Congressional Oversight: Interpreting the Phrase "Financial Statements" Within Section 10A of the Securities Exchange Act of 1934

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NOTE

CONGRESSIONAL OVERSIGHT: INTERPRETING THE PHRASE "FINANCIAL STATEMENTS" WITHIN SECTION 10A OF THE SECURITIES EXCHANGE ACT OF 1934

I. INTRODUCTION

In the fall of 2001, Enron Corporation ("Enron"), a company whose stock once traded at ninety dollars per share, announced that it had overstated its net income by $583 million. This announcement was the impetus behind a sell off in Enron stock that, at the end of 2001, culminated in the stock price reaching levels as low as eighty-seven cents per share. Essentially, "Enron came unglued as a result of a loss of investor confidence in the honesty of its accounting." As a result of its collapse, Enron filed for bankruptcy in what was at the time, "the biggest such filing in U.S. history." Additionally, many of Enron’s employees lost their entire savings as their 401(k) plans, which were largely funded with Enron stock, were wiped out. The recent activities of Enron and Arthur Andersen, Enron’s outside auditor, have prompted the Securities

3. See Jonathan Weil, Audits of Arthur Andersen Become Further Focus of Investigation by SEC, WALL ST. J., Nov. 30, 2001, at A3 (stating that Enron lost $75 billion of market value due to accounting improprieties); see also Emshwiller & Smith, supra note 1 (stating the low price of Enron’s stock).
and Exchange Commission ("Commission") to conduct an investigation into Enron's accounting practices.\footnote{7}

In June of 2002, the telecommunications giant, WorldCom, Inc. ("WorldCom"), announced that it had overstated its net income by nearly $4 billion in what has been dubbed "one of the largest accounting frauds in history."\footnote{8} Soon after publicly revealing its accounting overstatement, WorldCom filed for bankruptcy protection and surpassed Enron to be crowned the largest company to file for bankruptcy in history.\footnote{9}

The Enron and WorldCom sagas are merely the tip of the iceberg in the realm of accounting fraud.\footnote{10} Once large, stalwart companies have recently crumbled due to the dismantling of their accounting house of cards. The problem has become so rampant that, in 1998, it became the Commission's Division of Enforcement's number one priority.\footnote{11} The then director of the Division of Enforcement, Richard H. Walker, issued a "call to arms" to the Commission to crack down on accounting fraud and stressed the importance of outside auditors in the process of detecting it.\footnote{12} Although the Commission was (and still is) well intentioned on curbing accounting abuses, its limited resources greatly inhibit its ability to achieve that goal. Consequently, the Commission must go outside its doors for investigatory assistance often "relying on the press [and] company whistleblowers"\footnote{13} for leads.\footnote{14}

The old adage "an ounce of prevention is worth a pound of cure" has no more importance than in the realm of detecting financial

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7. See Weil, supra note 3, at A3.
10. See Coffee, Jr., supra note 4, at 1406-07 (describing the nexus between earnings restatements and accounting frauds and stating that the number of restatements has increased precipitously from 1997 to 2000).
12. See Walker, supra note 11.
13. Whistleblowers were so instrumental in the uncovering of accounting fraud at both Enron and WorldCom, Inc. that Time Magazine named two corporate insiders, Sherron Watkins of Enron and Cynthia Cooper of WorldCom, its Persons of the Year for 2002. See James Kelly, The Year of the Whistle-Blowers, TIME, Dec. 30, 2002, at 8. Ms. Watkins and Ms. Cooper are symbols of honesty and courage in a corporate climate of greed, deception, and intimidation that oftentimes turns would be whistleblowers into willfully blind facilitators.
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reporting fraud. By curing a fraud before its effects are cemented into a set of financial statements, regulators can save investors millions of dollars in potential trading losses. The aforementioned sources, although effective in an "after-the-fact" way, provide little preventative means for curing fraudulent behavior. The press usually can only conduct investigations based on public information and it oftentimes takes whistleblowers years to uncover fraud or build up enough courage to say something about it. Therefore, the Commission has sought ways to uncover accounting improprieties before fraud-ridden financial statements are released to the public. One way to accomplish this goal is to place pressure on a company's outside auditors, who must certify a company's financial statements before public release, to report accounting fraud to the Commission in advance of public filings.

