis of the auditor’s duty with respect to illegal acts, see Donald L. Neebe et al., Illegal Acts: What Are the Auditor’s Responsibilities?, J. ACCT., Jan. 1991, at 82, 82-93.

66. See Auditor Responsibility Hearing, supra note 8, at 108 (noting that Statement on Auditing Standards Nos. 53 and 54 “taken together represent the heart of the profession’s efforts to close the expectation gap between auditor performance and the public’s expectations” (statement of Donald L. Neebe, Chairman, Auditing Standards Board of the AICPA)).

67. See Statement on Auditing Standards, supra note 9, No. 54, § 317.05. The auditor’s responsibilities with respect to illegal acts are generally the same as that for errors and irregularities. See id.; see also id. No. 53, §§ 316.01–34. For a general discussion on the relationship between illegal acts and errors and irregularities under the professional literature, see O’REILLY ET AL., supra note 23, at 20. Because the standards apply to errors and irregularities, and illegal acts are closely related, they will be addressed together for the purposes of this discussion.

68. See Statement on Auditing Standards, supra note 9, No. 54, § 317.07; see also id. No. 53, § 316.10.

69. These are segmented into three principal areas: (i) management characteristics, (ii) operating and industry characteristics, and (iii) engagement characteristics. See id. No. 53, § 316.10. Management characteristics focus on the degree and manner of management review and whether there is an undue emphasis on meeting earnings projections. Operating and industry characteristics focus on the company’s profitability compared to other businesses within the same industry, recent economic trends within the company and the general industry, and whether matters exist that raise doubt about the company’s ability to continue as a going concern. See id. Engagement characteristics focus on the existence of serious accounting disagreements, difficulties in auditing specific balances or transactions, and significant related party transactions. See id.; see
misstatements and possible illegal acts\textsuperscript{70} are detailed in the professional literature, this listing is not all-inclusive and offers no guarantee that an audit performed in accordance with GAAS will in fact detect such illegal acts.\textsuperscript{71}

When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the act, the surrounding circumstances in which it occurred, and any other information necessary to evaluate its potential effect on the financial statements.\textsuperscript{72} This evaluation involves considerations of both the qualitative and quantitative effects on materiality, including contingent monetary effects such as fines, penalties, and damages.\textsuperscript{73} The evaluation also seeks to determine whether the financial statements contain the appropriate disclosures.\textsuperscript{74} The auditor is required to assure himself that the audit committee, or others of equivalent authority, is adequately informed with respect to such illegal acts.\textsuperscript{75}

The auditor's final, and perhaps most significant, responsibility involves how the auditor is to deal with those illegal acts that are discovered. If the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified or adverse opinion.\textsuperscript{76} This will result in notification to the SEC after the audited financial statements are filed. If the client refuses to accept the auditor's qualified or adverse opinion, the auditor is required to take the extreme step of withdrawing from the audit engagement.\textsuperscript{77} It is likely,

\textit{also supra} note 18.

\textsuperscript{70} These generally include unauthorized or improperly recorded transactions, investigations by governmental or regulatory agencies, excessive or unexplained payments for services or goods, failure to file tax returns, and unexplained banking transactions. \textit{See} Statement on Auditing Standards, \textit{supra} note 9, No. 54, § 317.09.

\textsuperscript{71} \textit{See id.} § 317.07.

\textsuperscript{72} \textit{See id.} This would include all possible illegal acts, whether first perceived to be material or not. \textit{See id.; see also} Auditor Responsibility Hearing, \textit{supra} note 8, at 112.

\textsuperscript{73} \textit{See} Statement on Auditing Standards, \textit{supra} note 9, No. 54, §§ 317.13-.14.

\textsuperscript{74} \textit{See id.} § 317.15.

\textsuperscript{75} \textit{See id.} § 317.17.

\textsuperscript{76} \textit{See id.} § 317.18.

\textsuperscript{77} \textit{See id.} § 317.20. Such a withdrawal would result in the company notifying the SEC under the SEC's Form 8-K reporting process, which mandates that the company notify the SEC of any change in its auditors and indicate the reasons for such change. \textit{See} MURRAY ET AL., \textit{supra} note 23, at 286. The AICPA's SEC Practice Section requires the auditor to notify a client that is an SEC registrant in writing within five business days of the end of its relationship. A copy of this notification is also required to be sent to the SEC. \textit{See id.} at 926. For a discussion of congressional concerns with regard to this reporting process, see \textit{infra} note 131.
however, that the auditor’s responsibilities with respect to illegal acts will be enhanced under section 10A of the Reform Act.\(^\text{78}\)

### B. Related Parties

The auditor is required to plan the audit in order to obtain reasonable assurance that all material related party\(^\text{79}\) transactions are appropriately accounted for and disclosed.\(^\text{80}\) In general, the risk associated with such transactions is that they may not have been executed at “arm’s-length”\(^\text{81}\) and therefore, the substance of the transaction may not be accurately reflected in the company’s financial statements.\(^\text{82}\) In essence, such transactions are more likely to be misstated because one of the parties may have exerted influence over the other based on the close nature of their relationship.\(^\text{83}\) While an audit performed in accordance

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78. See infra Part VLF and accompanying notes.
79. The accounting literature defines “related parties” as
   [a]ffiliates of the enterprise; entities for which investments are accounted for by the
   equity method by the enterprise; trusts for the benefit of employees, such as pension
   and profit-sharing trusts that are managed by or under the trusteeship of management;
   principal owners of the enterprise; its management; members of the immediate families
   of principal owners of the enterprise and its management; and other parties with
   which the enterprise may deal if one party controls or can significantly influence the
   management or operating policies of the other to an extent that one of the transacting
   parties might be prevented from fully pursuing its own separate interests. Another party
   is also a related party if it can significantly influence the management or operating
   policies of the transacting parties or if it has an ownership interest in one of the
   transacting parties and can significantly influence the other to an extent that one or more
   of the transacting parties may be prevented from fully pursuing its own separate interests.
   RELATED PARTY DISCLOSURES, Statement of Financial Accounting Standards No. 57, § 24f
   (Financial Accounting Standards Bd. 1982) [hereinafter RELATED PARTY DISCLOSURES].
80. See Statement on Auditing Standards, supra note 9, No. 45, § 334.04.
81. Transactions which may be indicative of the existence of related parties generally include
   (i) “[b]orrowing or lending on an interest-free basis or at a rate of interest significantly above or
   below market rates prevailing at the time of the transaction”; (ii) “[s]elling real estate at a price that
   differs significantly from its appraised [market] value”; (iii) “[e]xchanging property for similar
   property in a nongovernment transaction”; and (iv) “[m]aking loans with no scheduled terms for when
   or how the funds will be repaid.” Id. § 334.03.
82. The professional literature appears to offer differing presumptions about such transactions.
   As stated in the auditing standards, “[j]n the absence of evidence to the contrary, transactions with
   related parties should not be assumed to be outside the ordinary course of business.” Id. § 334.06
   (emphasis added). However, under the accounting standards, “transactions involving related parties
   cannot be presumed to be carried out on an arm’s-length basis, as the requisite conditions of
   competitive, free-market dealings may not exist.” RELATED PARTY DISCLOSURES, supra note 79, § 3.
   The auditor, however, is required to follow the former definition under GAAS and the latter
   definition under GAAP.
83. The existence of such a related party relationship was evidenced by the failure of Lincoln
   Savings & Loan, where Lincoln Savings was a wholly owned subsidiary of American Continental
with GAAS cannot necessarily detect all material related party transactions, the auditing literature provides some guidance by detailing those conditions which may give rise to such transactions.

If, as a result of performing specified auditing procedures, a related party transaction is discovered, the auditor must determine whether the transaction has a material effect on the financial statements and be satisfied that it has been adequately disclosed. This generally includes the nature of the relationship and a description and dollar amount of the transaction, as it effects both the income statement and balance sheet. If management fails to make such a disclosure, or the existing disclosure is judged to be inadequate or unsubstantiated, the auditor should express a qualified or adverse opinion because such failure constitutes a departure from GAAP. In such a case, the audit report would have to reflect the undisclosed material related party transaction.

C. Going Concern Evaluation

The auditor is required to make an evaluation about whether there is substantial doubt about a company’s ability to continue as a going

Corporation, which was controlled by Charles Keating. See Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong. 404 (1993) [hereinafter Private Litigation Hearings] (testimony of Melvyn I. Weiss, Partner, Milberg, Weiss, Bershad, Hynes & Lerach). Specifically, there was an alleged “bogus tax-sharing agreement between Lincoln and its parent, American Continental Corporation.” H.R. REP. NO. 102-890, at 9 (1992). Transactions between a parent and its subsidiaries are examples of such related party transactions. See RELATED PARTY DISCLOSURES, supra note 79, § 1; see also Statement on Auditing Standards, supra note 9, No. 45, § 334.07. For a general discussion of related parties, see O’REILLY, supra note 23, at 218-19.

84. See Statement on Auditing Standards, supra note 9, No. 45, § 334.04.
85. These include (i) a lack of working capital or credit, (ii) an overly favorable earnings forecast or projection, (iii) a general decline in the industry, (iv) significant litigation, and (v) dependence on a single or relatively few product lines. See id. § 334.06.
86. The literature provides a list of procedures to assist the auditor in identifying the existence of such transactions. See id. §§ 334.07-.08.
87. See id. §§ 334.09-.10.
88. See id. §§ 334.11-.12.
89. See RELATED PARTY DISCLOSURES, supra note 79, § 2.
90. See Statement on Auditing Standards, supra note 9, No. 45, § 334.12.
91. See id. No. 58, § 508.49.
concern for a reasonable period of time,\textsuperscript{93} not to exceed one year.\textsuperscript{94} Ordinarily, a company is considered a "going concern" when it is able to continue its business operations and meet its obligations in the ordinary course of business.\textsuperscript{95} If, however, the company is able to meet these obligations only by disposing of significant assets or by seeking a restructuring or forgiveness of its existing debt, doubts should be raised concerning the viability of the company.\textsuperscript{96} In general, continuation of an entity as a going concern is assumed in the financial statements in the absence of contrary information.\textsuperscript{97}

In planning the audit, the auditor is not required to design auditing procedures specifically directed at going concern issues.\textsuperscript{98} Rather, performance of those procedures related to the other audit objectives\textsuperscript{99} is usually sufficient in order to make such a determination. The professional literature, however, provides some guidance about conditions and events which may alert the auditor to potential going concern issues.\textsuperscript{100} If, in the aggregate, issues identified during the audit cause the auditor to believe that there is a substantial doubt of the company's viability, the auditor has an affirmative duty to consider management's plans for dealing with such adverse conditions and events.\textsuperscript{101} Those plans might include plans to dispose of certain assets or discontinue a line of business, new financing or a restructuring of existing debt, reducing or

\textsuperscript{93} The auditing standard and section 10A make a distinction with regard to the period of time covered by the auditor's evaluation. GAAS requires the evaluation to cover a "reasonable period of time, not to exceed one year." Statement on Auditing Standards, supra note 9, No. 59, § 341.02. The standard, however, does not offer guidance on what constitutes a "reasonable period of time." Section 10A, however, requires the evaluation to cover "the ensuing fiscal year." 15 U.S.C. § 78j-1(a)(3).

\textsuperscript{94} See Statement on Auditing Standards, supra note 9, No. 59, § 341.02.

\textsuperscript{95} For a general discussion of the going concern evaluation, see O'REILLY ET AL., supra note 23, at 649–52.

\textsuperscript{96} See id. at 649.

\textsuperscript{97} See Statement on Auditing Standards, supra note 9, No. 59, § 341.01.

\textsuperscript{98} See id. § 341.05; see also O'REILLY ET AL., supra note 23, at 650.

\textsuperscript{99} This typically includes analytical procedures, review of subsequent events, compliance with debt and loan covenants, reviewing the minutes of the board of directors, inquiry of a company's legal counsel about outstanding litigation, and third party confirmation concerning financing arrangements. See Statement on Auditing Standards, supra note 9, No. 59, § 341.05.

\textsuperscript{100} These include: (i) negative trends, e.g., recurring operating losses, negative cash flows, and adverse financial ratios; (ii) general financial difficulties, e.g., default on loan or debt covenants, a continued need for outside financing, disposition of substantial assets, and restructuring or forgiveness of the company's outstanding debt; (iii) internal problems, e.g., labor disputes or other work-related stoppages; and (iv) external matters, e.g., legal proceedings, loss of a significant customer, supplier or business line, and business shutdowns. See id. § 341.06.

\textsuperscript{101} See id. § 341.07.
delaying its expenditures, or increasing the equity in the company through new capital infusions or a reduction in its dividend payouts.\textsuperscript{102} When evaluating the feasibility of such plans, the auditor should perform additional procedures in order to obtain evidence to support those assumptions that are critical to management’s plans.\textsuperscript{103}

If, after considering management’s plans, the auditor still concludes that there is substantial doubt as to the company’s ability to continue as a going concern, the audit report should be modified\textsuperscript{104} to include an explanatory paragraph addressing this issue.\textsuperscript{105} A qualified or adverse opinion may, however, be appropriate if the auditor concludes that the disclosures are inadequate and constitute a material departure from GAAP.\textsuperscript{106}

Because much of Congress’s focus was directed at illegal acts and management fraud, and related parties and going concern considerations received little, if any, attention during the hearings,\textsuperscript{107} it is unlikely that the auditor’s responsibilities in this area will significantly change under section 10A of the Reform Act.

V. THE LEGISLATIVE HISTORY OF SECTION 10A

A. 99th and 100th Congress

In 1986, Congress introduced H.R. 4886,\textsuperscript{108} the Financial Fraud Detection and Disclosure Act of 1986, aimed at defining the auditor’s responsibilities in detecting and reporting financial fraud committed by its publicly held clients.\textsuperscript{105} Proposed in response to the massive S&L

\begin{footnotesize}
\begin{enumerate}
\item[102.] See id.
\item[103.] See id. §§ 341.08-.09.
\item[104.] In contrast to a qualified opinion, see supra note 9, such a modification is intended to inform the reader, rather than qualify the auditor’s opinion, see Statement on Auditing Standards, supra note 9, No. 58, § 508.11(d).
\item[105.] See id. No. 59, §§ 341.12-.13.
\item[106.] See id. § 341.14; see also id. No. 58, § 508.55.
\item[107.] See generally Auditor Responsibility Hearing, supra note 8; H.R. REP. NO. 102-890 (1992).
\item[108.] See H.R. 4886, 99th Cong. (1986).
\item[109.] See generally Corporate Audit Hearings, supra note 8. The hearings held by the Subcommittee on Oversight and Investigations in 1985-1986 represented a follow-up to hearings chaired in the late 1970s by Senator Lee Metcalf and Representative John Moss. The hearings followed the disclosure of financial problems at Penn Central Company and Lockheed Aircraft Corporation resulting in federal bailout programs, the massive fraud at Equity Funding Corporation, and other “widespread reports of corporate bribery and wrongdoing.” H.R. REP. NO. 102-890, at 7 n.11 (1992). The Metcalf subcommittee published a report in 1977 that made a series of recommendations designed to meet congressional and public expectations of the accounting
\end{enumerate}
\end{footnotesize}
insolvencies in the 1980s, the bill was designed to “require audits performed under the [f]ederal securities laws to include reasonable procedures for financial fraud detection, and to require that auditors report fraudulent activities to appropriate enforcement and regulatory authorities.” The significant provisions of the bill required the auditor to detect “any illegal or irregular activity” and evaluate and identify weaknesses in the company’s “internal accounting and administrative

profession. See Goldstein & Dixon, supra note 12, at 443. The report called for a strengthening of the basic audit function and the avoidance of activities that appeared to conflict with the public’s expectations. See Improving the Accountability of Publicly Owned Corporations and Their Auditors: Hearings Before the Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95th Cong. (1977) [hereinafter Metcalf Report]; Goldstein & Dixon, supra note 12, at 443-44. Although the Metcalf Report declined to introduce corrective legislation, opting to rely on the efforts of the accounting profession and SEC, the subcommittee outlined a number of recommendations. These included a self-regulatory organization to evaluate and improve the quality of work performed and the formation of independent audit committees designed to enhance corporate accountability and have full authority over the hiring and compensation of the auditors. See Metcalf Report; see also Goldstein & Dixon, supra note 12, at 444-45. Most notably, the Metcalf Report recommended that independent auditors be required to report illegal activities to corporate audit committees and appropriate government authorities, regardless of the materiality of such illegal acts on the financial statements being audited. See id.; see also Goldstein & Dixon, supra note 12, at 444. This recommendation represented the most substantial modification to the auditors’ existing responsibilities under the professional literature and was codified in the Reform Act. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 301(a), 109 Stat. 737, 762-64 (adding section 10A to the Securities Exchange Act of 1934).

During the Metcalf subcommittee hearings, Representative John Moss commenced an inquiry into the lack of public confidence in corporate accountability following the disclosure of illegal or improper payments made by public corporations and with the knowledge of the independent auditor. See Goldstein & Dixon, supra note 12, at 445. The Moss subcommittee published a report in 1976 providing that the “deficiencies” inherent in GAAS and the complex and multinational nature of corporations have made the SEC’s sole reliance on the private accounting profession insufficient to protect public investors and to assure compliance with the federal securities laws. See Report on Federal Regulation and Regulatory Reform: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 94th Cong. (1976). For a more complete discussion of congressional inquiry into independent auditors and corporate accountability, see Goldstein & Dixon, supra note 12, at 443-46.

110. H.R. 4886 Preamble. The sponsor of this legislation, Representative Wyden, stated that “this legislation is designed to provide assurances to Congress and the public that illegal and irregular activities . . . will be discovered and reported to the proper regulatory authorities by those in the best position to perform this vital function-independent auditors. All too often . . . independent auditors either have failed to detect or to report fraudulent activities . . . .

111. H.R. 4886, 4886, § 13A(b)(1) (emphasis added).

controls.” The audit requirements addressing illegal acts drew a great deal of adverse reaction from both the SEC and accounting profession due to the absence of any materiality standard with respect to the detection of such acts and the increased costs that would likely result from such a requirement. Although the provisions requiring the auditor to separately report on the client’s internal control structure were eventually omitted, the reaction was mixed when it was included as part of the discussion draft issued in 1990.

Recognizing the concerns expressed by Congress and the public in these hearings and legislation, the accounting profession conducted its own investigation aimed at improving the credibility and reliability of the existing financial reporting system. The Treadway Commission recognized that although the integrity of the financial statements was the responsibility of management, the independent auditor played a crucial role in the financial reporting process. The users of the financial statements expected the auditors to perform the audit competently and objectively and to search for and detect material misstatements in the

112. Id. § 13A(b)(2).
113. See Goldstein & Dixon, supra note 12, at 491-96.
114. The SEC indicated that such an audit requirement raised real concerns about the costs involved and careful consideration would have to be given to whether the expected benefits would justify these costs. See Auditor Responsibility Hearing, supra note 8, at 88-89 (Discussion Draft of July 30, 1990) (“Almost all of the commentators addressing this [audit requirement] issue opposed such direct auditor reporting, largely due to concerns about cost.” (statement of James R. Doty, General Counsel, SEC)).

The accounting profession indicated a far more favorable view on the benefits of such a requirement. See id. at 103 (“The profession . . . believes that auditor reporting on management’s assessment of its internal control structure related to financial reporting . . . would add significant benefit to the financial reporting process and, therefore, to investor protection.” (statement of Donald L. Nebes, Chairman, Auditing Standards Board of the AICPA)). The profession also noted that the benefits associated with such a reporting requirement would exceed the costs incurred. See id. at 104 (“[T]he need to strengthen investor confidence in the financial reporting system and the ancillary benefits associated with the effective functioning of a well-conceived and [well]-maintained internal control structure suggests that the benefits would exceed the marginal costs incurred.” (statement of Donald L. Nebes, Chairman, Auditing Standards Board of the AICPA (emphasis added)).

115. See JAMES C. TREADWAY, JR., REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (1987) [hereinafter TREADWAY REPORT], Chaired by James C. Treadway, Jr., former SEC Commissioner, the Treadway Commission analyzed current financial reporting systems and the expectations of its users in an effort to identify the causes of fraudulent financial reporting and to recommend solutions aimed at improving the accuracy and integrity of financial information reported to the public. See id. at 1. Fraudulent financial reporting is defined as “intentional or reckless conduct, whether an act or omission, that results in materially misleading financial statements.” Id. at 2. For a detailed discussion on the findings and recommendations of the Treadway Commission, see Goldstein & Dixon, supra note 12, at 468-74.
116. See TREADWAY REPORT, supra note 115, at 49.
reported financial information. These expectations are integral in ensuring the credibility of our capital markets and maintaining investor participation. In response to the findings and recommendations of the Treadway Commission, the AICPA adopted nine new auditing standards in 1988, many of which are included in the audit requirements outlined in the Reform Act.

H.R. 5439, a modified version of H.R. 4886, was introduced in 1986. H.R. 5439 was designed to “require audits performed under the Federal securities laws to include reasonable procedures for material

117. See id. The Treadway Report made a number of other recommendations regarding the responsibilities of each participant in the financial reporting process. These participants include, for example, the reporting company, the SEC, and the auditor. Regarding the reporting company, top management should establish a formal set of policies, procedures, and written codes of conduct in order to reduce the risk of fraudulent financial reporting. See id. at 33-36.

Recognizing the importance of the audit committee in preventing and detecting fraudulent and illegal acts, the Treadway Commission recommended that all public companies form such committees. See id. at 40. The audit committee would be responsible for assuring the independence of the auditors, maintaining a constant communication with the auditors during the audit, and ensuring that the company is operating in compliance with the internal policies and procedures. See id. at 42-44. In addition, the Treadway Commission recommended that the SEC require the reporting company to acknowledge its responsibilities with respect to the financial statements and internal controls in a separate report included in the audited annual report. See id. at 44-46. The report should also indicate that recommendations made by the auditors were responded to by senior management. See id. It is interesting to note that while both the SEC and Treadway Commission did not recommend that the independent auditor issue a separate report on the company’s internal control structure, the accounting profession advocated such a requirement. See id. at 58; Auditor Responsibility Hearing, supra note 8, at 89 n.13; see also supra note 114.

With respect to the independent auditor, the Treadway Commission recommended the establishment of auditing procedures aimed at reducing the risk of fraudulent financial reporting. See TREADWAY REPORT, supra note 115, at 49-51. Specifically, the auditor should design procedures to evaluate the risk of potential fraud and tests to provide reasonable assurance of detecting such fraud and illegal acts. See id. This would include an assessment of the company’s overall control environment, i.e., those policies and procedures promulgated and carried out by management in order to provide for accurate financial reporting, and a greater degree of skepticism of management’s integrity. See id. The independent auditor, however, should clearly indicate in his audit report the limitations associated with the audit and the inability of the auditor to guarantee the accuracy and reliability of the financial statements. See id. at 57. Most notably, the Treadway Commission recommended that the development of these standards be carried out by the Auditing Standards Board of the AICPA, rather than by governmental agencies. See id. at 59-61. However, the SEC’s enforcement authority over persons involved in fraudulent financial reporting should be increased. See id. at 63-76.

118. See Statement on Auditing Standards, supra note 9, No. 53, § 316; No. 54, § 317; No. 55, § 319; No. 56, § 329; No. 57, § 342; No. 58, § 508; No. 59, § 341; No. 60, § 325; No. 61, § 380. See generally Auditor Responsibility Hearing, supra note 8, at 101.


120. See H.R. 5439, 99th Cong. (1986).
financial fraud detection . . . and to require the reporting of fraudulent activities to appropriate enforcement and regulatory authorities."\(^{121}\) While the inclusion of a materiality standard represented a more workable standard for the auditor than that provided by H.R. 4886, it was still significantly broader than the materiality standard currently employed in the existing professional literature.\(^{122}\) Specifically, a transaction or event could be material based on its impact on a specific line of business or subsidiary of the issuer, or if it presented an actual or potential risk of serious damage to the issuer's reputation or standing.\(^{123}\) Therefore, although H.R. 5439 placed some limitation on the auditor's responsibilities with respect to illegal acts, it still obligated the auditor to structure the audit to detect those acts which might not be material in a financial statement audit.\(^{124}\) In hearings that began in the late 1980s and continued into 1990, congressional scrutiny began to focus strongly on the SEC's 8-K reporting process, which is triggered by, inter alia, a change in the company's auditors.\(^{125}\)

### B. 101st Congress

In a discussion draft introduced in 1990, the auditor's responsibilities with respect to detecting material illegal acts were increased by a broader definition of "illegality"\(^{126}\) and the absence of any defined

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121. Id. Preamble (emphasis added).
122. See id. § 13A(f)(4).
123. See id. § 13A(f)(4)(A), (B).
124. It appears from the language of the statute that an item which might be considered immaterial in a company's consolidated financial statements might otherwise be considered material when measured against a specific subsidiary's financial statement. Because the subsidiary will, in all likelihood, report significantly lower balances than those reported by the parent company, this will expand the scope of illegal acts that are judged to be material. In addition, standards such as reputation and standing are highly subjective and arguably outside the scope of the auditor's expertise and the general audit function.
126. Under section 13A(g)(1) of the discussion draft, the term "illegality," rather than "illegal acts," was defined as "any action or omission to act that violates any law, or any rule or regulation having the force of law—(A) which relates to (i) financial transactions, or (ii) access to and accountability for assets, or (B) the effect of which would have a material impact on such transactions or assets." Auditor Responsibility Hearing, supra note 8, at 11 (emphasis added) (as provided in the Discussion Draft of July 30, 1990). This definition would require the auditor to design the audit with procedures to detect illegal acts that have a material and direct effect on the financial statements and illegal acts which "relate to" or indirectly affect the financial statements. See supra note 124.
materiality standard.\textsuperscript{127} In addition to the earlier requirement that the auditor issue a separate report on the adequacy of the issuer’s internal control structure,\textsuperscript{128} the auditor now assumed additional responsibilities for designing specific procedures pertaining to the related parties and the going concern evaluation.\textsuperscript{129} Perceived weaknesses in the scope and timing of the SEC 8-K notification process\textsuperscript{130} became the source of significant debate with respect to the auditor’s responsibility to timely report illegal acts and fraud.\textsuperscript{131} Much of this scrutiny was the result of

\begin{itemize}
  \item \textsuperscript{127} The draft statute did, however, define “substantial,” a term used in connection with those illegal acts that are subsequently discovered during the course of the audit. See Auditor Responsibility Hearing, supra note 8, at 11-12. Therefore, the auditor is required to apply a different standard with respect to procedures designed to detect illegal acts, i.e., material, and those procedures the auditor must perform once an illegal act is detected, i.e., substantial. The term “substantial,” as applied to an illegality, means that the particular illegality, or any pattern or practice of such illegalities, presents a risk of financial loss (or of the failure to obtain a financial gain) that is—
  \begin{itemize}
    \item (A) material in relation to the financial statements of the issuer, or
    \item (B) to the extent required by [SEC] rule, material in relation to the financial statements of any industry segment of the issuer (in which the risk occurs) or to the financial statements of any subsidiary or affiliate of the issuer (in which the risk occurs).
  \end{itemize}
  \textit{Id.} Section (B) represented a carry-over of part of the definition of “material” as provided in H.R. 5439, now to be applied after, rather than before, an illegal act is discovered. See \textit{id.}; H.R. 5439, 99th Cong. \textsection 13A(f)(4)(A).

  Given the statute’s distinction between “material” and “substantial,” it is clear that Congress intended the standards to be different, and therefore, the auditor would likely apply the same materiality standard that is currently provided in the auditing standards. See Statement on Auditing Standards, supra note 9, No. 54, \textsection 317.05.

  \item \textsuperscript{128} See Auditor Responsibility Hearing, supra note 8, at 7-8 (as provided in the Discussion Draft of July 30, 1990).

  \item \textsuperscript{129} See \textit{id.} at 9.

  \item \textsuperscript{130} See supra note 77.

  \item \textsuperscript{131} See Auditor Responsibility Hearing, supra note 8, at 37-38. There was a consensus that the current 8-K report provided an inadequate means of notifying the SEC concerning illegalities and frauds. See \textit{id.} at 38 (“I’m just concerned that illegalities and frauds are not necessarily reportable events under these 8-Ks, and particularly if you have a situation where it’s a financial statement or something and management says [the auditor is] fired and [the auditor] can’t disagree with that.” (statement of Rep. Wyden)). A great deal of the frustration voiced by Congress related to the absence of any disclosures in examined 8-Ks that addressed management fraud or illegal acts in institutions where these acts caused business failure or collapse. See \textit{id.} at 132 (“I want to be told that these illegal acts are reportable events to the [SEC], specifically and directly. I can’t find anything that indicates that they are.” (statement of Rep. Wyden) (emphasis added)). This was exemplified by the ZZZZ-Best collapse where the company engaged in massive illegalities, and, although an 8-K was filed by management after the auditor resigned, the accounting firm’s response was filed after the fraud had been exposed by the press, and the company declared bankruptcy many days earlier. See H.R. Rep. No. 102-890, at 9 (1992).

  While recognizing the need for such information to get to its attention, the SEC has expressed mixed views on the effectiveness of the current 8-K process. See Auditor Responsibility Hearing, supra note 8, at 133 (“I inquiries are taken seriously by good lawyers and good
Congress’s belief that had the accountants “sounded an early alarm about [S&L] fraud, the billions that American taxpayers [had] to pay would [have been] far less.”

The proposed discussion draft drew a mixed reaction from the accounting profession and government agencies and regulators. Concerns were raised with respect to the adequacy of the auditor’s detection and reporting of management fraud and the ability of the accounting profession to address these concerns. The Government Accounting Office (“GAO”) advocated the broadest role for the auditor, placing a greater responsibility on the auditor to evaluate and report on management’s internal control structure and compliance with laws and regulations. In addition, the GAO recommended that the SEC play a more active role in setting auditing standards and a requirement that registrants create independent audit committees.

accountants. . . . But I’m not quarreling with [Congress] that there’s an issue here of how the information gets to the [SEC].” (statement of James R. Doty, General Counsel, SEC); see also Financial Fraud Detection Hearing, supra note 20, at 21-24 (statement of Richard C. Breeden, Chairman, SEC).

The accounting profession, however, contended that the current reporting process was adequate. See Auditor Responsibility Hearing, supra note 8, at 134-36.

[D]irect notification to the client with a copy to the chief accountant [at the SEC is made saying] that we are no longer auditors. That enables the SEC to make sure that an 8-K describing the termination and the reason for it is filed timely, and then, after that, [the auditor’s] report. So if we disagree with management’s description of the reason[s] . . . we would communicate that agreement or disagreement in our letter that would be filed with the SEC.

Id. at 135 (statement of Donald L. Neebe, Chairman, Auditing Standards Board of the AICPA).


133. During these hearings, the House Subcommittee on Telecommunications and Finance heard testimony from the Comptroller General of the United States, the General Counsel of the SEC, and the Chairman of the Auditing Standards Board of the AICPA. See id. at 13-36, 72-95, 96-117.

134. See id.

135. See id. at 22-36 (statement of Hon. Charles A. Bowsher, Comptroller General of the United States). The GAO has recently issued a report advocating the accounting profession’s required evaluation of the effectiveness of management’s internal controls in detecting fraud and narrowing the expectation gap regarding the public’s perception of the auditor’s responsibilities in this area. See U.S. GEN. ACCOUNTING OFFICE, THE ACCOUNTING PROFESSION, MAJOR ISSUES: PROGRESS AND CONCERNS (1996) [hereinafter GAO REPORT]. For a summary of the GAO’s findings and recommendations, see Douglas R. Carmichael, Report Card on the Accounting Profession, CPA J., Jan. 1997, at 18, 22-23 (noting that to support its recommendation, the GAO “points to the S&L crisis in the 1980s, as demonstrable proof of the cost to the public of weak internal controls”).

136. See Carmichael, supra note 135, at 24; see also Auditor Responsibility Hearing, supra note 8, at 22-36.

137. See Auditor Responsibility Hearing, supra note 8, at 32. The GAO suggested language that would require “[e]very issuer to . . . have an independent audit committee made up of totally independent outside directors (in both fact and appearance), including at least one attorney.” Id.
The SEC took a more practical view, focusing primarily on the additional costs that would result from requiring additional audit procedures. Specifically, the SEC maintained that the benefits associated with investor protection must be measured against the burden such costs would likely have on the capital formation process. Recognizing that changes were made in the 8-K reporting process, the SEC cautioned that any additional reporting requirements might inhibit an issuer’s ability to raise capital. The SEC also indicated that the overly broad definition of “illegality” would require the auditor to determine whether a violation of a law or regulation could potentially “relate to” or have a material impact on the company’s financial transactions or assets. Given the complexity and size of most companies, this standard would, in effect, require the auditor to make legal conclusions concerning a multitude of laws and regulations well beyond his expertise.

Although the accounting profession supported additional audit requirements with respect to separately reporting on management’s internal controls, it cautioned against expanding the auditor’s role to detect and report illegal acts. Given that the recommendations of the Treadway Commission were beginning to be implemented alongside the AICPA’s new auditing standards, the accounting profession favored (emphasis added).

138. See id. at 72-75 (statement of James R. Doty, General Counsel, SEC).
139. See id.
140. This included shortening the period for the registrant’s filing of the 8-K report to five business days and requiring greater disclosure in cases where there is a change in the accountants. See id. at 85-86. In specific cases, detailed disclosure would be required when the former accountant recommended that the audit scope be extended or actions by management could indicate opinion-shopping among auditors. See id. at 86.
141. See id.
142. See id. at 91.
143. See id. at 91-92 (advocating the idea that the auditor’s responsibilities should be limited to specified laws and regulations where violations have a “direct link with the audit”).
144. Such a requirement was not recommended by the Treadway Commission when it independently reviewed the role of the accountant in the audit process. See supra note 115. A separate report on the adequacy of management’s internal controls is arguably more detailed than a typical financial statement audit and would significantly increase audit fees. But see PUBLIC OVERSIGHT BD., A SPECIAL REPORT BY THE PUBLIC OVERSIGHT BOARD: ISSUES CONFRONTING THE ACCOUNTING PROFESSION (SEC Practice Section of the Am. Inst. of Certified Pub. Accountants 1993) [hereinafter POB REPORT] (recommending that the auditor express an opinion on management’s assertions regarding the adequacy of the company’s internal control structure).
145. See Auditor Responsibility Hearing, supra note 8, at 96-97 (statement of Donald L. Neebes, Chairman, Auditing Standards Board of the AICPA).
146. See supra note 115.
a "wait and see" approach before similar requirements were statutorily defined by Congress.\textsuperscript{147} In light of the increased costs and lack of expertise in the many laws and regulations to which a typical company is subject, the profession also disfavored broadening the auditor's responsibilities with respect to illegal acts.\textsuperscript{148}

\textbf{C. 102d and 103d Congress}

In 1992, the House proposed legislation which did not require the auditor to issue a separate report on management's internal controls, and instead, made the auditor's responsibilities with respect to detecting illegal acts more consistent with the existing auditing standards.\textsuperscript{149} However, the bill enhanced the auditor's duty to report illegal acts to the SEC when the company fails to do so or when the auditor resigns.\textsuperscript{150} A report issued by the House Committee on Energy and Commerce in support of H.R. 4313 cited a history of inadequacies in the auditor's detection and reporting of financial fraud,\textsuperscript{151} as well as a need to "restore the confidence of the investing public in the integrity of financial disclosures."\textsuperscript{152}

This theme continued into 1993 with legislation introduced by the House\textsuperscript{153} and Senate,\textsuperscript{154} and hearings which again focused on expanding the auditor's duty to detect and report management fraud in a more

\textsuperscript{147} See Auditor Responsibility Hearing, supra note 8, at 100-02.
\textsuperscript{148} See id. at 107-12.
\textsuperscript{149} See H.R. 4313, 102d Cong. § 1 (1992) (cited as the "Financial Fraud Detection and Disclosure Act"). At the same time, the Senate introduced S. 3181 to "establish a filing deadline and to provide certain safeguards to curb frivolous . . . cases." Securities Private Enforcement Act of 1992, S. 3181, 102d Cong. Preamble. The Senate bill, however, did not focus on auditor responsibilities. See id.
\textsuperscript{150} See H.R. 4313, 102d Cong. § 13A(b)(2)(B), (C) (1992).
\textsuperscript{152} Id. at 15 ("By establishing procedures for directly reporting illegal activities . . . to the [SEC], H.R. 4313 will better enable auditors to carry out their responsibilities to ensure the integrity and accuracy of financial disclosures."). The report, however, declined to specifically state that this is primarily the responsibility of management and forces the auditor into the difficult and almost impossible role of ensuring the accuracy of financial statements. See id. at 7-15. The bill also drew support from the SEC. See id. at 26-28 (letter from Richard C. Breeden, Chairman, SEC).
\textsuperscript{153} See H.R. 574, 103d Cong. Preamble (1993) (cited as the "Financial Fraud Detection and Disclosure Act"); H.R. 417, 103d Cong. Preamble (1993) (cited as the "Securities Private Enforcement Reform Act"). Interestingly, Congress proposed this legislation as an amendment to section 10 (anti-fraud provisions), rather than section 13 (periodic reporting requirement provisions) of the Securities Exchange Act. This would arguably make any violations by the auditor more serious and subject to greater scrutiny in enforcement actions.
\textsuperscript{154} See S. 630, 103d Cong. Preamble (1993) (cited as the "Financial Fraud Detection and Disclosure Act").
timely basis. The House heard the testimony of Richard C. Breeden, Chairman of the SEC, relating to the provisions of H.R. 574 and audit reports issued in connection with S&Ls and other businesses that failed during the 1980s. Chairman Breeden supported this legislation, indicating that while H.R. 574 did not represent a "dramatic change in existing law," the enhanced reporting requirements were "a step in the right direction." For the accounting profession, however, this legislation signaled the beginning of greater SEC involvement in the establishment of auditing standards.

The Senate hearings, focusing on the larger issue of a growing increase in class action securities litigation, began in the same year and solicited testimony from both the public and private sector. In discussions surrounding audit requirements, the Senate emphasized the need to establish timely and direct disclosure of management fraud that is discovered by the auditor. The accounting profession and other members of the financial and academic communities supported the audit requirements provisions of both H.R. 574 and its companion bill S. 630,

155. See generally Financial Fraud Detection Hearing, supra note 20; Private Litigation Hearings, supra note 83.

156. See Financial Fraud Detection Hearing, supra note 20, at 18-87.

157. See id. at 48 ("[P]roposed Section 10A could aid enforcement efforts by giving the [SEC] earlier warning of possible frauds, thus permitting earlier commencement of enforcement actions.").

158. Id. at 50.

159. Id.

160. See id. at 43 ("The [SEC] . . . would be prepared, should it prove necessary to fulfill its statutory mandate, to establish separate auditing standards . . . .").

161. See Private Litigation Hearings, supra note 83; see also Securities Litigation Reform Hearings, supra note 55.

162. See Private Litigation Hearings, supra note 83, at 89-91 (statement of Sen. Kerry). In effect, Congress sought to reestablish the "public watchdog" role of the auditor whose primary allegiance is directed to the public, rather than the client. See id. at 293 (statement of Rep. Wyden). As expected, this view drew strong support from plaintiff attorneys in securities actions. See Melvyn I. Weiss, Why Auditors Have Failed to Fulfill Their Necessary Professional Responsibilities—And What to Do About It at the 1992 Abraham J. Briloff Lecture Series on Accounting and Society, SUNY-Binghamton School of Management (contending that accounting firms have to accept the responsibility to affirmatively search for and report management fraud).

163. See Private Litigation Hearings, supra note 83, at 299-302 (statement of Jake L. Nettville, Chairman of the Board, AICPA). In addition, the AICPA supported the recommendations provided by the report of the Public Oversight Board, see supra note 144, and continued efforts for the profession to police itself through a program of peer review, quality control checks, and studying previous cases of management fraud in order to identify possible instances of fraudulent financial reporting. See Board of Dirs. of the Am. Inst. of Certified Pub. Accountants, Meeting the Financial Reporting Needs of the Future: A Public Commitment from the Public Accounting Profession, J. ACCT., Aug. 1993, at 17; see also Securities Litigation Reform Hearings, supra note 55, at 190-209 (statement of J. Michael Cook, Chairman and Chief Executive Officer, Deloitte & Touche).
recognizing a genuine need for the profession to "step-up" its efforts in this area and regain the public's confidence in the financial reporting process. 164 Neither the House nor Senate bill, however, were acted upon by the committees, and therefore, the legislation expired at the end of the 103d Congress.

Concurrent with Congress's efforts, the Public Oversight Board ("POB") of the AICPA 165 issued a special report addressing current issues confronting the accounting profession. 166 Having first rejected new mechanisms to regulate the accounting profession, 167 the POB concentrated on ways to improve the existing self-regulatory structure in order to reduce the growing number of audit failures that plagued the 1980s. 168 Following the POB's report, the Senate, in its first concentrated effort of reform in this area, proposed legislation that would have modified certain litigation practices in private securities class actions. 169 With respect to the accounting profession, S. 1976 required the SEC to establish a public auditing self-disciplinary board ("Self-Disciplinary

164. Many of these commentators noted that an expectation gap existed between the accounting profession and the public with respect to the auditor's role to detect and report management fraud. *See Private Litigation Hearings*, supra note 83, at 314-16 (statement of Robert A. Bowman, Chief Financial Officer, ITT Corporation, on behalf of Financial Executives Institute); *id.* at 365-64 (statement of Abraham J. Briloff, Emanuel Saxe Distinguished Professor Emeritus, Bernard M. Baruch College, The City University of New York); *id.* at 351-55 (testimony of A.A. Sommer, Jr., Chairman, Public Oversight Board of the SEC Practice Section of the AICPA); *see also id.* at 614-20 (testimony of the AICPA on recent progress in financial accounting and reporting).

165. The POB is a division of the SEC Practice Section of the AICPA that is responsible for overseeing the peer review process whereby auditors perform a detailed review or "quality control check" on the work completed by other auditors. The POB was chaired by A.A. Sommer, Jr., former Commissioner of the SEC, and included other members of distinguished professional careers in the public and private sector. *See POB REPORT*, supra note 144, Preface.

166. The report focused on (i) the existing litigation crisis, (ii) the effectiveness of the AICPA's self-regulatory programs and proposed recommendations, (iii) improvements to existing auditing standards relating to financial statement audits, and (iv) recommendations addressing the auditor's role in detecting management fraud and enhancing the financial reporting process. *See id.; see also Private Litigation Hearings*, supra note 83, at 302-04.

167. The recommendation that accounting firms create self-regulatory bodies to improve the quality of the audit was first recognized by congressional hearings that resulted in the Metcalf Report. *See supra note 109.*

168. *See POB REPORT*, supra note 144, at 27-30. The POB recommended that all accounting firms performing financial audits of public companies be a member of the SEC Practice Section of the AICPA and be subject to annual peer reviews and quality control guidelines. *See id.* at 17-18, 27-30. The POB also recommended that accounting firms (alternatively, "member firms") modify their internal quality control systems so that a uniform set of accounting and auditing procedures addressing new or special problems is established in light of the increase in litigation currently experienced by the profession. *See id.*

169. *See S. 1976, 103d Cong. (1994)* (introduced by Sen. Christopher Dodd (D-Conn.) and Sen. Pete Domenici (R-NM)).
Board"). Section 204 of S. 1976 would require all accounting firms whose reports are filed with the SEC to register with the Self-Disciplinary Board and be subject to investigations and disciplinary proceedings for violations of federal securities laws or professional standards in connection with their audit reports. Although this provision was ultimately eliminated from the enacted law, it was significant in that it represented Congress's concerted effort to require the SEC to create a statutory self-disciplinary organization to regulate the public accounting profession in place of the profession's existing self-policing policies.

The POB also made recommendations aimed at improving the quality of the audit by enhancing the accounting profession's "capacity and willingness to detect fraud" in light of the serious economic losses experienced by investors and creditors. First, the POB advised that a uniform set of guidelines should be established in order to assist the profession in identifying management fraud and reemphasized the need for the auditor to maintain the highest level of independence. Second, the POB supported the profession's view that it report separately

170. See id. § 204 (included in Title II of the Private Securities Litigation Reform Act of 1994). Prior to S. 1976, the House and Senate introduced legislation addressing the auditor's responsibility to detect and report fraud only. See H.R. 574, 103d Cong. (1993); S. 630, 103d Cong. (1993). S. 1976, therefore, represented broader legislation that incorporated the provisions of H.R. 574 and S. 630 and represented the first time that outside regulation of the accounting profession was statutorily defined. Surprisingly, this provision was supported by the accounting profession. See Securities Litigation Reform Hearings, supra note 55, at 199 (statement of J. Michael Cook, Chairman and Chief Executive Officer, Deloitte & Touche).

171. This would be accomplished by the filing of an application that detailed (1) the names of all clients of the accounting firm for which an audit report is filed, (2) financial information for the accounting firm's most recent fiscal year, and (3) a statement of the accounting firm's policies and procedures with respect to quality control of its accounting and auditing practice. See S. 1976 sec. 204, § 13A(a)(2)(A)-(C).

172. See id. § 13A(f)(1). The Self-Disciplinary Board, partially run by individuals currently associated with a public accounting firm, would have the authority to review a member firm's work papers and require testimony of any of the involved parties. See id. § 13A(f)(2)(B)(i)-(iii). Based on its findings, the Self-Disciplinary Board could revoke the member firm's registration and effectively prevent them from auditing public companies, limit the accounting firm's professional activities, order a fine or censure, or suspend the accounting firm for a period of time. See id. § 13A(f)(3)(A), (B).

173. For a detailed listing of the accounting profession's self-regulatory programs, see POB REPORT, supra note 144, at 71-80.

174. Id. at 41.

175. See id. at 43 (Recommendations V-1 and V-2).

176. See id. at 44-45 (Recommendations V-3 and V-4). The POB also "reminded" the accountant "that the [auditing] firm's reputation for independence is far more valuable than the fees obtained from any client." Id. at 44 (emphasis added).
on the client’s internal control structure relating to financial reporting. More importantly, the POB, in agreement with Congress, recommended that the auditor report “suspected illegalities” to the SEC if the client fails to take remedial action, but indicated that guidance would be necessary in order to limit the scope of illegal acts for which the profession would be responsible. Additionally, in an effort to narrow the expectation gap, the POB attempted to clarify the roles of the accountant and the audit committee in the financial reporting process.

D. 104th Congress

The 1994 election brought a Republican majority to Congress and accelerated legislation in the area of securities litigation reform. These efforts, however, mainly represented Congress’s aggressive support for an overhaul of the existing securities litigation process and did not specifically focus on the auditor’s responsibility to detect and report fraud. Indeed, this shift in attention away from the accounting profession ultimately led to the House Commerce Committee omitting the fraud detection and disclosure section from H.R. 10. The Senate, however, included such provisions in companion legislation that it proposed in both the prior and current term. In the end, because

177. See id. at 54 (Recommendation V-12). For a general discussion on the mixed reaction this recommendation has historically received, see supra notes 114 and 144.
178. Id. at 55 (Recommendation V-14) (emphasis added). The POB report does not, however, clarify or define the scope of this term.
179. See id.
180. See id. at 39-40 (Recommendation IV-4) (recommendating that the auditor’s standard report be modified in order to indicate the “limitation of assurance” associated with certain accounting estimates).
181. See id. at 51-52 (Recommendation V-10) (recommendating that companies include a separate document indicating the responsibilities of the audit committee and the manner in which they are carried out).
182. See Phillips & Miller, supra note 3, at 1019 n.63.
183. See Common Sense Legal Reform Act: Hearings Before the Subcomm. on Telecomms. and Fin. of the House Comm. on Commerce, 104th Cong. (1995). These hearings did, however, focus on the issue of proportionate liability with respect to the accountant. See id.
previous legislation that codified these audit requirements had gained strong support in Congress as a deterrent to securities fraud, they were included as part of comprehensive legislation on securities litigation reform which was ultimately enacted. A Conference Report on H.R. 1058, the enacted bill, was submitted to both the House and Senate and overwhelmingly passed.

VI. THE IMPLICATIONS OF SECTION 10A ON THE AUDIT ENGAGEMENT AND THE USERS OF AUDITED FINANCIAL STATEMENTS

A. An Increase in Up-Front Audit Planning and Higher Audit Fees

The initial effect of section 10A of the Reform Act on the auditor will be the need to perform more up-front planning of audit procedures. This will entail a comprehensive review of existing audit programs, clearer documentation with respect to procedures the audit team must perform, and specific procedures for situations where a possible illegal act warrants further investigation. The engagement team must be aware of the laws and regulations affecting their client’s industry and plan the audit to detect material and direct illegal acts. For example, if the client is a broker-dealer, the auditor would certainly need to assess the company’s compliance with the IRS, the Securities and Exchange Acts of 1933 and 1934, and rules and regulations promulgated by the SEC, New York Stock Exchange, National Association of Securities Dealers, and other regulatory agencies. However, it is unclear whether the auditor’s responsibilities will change with respect to other areas where illegal acts may occur, such as violations of environmental and fair labor laws. Additionally, the wide array of legal requirements affecting companies that are engaged in foreign operations could affect the

186. See 141 CONG. REC. H14049 (daily ed. Dec. 6, 1995) (“[I]n the future, management will know that they cannot have an auditor in their pocket. They will know that an auditor has a legal responsibility to report fraud when this legislation is signed.” (statement of Rep. Wyden)).
188. See H.R. CONF. REP. NO. 104-369.
190. See Auditor Responsibility Hearing, supra note 8, at 92 (statement of James R. Doty, General Counsel, SEC).
auditor's responsibilities. The auditor, therefore, will likely face a difficult situation when possible illegal acts outside the familiar "domain of financial oversight" are discovered.

In addressing some of these uncertainties, the auditor may initially need to meet with his own in-house legal counsel to be assured that he has adequately assessed the client's legal environment. In addition, discussions with the client's counsel will also be necessary in order to review the company's procedures for complying with these laws and regulations, as well as identifying other areas in which an illegal act would likely have a material effect on the company's financial statements. As a matter of self-protection, the auditor should seek additional representations from management clearly defining the auditor's responsibility to prevent and report such acts as well as assurances that all relevant information regarding any possible illegal acts has been provided to the auditor in an accurate and timely manner. The auditor may seek additional protection by increasing the audit fees to reflect the anticipated liability that would accrue if the auditor is later judged to have violated the provisions of section 10A.

Audit areas such as related parties and a going concern evaluation have traditionally received less scrutiny than that given to illegal acts. For example, under the existing professional literature, the

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191. See id. at 109 (statement of Donald L. Neebes, Chairman, Auditing Standards Board of the AICPA).
193. Under GAAS, the auditor is required to obtain written representations from the company's management regarding oral representations made during the audit or to complement audit procedures performed. See Statement on Auditing Standards, supra note 9, No. 19, §§ 333.01-.03. While the elements of a management representation letter will vary by engagement, all such letters will include a representation that the company's management has disclosed "[v]iolations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency." Id. § 333.04(q).
194. See DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (Easterbrook, J).
195. In many cases, the task of completing audit "checklists" addressing these areas were last minute and general in nature. A going concern evaluation was rarely formally documented and if significant, would be raised as an audit issue early on in the engagement. See Steven G. Blum & Reva B. Steinberg, Earnings Per Share: Confronting Fraud in a Financial Statement Audit, INSIGHTS, Aug. 1996, at 34, 36 (noting that in cases where audit procedures addressing management fraud are "merely relegated to auditor checklists obligingly checked off, no incremental good will come from them").
196. Under the existing auditing standards, the auditor is required to inquire of the company's lawyer(s) concerning litigation, claims, and assessments pending or threatened against the company. See Statement on Auditing Standards, supra note 9, No. 12, § 337. This will enable the auditor to identify those illegal acts allegedly committed by the company in which a material or probable loss
auditor is not required to design procedures directed specifically at a going concern evaluation.\textsuperscript{197} Under the Reform Act, however, such a requirement now exists;\textsuperscript{198} the auditor must formally document the procedures and analyses undertaken to support the determination that the company is indeed a going concern. This will range from discussions with management and review of board meeting minutes to increased analytical procedures and a review of any financial projections and forecasts prepared by the company.

These factors will result in additional audit hours and fees that the auditor will attempt to recover from the client. This increase in audit fees will likely be met with a strong level of resistance by client management. Indeed, the private sector has already indicated an unwillingness to pay fees related to additional audit procedures that "will result in substantial increased costs without providing sufficient incremental benefit."\textsuperscript{199} In many cases, the audit fee is the basis of considerable negotiation as the client will attempt to keep these fees as low as possible while the accounting firm will attempt to avoid discounting its fees.\textsuperscript{200} If the client refuses such fee increases, the auditor may feel pressured to reduce or eliminate certain audit procedures, thereby jeopardizing the overall quality of the audit.\textsuperscript{201}

\textsuperscript{197} See supra note 97; see also Auditor Responsibility Hearing, supra note 8, at 16 (statement of Hon. Charles A. Bowsher, Comptroller General of the United States).


\textsuperscript{199} Auditor Responsibility Hearing, supra note 8, at 121 (statement of John W. Spiegel, Chairman of the American Bankers Association’s Chief Financial Officer Division).

\textsuperscript{200} Recognizing this tension, the POB noted that “[a]udit firms have [an] obligation to refuse to perform audit services for fees that may compromise the integrity of the audit.” POB REPORT, supra note 144, at 52.

\textsuperscript{201} See id.
B. A Need to Modify Engagement Letters to Clearly Define the Auditor’s and Management’s Roles

The audit detection and reporting requirements under section 10A may prompt the auditor to include specific language in the client engagement letter as a protection against liability.202 This would likely include specific language indicating that management be responsible for providing additional information and the necessary resources in the event that the auditor discovers an illegal act and must therefore perform additional procedures. In order to avoid future disagreement, the auditor should draft the engagement letter with broad language, indicating that “[m]anagement and the audit committee [will] provide whatever assistance and information [that] may be appropriate to enable the auditors to fulfill their statutory obligations.”203

While the plain language of section 10A refers to illegal acts discovered “in the course of conducting an audit,”204 the auditor should seek to clarify the method for handling acts discovered outside the annual audit.205 If the SEC resolves this ambiguity by placing a similar requirement on all services performed by the auditor, the accounting profession will need assurance that the auditor liability limitation provided for in section 10A is also applicable to these additional services.206 It is likely that the requirements of section 10A will be held applicable to reviews of interim financial statements, given the auditor’s reliance on these procedures when planning and performing the annual audit.207

Lastly, the auditor should carefully draft the engagement letter so that management is responsible for any additional costs incurred in the

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202. Although not required by the auditing standards, the use of an engagement letter is a widely accepted practice in specifying the responsibilities of both client management and the auditor with respect to the audit procedures and a proposed fee, subject to increase if additional work is necessary. See O’REILLY ET AL., supra note 23, at 96.

203. Pitt et al., supra note 37, at 279 (emphasis omitted). This could include an examination of previous regulatory filings, customer complaint files, and management reports; discussions with counsel and senior management; and additional audit procedures deemed necessary by the auditor. See id.


205. See Pitt et al., supra note 37, at 280 (noting that the accountant may also perform quarterly reviews of interim financial statements and other non-attest services concerning the company’s operations or other reported financial information).

206. See id.

207. See id. at 456 n.22.
event that a possible illegal act is discovered. While this will inevitably lead to some disagreement over what constitutes a "possible illegal act," without such qualifying language the auditor will have little, if any, chance of collecting any additional fees.

C. A Need to Develop a Uniform Standard of Evidence and Investigative Procedures in Detecting Illegal Acts

Section 10A requires the accountant, in the course of conducting an audit, to "determine whether it is likely that an illegal act has occurred."\(^{208}\) It does not, however, provide the auditor with a standard of evidence to be used in determining whether an illegal act has occurred. Given Congress's clear displeasure with the accounting profession's past efforts in detecting and reporting management fraud and illegal acts, it is unclear why it would leave such a standard of evidence undefined and use language that so closely tracks the profession's existing literature.\(^{209}\) In effect, section 10A forces the auditor to make legal judgments regarding the existence of certain facts and the likelihood that an illegal act has occurred.\(^{210}\) Once the auditor makes such a determination, these matters must be promptly communicated to the company's audit committee or board of directors.

There is also a lack of guidance on the nature and scope of the investigation that the auditor is expected to undertake once an illegal act is discovered. For example, the auditor may decide to involve both the client's or accounting firm's in-house or outside counsel, conduct his own investigation,\(^{211}\) or, depending upon the complexity or significance

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209. It is possible that Congress did not want the auditor to engage in making such a legal determination, and by omitting a legal standard, the auditor would be inclined to report a greater number of items to management or the SEC.

The auditing standards do not offer any further guidance on the standard of evidence the auditor should apply. See Statement on Auditing Standards, supra note 9, No. 54, §§ 317.10-.12. "When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit." Id. § 317.12 (emphasis added).


211. In such cases, the auditor could use the audit engagement team to perform any additional procedures or the accounting firm's litigation support group which is specifically trained for such situations. See Elizabeth MacDonald, Accounting Sleuths Ferret Hidden Assets, WALL ST. J., Dec. 18, 1996, at B1 (noting that an increasing number of forensic accountants are being used in investigating white-collar crimes and fraud).
of the item, contract with a third party to conduct a separate investigation. If the client conducts its own investigation with counsel, issues of attorney-client and work-product privileges arise. This will create tension because providing the auditor access to this information may jeopardize those privileges, but may also be the “best way to convince the auditors that no illegal act has occurred or that the remedial actions taken were ‘timely and appropriate.’” Management will most likely choose not to waive these privileges, and as a result, the auditor may have difficulties satisfying his statutory obligations under the Reform Act.

D. A Need for Greater Communication Between the Auditor and Client Management

Section 10A will require a greater level of communication between client management and the auditor both before and during the audit. Given the immediacy of the reporting requirements, management should “review, enhance and regularize its lines of communication with company auditors” in order to avoid being subject to the strict notification requirements under the Reform Act. More importantly, such on-time discussions will provide management with the opportunity to take remedial action for illegal acts detected by the auditor before a section 10A Report is filed with the SEC. Management will seek to avoid this notification because it may subject the company to adverse publicity and attention from various governmental agencies.

Current auditing standards provide for some level of communication between the auditor and client management both during and at the conclusion of the audit. Under the Reform Act, however, manage-

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212. See Carberry & Gordon, supra note 192, at 5; Pitt et al., supra note 37, at 280.
213. Carberry & Gordon, supra note 192, at 5.
214. Because the auditor’s work papers are not privileged, management’s decision will be influenced by the likelihood that information released will be used against the company in future litigation or enforcement actions. See id.
215. Pitt et al., supra note 37, at 273 (emphasis omitted).
216. This refers to the report filed by either the company or the auditor under section 10A(b)(3) of the Reform Act.
217. See Pitt et al., supra note 37, at 274.
218. See Statement on Auditing Standards, supra note 9, No. 53, § 316.28 (“For the audit committee to make the informed judgments necessary to fulfill its responsibility for the oversight of financial reporting, the auditor should assure himself that the audit committee is adequately informed about any irregularities of which the auditor becomes aware . . . .”); No. 54, § 317.17 (“The auditor should assure himself that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to illegal acts that come to the auditor’s
ment must adopt a proactive approach in their dealings with the auditors by formally designating certain senior level officers to communicate with the auditors on a more regular basis. In addition, both the auditor and client management should strongly consider maintaining a formal record detailing the timing and context of their discussions and the disposition of any possible illegality or fraudulent financial reporting. If such issues become the subject of future litigation, this record will protect the auditor by indicating that the matter was either appropriately identified and resolved or not discovered even though the auditor complied with the requirements of both GAAS and section 10A.

E. A Need to Assess the Adequacy of the Company’s Remedial Actions for Material Illegal Acts

Under section 10A\(^2\)\(^{219}\) and current auditing standards,\(^{220}\) the auditor must structure the audit to detect illegal acts, determine whether such an act occurred, and assess the potential financial impact of such acts.


\(^{220}\) See Statement on Auditing Standards, supra note 9, No. 54, § 317. Accountants have long held that such a requirement is outside the scope of their expertise. Traditionally, the professional literature has disclaimed the ability of the accountants to make such legal determinations. See id. § 317.03 (“Whether an act is, in fact, illegal is a determination that is normally beyond the auditor’s professional competence. . . . [This determination] would generally be based on the advice of an informed expert qualified to practice law . . . . ”). The literature further provides that an audit conducted in accordance with GAAS “provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.” Id. § 317.07; see also Elizabeth MacDonald, Auditors Are Ending Up Between a Rock and a Hard Place over Securities Law, WALL ST. J., Dec. 24, 1996, at Cl.

This view has also garnered some support from the SEC. See Auditor Responsibility Hearing, supra note 8, at 91.

[T]he auditor will have to acquire or develop the expertise necessary to understand the requirements of all federal, state, and foreign statutes and regulations applicable to the registrant . . . Designing an audit to meet this standard would require auditors to determine the elements of every law violation that arguably . . . has a “material impact on” financial transactions, a determination that may be beyond their professional expertise.

\(^{219}\) (statement of James R. Doty, General Counsel, SEC, relating to a July 30, 1990 Discussion Draft). Members of the banking industry have also sided with the accountants on this issue. See id. at 117 (testimony of John W. Spiegel, Chairman of the American Bankers Association’s Chief Financial Officer Division).
Moreover, section 10A requires an auditor to determine whether a company has taken "timely and appropriate remedial actions" when a material illegal act has been detected.\(^\text{221}\) This places both a managerial and legal responsibility on the auditor to assess the adequacy of a company's response and perhaps play a role in developing and implementing such remedial measures. However, neither the Reform Act nor the legislative history offers the auditor guidance in assessing whether the remedial actions taken by the company are adequate.\(^\text{222}\)

The task of evaluating such nonfinancial matters traditionally falls outside the scope of the auditor's professional expertise. This further places the auditor in a difficult position as management's remedial actions could range from an internal reprimand and a change in the company's policies to firing any parties involved and obtaining expert legal advice.\(^\text{223}\) Moreover, if there is a future dispute between the SEC and client management over the seriousness of the wrongdoing and the remedial actions taken, the auditor may be subject to future litigation concerning his role in agreeing with such actions and not reporting the illegal act. This is also likely to challenge the long-standing requirement that the auditor remain independent from the client at all times given the auditor's role in determining the adequacy of actions undertaken by the company's management.\(^\text{224}\)


\(^{222}\) See Carberry & Gordon, supra note 192, at 5; see also Pitt et al., supra note 37, at 277 n.18 ("While current auditing standards imply that auditors should consider whether management has taken appropriate remedial measures upon learning that illegal acts may have occurred, they provide limited guidance as to what types of measures are appropriate in different circumstances."). In addition, section 10A offers no guidance on whether such remedial actions must address future illegal acts. See Eldon Olson, Fraud Detection and Disclosure—Private Securities Litigation Reform Act of 1995, in Sweeping Reform: Litigating and Bespeaking Caution Under the New Securities Law, at 497, 507 (PLI Corp. Law & Practice Course Handbook Series No. B-923, 1996).

\(^{223}\) The accounting standards indicate that remedial actions typically include "disciplinary action against involved personnel, seeking restitution, adoption of preventive or corrective company policies, and modifications of specific control procedures." Statement on Auditing Standards, supra note 9, No. 54, § 317.17.

If the auditor and client management disagree over the adequacy of the remedial actions taken in light of the illegal acts discovered, the company will likely face a section 10A report that will be filed with the SEC. See Carberry & Gordon, supra note 192, at 5. Therefore, agreement between these parties is essential in order to avoid the repercussions associated with SEC notification.

\(^{224}\) See Pitt et al., supra note 37, at 282. The importance of the auditor's independence is underscored by its placement as the second general standard of GAAS. See Statement on Auditing Standards, supra note 9, No. 1, § 150.02 ("In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.").
F. An Increase in the Overall Audit Procedures Applied to Illegal Acts Discovered

Section 10A significantly increases the auditor’s responsibilities once an illegal act is detected. In earlier versions of proposed legislation concerning illegal acts, Congress intended a far broader definition of "illegal act" than is presently required under the professional literature. Although the present definition is arguably more narrow in scope, there is an absence of any clear guidance on whether the audit is limited to those illegal acts which have a natural or direct link with the audit process. Thus, the courts will be left with the responsibility of establishing standards in this area, and the auditor will be subjected to the real risk that the courts will adopt a broader definition consistent with the views expressed by clear congressional intent.

Although the audit need only be planned to provide reasonable assurance of detecting material and direct illegal acts, section 10A requires the auditor to perform additional audit procedures whether or not the illegal act is perceived to have a material effect on the company’s financial statements. While both the existing auditing standards

The issue of auditor independence has drawn attention in a recent report prepared by the GAO in conjunction with Congress’s consideration of section 10A, aimed at evaluating the overall performance of the accounting profession. See GAO REPORT, supra note 135, at 37-59; see also Carmichael, supra note 135, at 18-24. While the report noted that auditor independence has strengthened, serious challenges continue due to the increase in management consulting services, management “shopping” for favorable audit opinions, and instances where there is “a more direct working relationship between the auditor and the board of directors.” Id. at 20. This concern will be heightened by the enactment of section 10A given the auditor’s increased role in evaluating those remedial acts taken by management in response to illegal acts detected by the auditor.

225. See supra note 126. In the final passage of the Reform Act, however, this definition was amended and “illegal act” was defined only as “an act or omission that violates any law, or any rule or regulation having the force of law.” 15 U.S.C. § 78j-1(f).

226. The SEC recognized this issue and has advocated that Congress should consider limiting the scope of such laws and regulations to cases where compliance problems have a direct link with the audit process. See Auditor Responsibility Hearing, supra note 8, at 90-92 (statement of James R. Doy, General Counsel, SEC).


228. This closely parallels the requirements under the existing professional literature. See Statement on Auditing Standards, supra note 9, No. 54, §§ 317.10-16. The real impact of section 10A is likely to result from the Reform Act’s express grant of authority to the SEC to modify or supplement GAAS. Although the SEC has traditionally not taken an active role in formulating accounting and auditing standards, it is likely that section 10A will heighten the SEC’s role in the future adoption of such standards. See infra Part VI.G.

229. See Statement on Auditing Standards, supra note 9, No. 54, § 317.17.
and the Reform Act\textsuperscript{230} do not require the auditor to report those illegal acts to the audit committee that are “clearly inconsequential,” this term is left undefined in the Reform Act, and again, the auditor is offered no guidance from Congress in making such a determination.\textsuperscript{231} This will require the audit committee and the auditors to reach an agreement on the type of acts which may qualify for this narrow designation. In many cases, however, it may prove easier for the auditor to perform expanded or heightened auditing procedures when such acts are discovered in order to avoid future liability if the courts adopt a narrower definition of this exclusion.\textsuperscript{232}

The legislative history will offer the auditor little help if it is considered by the courts when interpreting the statute.\textsuperscript{233} A review of this history reveals that section 10A was borne out of Congress’s frustration with the auditor’s inability to detect and report illegal acts and fraud in a timely manner in order to prevent investor losses and federal bailouts. It will also reveal that from the outset, Congress intended the auditor to assume the broadest possible role in this area, thus reinforcing the Supreme Court’s earlier mandate that the auditor serve as the public’s “watchdog.” Given this scenario, it is unlikely that the auditor will be able to raise many defenses in light of his affirmative duty to detect fraud under section 10A. In separate efforts by the profession to deal with this issue, the accounting profession has issued a new auditing standard that provides operational guidance on the consideration of fraud in a financial statement audit.\textsuperscript{234}

\textsuperscript{230} See 15 U.S.C. \textsuperscript{231} § 78j-l(b)(1)(B).
\textsuperscript{232} Since the same term appears in the current auditing standards, it is logical to assume that Congress intended the auditor to use the same or similar standards in making such an evaluation.
\textsuperscript{233} Section 10A does not provide the accounting firm with a safe harbor in cases where the auditor makes a good faith determination that notification to the SEC is not warranted because an illegal act has not occurred or that an illegal act discovered during the audit was judged to be “clearly inconsequential.” See Dan L. Goldwasser, The Private Securities Litigation Reform Act of 1995: Impact on Accountants, CPA J., Jan. 1997, at 72, 74-75.
\textsuperscript{234} The new standard is the direct result of the massive financial frauds and scandals which prompted the enactment of the Reform Act, discussed supra note 11. See Mark Maremont, Bean Counters Get an Early-Warning System, Bus. Wk., Dec. 9, 1996, at 68 (noting that “the [proposed] standard sets far tougher guidelines for auditors assessing the risk of fraud when conducting an audit’’); Lee Berton, Auditors Face Stiffer Rules for Finding, Reporting Fraud at Client Companies, WALL ST. J., Feb. 5, 1996, at A2 (“[T]he proposed standards [will] provide auditors with more ‘red flags’ for fraud, such as a toothless board of directors or a domineering chief executive who fails to set an ethical tone, as well as poor internal controls.’’); see also Elizabeth MacDonald, CPA Institute Tightens Rules to Find Fraud, WALL ST. J., Nov. 13, 1996, at A6; Thomas Ray & Jane Mancino, Auditing Standards Board Addresses Fraud, J. ACCT., June 1996, at 17. For a detailed
G. An Increased Role by the SEC in the Promulgation of Auditing Standards

The SEC’s express authority to modify or supplement GAAS under the Reform Act235 is likely to increase the SEC’s presence in an area that has traditionally been the domain of the accounting profession.236 In hearings held in connection with the Reform Act, former SEC Chairman Richard C. Breeden noted that the accounting profession must promulgate accounting and auditing standards that “enhance the relevance, reliability, and credibility of financial statements.”237 Indeed,

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discussion of this standard, see infra Part VILA.

235. See supra note 22.

236. See supra note 23. The SEC has indicated their intention to assume a greater role in the setting of auditing standards. As Richard C. Breeden, former chairman of the SEC has stated:

Not every accounting principle is what it should be, in my opinion, and there is plenty of room for improvement in both GAAP and GAAS. Nonetheless, we have a system that does have considerable flexibility and it benefits enormously from the expertise of the [accounting] profession mixed with the representation of the public interest provided by the SEC.

.....

At the same time, when [GAAS] and implementation of those standards through auditing procedures lags too far behind generally accepted embezzling practices, the public will suffer, and it can suffer in an enormous amount. Some members individually who become victims of these frauds can suffer in a very big way.


The SEC is concerned about standard setting because of our mandate to protect investors. . . . In many respects, the [accounting] profession has performed its role well. Indeed, the incidence of fraudulent financial reporting in this country has been very low. But certain rumblings above and below the surface suggest that the profession may be discounting the huge importance investors place on the objectivity and independence of auditors.

Id. It does not appear, however, that the SEC currently plans to increase its existing role in the promulgation of accounting principles (GAAP). See id. While noting that the SEC has the statutory authority to promulgate accounting standards, it has “looked to the accounting profession to play a leading role, while the SEC staff monitors and oversees these standard setting activities.” Id. In reference to the increasing attempts to enhance the role of the SEC in this area, (e.g., the Reform Act), Chairman Levitt has stated, “we’re all better off in the long run if we respect [this existing] process.” Id.

237. Financial Fraud Detection Hearing, supra note 20, at 51. Chairman Breeden further noted that “[s]impler, more objective accounting standards would make it possible for auditors to obtain more objective and relevant evidence regarding compliance with those accounting standards, resulting in more reliable audit reports.” Id. at n.40 (referring to accounting standards currently used to measure the carrying value of assets).
Congress intended to specifically provide for the SEC’s authority in this area.\textsuperscript{238} Given this clear authorization, the SEC may be “unable, or unwilling, to resist the temptation to issue new audit requirements.”\textsuperscript{239}

The SEC may also be prompted to set new auditing standards in response to Congress’s clear disfavor of the accounting profession’s previous efforts in detecting and reporting management fraud and illegal acts.\textsuperscript{240} This may force the SEC to adopt a more visible role in the development of auditing standards. Consequently, the SEC may decide to promulgate new audit requirements or take a more reserved role and issue interpretations of existing audit standards, leaving the accounting profession with the primary responsibility of defining GAAS.\textsuperscript{241} The GAO has recommended that the SEC take “a more decisive and affirmative approach to its oversight of the financial regulatory process”\textsuperscript{242} as part of a “cooperative action by the [accounting] profession and [f]ederal regulators to strengthen public accounting practice.”\textsuperscript{243} In the end, section 10A and the ever-growing sophistication of business transactions and strategies will likely result in the SEC infringing upon areas traditionally considered to be the accounting profession’s domain.\textsuperscript{244}

\begin{itemize}
\item \textsuperscript{238} See Private Litigation Hearings, supra note 83, at 90 (“The Financial Fraud Detection and Disclosure Act [S. 630] would give the SEC the ability to issue new requirements to auditors to supplement current auditing standards, to assist them in detecting financial chicanery.” (statement of Sen. Kerry)).
\item \textsuperscript{239} Pitt et al., supra note 37, at 281 (footnote omitted).
\item \textsuperscript{240} See supra note 12. But see Pitt et al., supra note 37, at 281 (noting that the SEC “has only rarely disciplined accountants based on their alleged failure under GAAS to detect and report illegal acts by clients”).
\item \textsuperscript{241} See Pitt et al., supra note 37, at 281.
\item \textsuperscript{242} Carmichael, supra note 135, at 24.
\item \textsuperscript{243} Id.
\item \textsuperscript{244} The SEC recently adopted Rule 10A-1 in connection with the implementation of section 10A. See Implementation of Section 10A of the Securities Exchange Act of 1934, 62 Fed. Reg. 12,743 (1997). The reports submitted by the auditor will be nonpublic and therefore will be accorded confidential treatment. See id. at 12,745. The SEC also conformed the definition of “audit” in regulation S-X with section 10A in order to “alert auditors and issuers to the possibility that additional audit procedures, beyond those required by GAAS, may be required by the [SEC] in certain circumstances.” Id. at 12,746-47. In general, however, the SEC plans to continue its practice of “‘looking to the private-sector . . . in establishing and improving GAAS.’” SEC Adopts New Audit Requirements, J. ACCT., June 1997, at 13, 13. However, the “SEC could require audit procedures in addition to those required by [GAAS].” Id.
\end{itemize}
H. A “Chill” on the Auditor-Client Relationship

The auditor’s enhanced reporting requirements under section 10A will test the existing auditor-client relationship and force the accountant to assume the role of a “whistle-blower.”245 Given the strict reporting deadlines imposed upon the auditor under section 10A, management will be less willing to disclose certain internal investigations until it has enough time to assess the magnitude of the problem and implement appropriate remedial actions. In contrast, the auditor will be inclined to report a greater number of questionable illegal or fraudulent actions in order to be protected from future liability.246 Once the auditor learns of a possible illegal act and management fails to act, the auditor is placed in the difficult position of choosing between “the threat of civil penalties from the SEC on the one hand and the consequences of a mistaken report.”247

If the auditor decides that notification to the SEC is warranted, he is faced with the unenviable choice of resigning from the account or risk being fired. If, however, the auditor has not already resigned or been fired, but is subsequently proved wrong, section 10A can do little to salvage a working relationship between the auditor and the client or, more importantly, remedy the damage caused to the company’s reputation and heightened scrutiny from the regulators.

The auditor may decide that notification is not warranted if the illegal act is deemed to be immaterial248 or senior management has taken “timely and appropriate remedial actions.”249 If it is determined

(CCH) ¶ 85,716 (Dec. 28, 1995); see also Steven M.H. Wallman, The Future of Accounting and Financial Reporting Part II: The Colorized Approach, ACCT. HORIZONS, June 1996, at 141 (“It is becoming harder to define the outer edges of companies. The information revolution is moving us to a new plateau where businesses can operate with greater agility than ever before.”).

245. Congress specifically envisioned that the auditor would assume such a role. See 141 CONG. REC. H14049 (daily ed. Dec. 6, 1995) (“Let us do more to prevent fraud up front by requiring the auditors to blow the whistle.” (statement of Rep. Wyden)); Carberry & Gordon, supra note 192, at 4 (“[Section] 10A imposes a statutory obligation on public accounting firms, in certain circumstances, to ‘blow the whistle’ on their clients by reporting suspected unlawful conduct to the [SEC].”); see also Brodsky, supra note 7, at 3; Robert Sidorsky, Auditor’s Duty to Blow the Whistle Under the Litigation Reform Act, N.Y. L.J., Feb. 9, 1996, at 1; McDonald, supra note 211, at B1.

246. See 15 U.S.C. § 78j-1(e) (Supp. I 1995). The auditor may, however, be subject to civil penalties or other disciplinary actions. See id. § 78j-1(d).


249. Id. § 78j-1(b)(2)(B).
that notification was in fact warranted, it might prove more fair for the SEC and the courts not to hold the auditor liable if the decision not to report the illegal act was based on the auditor’s reasonable or good faith judgment that the item was immaterial. If, however, the auditor’s judgment is afforded no deference, there will be little incentive for the auditor not to report such items in order to protect himself against future liability.

Congress’s clear indication that the auditor’s primary duty is to the public and not to the client casts the auditor in the role of a detective. While it is designed to afford investors with a greater level of protection, it does so at the expense of the auditor-client relationship. Under section 10A, it will be more difficult for the auditor to readily obtain the confidence of the client’s management or play a significant role in assisting management in resolving issues and problems that may arise. Given the complexity and collusive nature of many illegal acts, section 10A may offer little, if any, additional assurance that such acts will now be detected and reported in a timely fashion.

VII. RECENT EFFORTS BY THE ACCOUNTING PROFESSION TO ENHANCE THE AUDITOR’S DETECTION OF FRAUD

A. Statement on Auditing Standard No. 82

The Auditing Standards Board of the AICPA recently issued a new auditing standard (“Fraud Standard”) to provide enhanced operational guidance on the consideration of fraud in conducting a financial statement audit. The Fraud Standard was drafted in response to the expectation gap between the accounting profession and the public regarding the auditor’s responsibilities to detect and report fraud.

250. The term “fraud” refers to intentional acts that encompasses both (i) fraudulent financial reporting and (ii) misappropriations of assets. See Statement on Auditing Standards, supra note 9, No. 82, ¶ 3; see also id. ¶¶ 2-10.

251. Specifically, the Fraud Standard (i) “[d]escribes fraud and its characteristics”; (ii) “[r]equires the auditor to specifically assess the risk of material misstatement due to fraud and provides categories of fraud risk factors to be considered in the auditor’s assessment”; (iii) “[p]rovides guidance on how the auditor responds to the results of the assessment”; (iv) “[p]rovides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud”; (v) “[d]escribes related documentation requirements”; and (vi) “[p]rovides guidance regarding the auditor’s communication about fraud to management, the audit committee, and others.” Id. at ¶ 1.

252. See Proposed Statement on Auditing Standards, Consideration of Fraud in a Financial Statement Audit 8 (May 1, 1996) [hereinafter Proposed Statement on Auditing Standards].
rather than as a result of the audit requirements outlined in the Reform Act. In issuing a new auditing standard that specifically addresses fraud (i.e., irregularities), the accounting profession obtained the "add[ed] assurance that the responsibility of the auditor regarding detection of material misstatement due to fraud is appropriately addressed." The Fraud Standard requires the auditor to separately assess the risk of a material misstatement due to fraud in designing the audit procedures. In making this assessment, the auditor should focus on "fraud risk factors" that increase the likelihood that fraudulent activity may exist. The risk factors are distinguished by whether they relate to fraudulent financial reporting or misappropriation of assets. The Fraud Standard offers the auditor additional guidance by listing examples of risk factors which the auditor might consider when assessing the risk levels. In addition, the auditor should also consider any other risk factors based on their knowledge and experience of the company's operations and industry, management structure, and internal controls.

Once the risk assessment is completed, the auditor must determine whether the nature, timing, and extent of planned audit procedures needs to be modified or supplemented with more extensive procedures. In making this decision, the auditor should also consider the expertise of the

Auditing Standards Board was also influenced by the findings and recommendations made by the POB and Treadway Commission regarding the expectation gap "relating to the detection of material misstatement in financial statements resulting from fraud." Id. at 7; see also supra notes 117 and 180.

253. While the Fraud Standard applies to audit engagements of both privately and publicly held entities, the Reform Act applies solely to companies that are registered with the SEC.

254. See supra note 43.


256. See Statement on Auditing Standards, supra note 9, No. 82, ¶ 12.

257. See id.

258. These risk factors are grouped into three categories, namely, (a) management characteristics, e.g., "management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process"; (b) industry conditions, e.g., those risks relating to the "economic and regulatory environment in which the entity operates"; and (c) operating characteristics and financial stability, e.g., those risks relating to the "nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability." Id. ¶ 16.

259. These risk factors are grouped into two categories, namely, (a) susceptibility of assets to misappropriation, e.g., those relating to the "nature of an entity's assets and the degree to which they are subject to theft" and (b) controls, e.g., those risks that "involve the lack of controls designed to prevent or detect misappropriations of assets." Id. ¶ 18.

260. See id. ¶¶ 17, 19.

261. See id. ¶¶ 19-25.

262. See id. ¶¶ 26-32.
engagement team, the availability of necessary information and documents, and the potential effect the assessed risk may have on the audit report. In order to make a meaningful assessment of the perceived risk attributable to fraud, the auditor must possess an understanding of the company’s operations and internal control structure.263

If, after the audit procedures are performed, a misstatement is identified, the auditor must determine whether such misstatement “may be indicative of fraud” and whether it may be material to the financial statements.264 At this stage, it may be necessary for the auditor to perform additional procedures in order to determine whether a material fraud exists.265 The results of the auditor’s investigation may reveal a significant fraud that warrants a communication with the audit committee and the possibility that the auditor resign from the engagement.266 In addition, it is critical that the audit working papers clearly reflect the auditor’s assessment of risk attributable to fraud, planned audit procedures, and any additional steps necessary, based on the auditor’s judgment, to detect or dispose of any material misstatements.267

The Fraud Standard provides that in cases where the auditor has determined that a fraud may exist, the matter should be brought to the attention of management “even if the matter might be considered inconsequential.”268 The proposed standard recognizes that while the auditor does not generally have a duty to disclose fraud to parties other than the client’s audit committee or its functional equivalent, such a duty may arise in cases where the auditor is complying with certain legal and regulatory requirements,269 including, but not limited to, the auditor’s responsibilities under section 10A of the Reform Act270 and in connec-

263. See supra note 19.
264. Statement on Auditing Standards, supra note 9, No. 82, ¶ 34.
265. See id. ¶ 35.
266. See id. ¶ 36.
267. See id. ¶ 37.
268. Id. ¶ 38 (emphasis added). Under the Reform Act, such inconsequential matters need not be communicated to the audit committee. See 15 U.S.C. § 78j-1(b)(1)(B) (Supp. I 1995). By advocating a lower standard in determining whether an item should be communicated to management, the auditor will protect himself if the matter is later judged to be significant or identified by management independent of the audit process.
269. See Statement on Auditing Standards, supra note 9, No. 82, ¶ 40. In addition, the auditor may disclose such matters in connection with a communication with a successor auditor, see id. No. 7, § 315, in response to a subpoena, and in accordance with certain governmental regulations, see id.
tion with the SEC Form 8-K filing.\textsuperscript{271}

B. Statement of Position\textsuperscript{272} 94-6

Statement of Position ("SOP") 94-6, "Disclosure of Certain Significant Risks and Uncertainties," provides specified standards to be applied against risks and uncertainties that regularly affect an entity in order to limit disclosure to "matters significant to a particular entity."\textsuperscript{273} The risks and uncertainties addressed by SOP 94-6 require disclosure in four areas: (i) the nature of the entity's operations,\textsuperscript{274} (ii) estimates used by management in preparing the financial statements,\textsuperscript{275} (iii) certain significant estimates,\textsuperscript{276} and (iv) a possible vulnerability due to certain concentrations\textsuperscript{277} in aspects of the entity's operations.\textsuperscript{278} The SOP also

\textsuperscript{271} See supra note 131.

\textsuperscript{272} SOPs are issued by the Accounting Standards Executive Committee, the senior technical body of the Accounting Standards Division of the AICPA, and generally involve a reporting issue in a given industry. See DONALD E. KIESO & JERRY J. WEYGANDT, INTERMEDIATE ACCOUNTING 17-18 (8th ed. 1995).

\textsuperscript{273} DISCLOSURE OF CERTAIN SIGNIFICANT RISKS AND UNCERTAINTIES, Statement of Position No. 94-6, § 10,640 (Accounting Standards Executive Comm. 1994) [hereinafter SOP 94-6].

\textsuperscript{274} The financial statements should disclose a description of the "major products or services [of] the reporting entity . . . and its principal markets." Id. § 10,640.10. In addition, the entity should disclose the "relative importance of its operations in each business and the basis for the determination" in both qualitative and quantitative terms. Id.

\textsuperscript{275} The entity should disclose that "financial statements in conformity with GAAP" require the use of estimates by management. Id. § 10,640.11.

\textsuperscript{276} SOP 94-6 provides that accounting pronouncements typically require disclosure about uncertainties and estimates affecting amounts reported in the entity's financial statements. See id. § 10,640.12. Certain significant estimates are used by management when disclosing amounts related to (a) inventory, (b) depreciation, (c) litigation reserves, (d) deferred tax receivables and payables, (e) long-term construction contracts, (f) capitalized software costs, (g) the net realizable accounts receivable, and (h) the carrying value of fixed assets. See id. § 10,640.18, app. A § 10,640.27. Disclosure of significant estimates is required when known information is available with respect to changes in the estimate, the effect of which would be material to the financial statements. See id. § 10,640.13.

\textsuperscript{277} "Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification." Id. § 10,640.20. This includes concentrations in the following areas: (a) "the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor"; (b) "revenue [derived] from particular products, services, or fund-raising events"; (c) "available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations"; and (d) "the market or geographic area in which an entity conducts its operations." Id. § 10,640.22 (footnote omitted). SOP 94-6 specifically excludes disclosures relating to concentrations of financial instruments. See id. § 10,640.23. In such cases, disclosure is required if the entity is vulnerable to a severe impact, i.e., a "significant financially disruptive effect on the normal functioning of the entity" in the near-term, i.e., a "period of time not to exceed one year from the date of the financial statements." Id. §§ 10,640.07, 21.
provides illustrative language to be used by the auditor in assisting management in drafting the appropriate disclosures,\textsuperscript{279} as well as background information and sources of information to assist the auditor in forming the basis of his conclusions.\textsuperscript{280} Similar to the proposed audit standard, the SOP will enable the auditor to detect and report significant risks affecting the client's business to the investing public.\textsuperscript{281}

The immediate impact on the auditor will be a determination that the required disclosures are properly made. This may be accomplished through the use of disclosure checklists which enable the auditor to evaluate the issuer's compliance with SOP 94-6.\textsuperscript{282} In addition, the auditor will likely need to revise existing audit programs and possibly design new audit procedures in light of the required disclosures under SOP 94-6.\textsuperscript{283}

\textbf{VIII. CONCLUSION}

By enacting section 10A, Congress codified audit requirements already existing under GAAS and extended the auditor's reporting requirement to include a direct communication with the board of directors and possible notification filed with the SEC. In doing so, Congress vested the auditor with the "broader duty to search and sing,"\textsuperscript{284} thereby making the auditor the public's fraud detective. More importantly, by including this duty as an anti-fraud provision, rather than a periodic reporting requirement provision, the auditor will be subject to both greater scrutiny and penalty for noncompliance.

The increased investor protections expected through earlier reporting

\textsuperscript{278} See id. § 10,640.02. SOP 94-6 does not, however, encompass risks and uncertainties associated with "management or key personnel, proposed changes in government regulations, proposed changes in accounting principles, or deficiencies in the internal control structure." Id. § 10,640.04 (footnote omitted).

While issuers have been able to implement disclosures in their financial statements with respect to the nature of the company's operations and the use of estimates, definitional problems with the meaning of such phrases as "reasonably possible" and "severe impact" have resulted in implementation problems with respect to the disclosure of significant estimates and the issuer's vulnerability due to certain concentrations. See C. Richard Baker, \textit{Implementing the SOP on Risks and Uncertainties}, CPA J., Feb. 1997, at 36, 37.

\textsuperscript{279} See SOP 94-6, supra note 273, app. A § 10,640.27.

\textsuperscript{280} See id. app. B § 10,640.28.

\textsuperscript{281} For examples of SOP 94-6 disclosures in recently issued financial statements, see Baker, supra note 278, at 39-41.

\textsuperscript{282} See id. at 52.

\textsuperscript{283} See id.

\textsuperscript{284} DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990).
to the SEC will be offset by an equal decrease in the level of trust that exists between the client and auditor. Indeed, the Seventh Circuit noted that "[s]uch a duty would prevent the client from reposing in the accountant the trust that is essential to an accurate audit."\(^{285}\) This will place a limitation on the auditor’s access to information essential in detecting instances of management fraud and run directly counter to Congress’s express intention that such acts be subject to an enhanced reporting requirement.

As previously indicated, accounting firms are likely to increase their audit fees to reflect both the additional procedures and greater liability assumed in cases where the auditor is judged to have failed to comply with the fraud detection and reporting provisions of section 10A. The DiLeo court noted that this will result in companies refusing to pay the additional fees or reducing those accounting services purchased in addition to the audit.\(^{286}\) This will ultimately hurt the investor as the company will be spending more of the company’s earnings on the audit, while receiving a reduced level of auditor oversight of the company’s activities.\(^{287}\)

Like all new legislation, many of the real effects of section 10A will be determined by future action taken by the courts and the SEC. As ambiguities in the statute are resolved and clearer standards are established, Congress will need to do a postmortem and determine whether it has achieved its objective of greater investor protection and a more credible financial reporting process.\(^{288}\)

For the accountant, however, the political compromise is clear. Congress traded the accounting profession proportionate liability in exchange for the auditor becoming the public’s primary tool for policing

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285. Id. ("Firms would withhold documents, allow auditors to see but not copy . . . if they feared that access might lead to destructive disclosure . . . [for] fear that one of its . . . auditors would misunderstand the situation and ring the tocsin needlessly, with great loss to the firm.").
286. See id.
287. See id.; see also Goldwasser, supra note 232, at 75 ("[Management] may become less candid with their auditors in an effort to avoid unnecessary witch-hunts. In this respect, Section 10A may actually make financial statements less (and not more) effective.").
288. Senator Wyden, the principal author of section 10A, stated that he was "pleased with the recent work of the accounting profession and the [SEC] in clarifying the role of auditors in detecting fraud." Senator Lauds Efforts to Uncover Fraud, J. ACCT., May 1997, at 13, 13. Additionally, both Senator Wyden and SEC Chairman Levit noted that the new auditing standard, Statement on Auditing Standard No. 82, will improve the detection of fraud and is consistent with the objectives of section 10A. See id.
and reporting corporate fraud. Time will only tell whether the public’s interests were best served by the accounting profession’s and Congress’s strong support for this new legislation.

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