Auditors are often considered "the first line of defense in the fight against fraud." Currently, four main auditing firms exist in the United States and each are paid by companies to audit their financial statements. The purpose of such audits is to certify, to a certain level of reasonableness and materiality, that company-prepared financial statements are accurate. Without an audit, investors could only rely on the representations of a company's management, who may be too self-interested to be credible. The purported independence and astute financial acumen of auditors makes them the strongest weapon in the Commission's fraud-fighting arsenal.

Yet, due to the nature of the relationship between auditors and their clients, auditors are oftentimes under tremendous pressure "to produce earnings growth", and this pressure can turn auditors into "enablers." Many see the conflicting nature of the auditor-client relationship as causing auditors to forsake "their traditional role of outside skeptic for that of inside business partner and [transforming] ... their age-old function of discloser of information for that of master magician who

15. See id. (stating that Commission accountants have been looking for ways to discover accounting fraud earlier).
16. Id.
hides the financial rabbit." Because of the incestuous relationship between auditors and the companies they audit, a legal duty to report fraud to the Commission before it is made public is necessary not only to prevent investor losses but also to ensure that auditors will even report fraud.

In 1995, Congress overrode a presidential veto and passed the Private Securities Litigation Reform Act ("PSLRA"). The PSLRA was enacted as a response to an alleged overabundance of securities lawsuits brought by shareholders against public companies. The PSLRA's main purpose was to deter securities litigation. Nevertheless, Congress, within the PSLRA, amended the Securities Exchange Act of 1934 to include section 10A ("10A"). 10A states, in pertinent part, that if "in the course of conducting an audit" an "independent public accountant detects or otherwise becomes aware of information indicating that an illegal act ... has or may have occurred," the accountant must

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20. Id. The auditor-client relationship provided for conflicts in two main ways. First, the fact that clients pay auditors for their services creates an opportunity for clients to threaten dismissal if auditors do not acquiesce to aggressive accounting policies. Secondly, auditing firms would often sell consulting services with their auditing services. Consulting contracts were extremely lucrative and clients often used the contracts as leverage against auditors. See Coffee, Jr., supra note 4, at 1408-16. With the passage of the Sarbanes-Oxley Act of 2002, however, auditors are no longer allowed to perform certain non-audit services for their audit clients. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. § 78j-1 (2002)). The act therefore eliminated one of the conflicts inherent in the auditor-client relationship; however, the fact that auditors are paid by the companies they audit is a conflict that still exists.


22. See id. at 1262 (stating that one of the purposes of the PSLRA was to assure "that the litigation process is not used for abusive purposes and does not unfairly target defendants who are guilty of no wrongdoing").


24. See Reiss, supra note 21, at 1266 (stating that the "Reform Act's statutory audit requirements were codified by adding section 10A to the Securities Exchange Act of 1934").

determine whether an illegal act is "likely" to have occurred. If it is likely that an illegal act has occurred, the auditor must report her findings to an appropriate level of management and the audit committee of the board of directors. After informing the company’s management and audit committee, the auditor is required to determine if the "illegal

26. 15 U.S.C. § 78j-1 (2003). This section is otherwise known as section 10A ("10A") and states, in part:

(b) Required Response to Audit Discoveries-

(1) Investigation and Report to Management.
If, in the course of conducting an audit..., the independent public accountant detects... information indicating that an illegal act... has or may have occurred, the accountant shall...

(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... and

(B) as soon as practicable, inform the appropriate level of management of the issuer and assure that the audit committee of the issuer... is adequately informed with respect to illegal acts... unless the illegal act is clearly inconsequential.

(2) Response to Failure to Take Remedial Action
If, after determining that the audit committee of the board of directors of the issuer... is adequately informed with respect to illegal acts... 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... the independent public accountant shall... 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 public accountant shall—

(A) resign from the engagement; or

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

(4) Report After Resignation
If a registered public accounting firm resigns from an engagement under paragraph (3)(A), the firm 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 report of the firm (or the documentation of any oral report given).


27. See id.
act has a material effect on the financial statements of the issuer” and, if so, whether or not management has taken the appropriate steps to remedy the fraud. If the illegal act is material to the financial statements and management has not taken adequate steps to remedy it, the auditor is required to report the act directly to the board of directors. When the board of directors receives the auditor’s report, it has only one day to submit it directly to the Commission. If the board does not report the fraud directly to the Commission, the auditor is required to do so.

10A places a legal duty on auditors to report fraud to a company’s board of directors or the Commission. The threat of legal liability for failure to report a fraud would seem to be a motivating factor for auditors to comply with their 10A duties. However, to date, very few 10A reports have been filed with the Commission. In explaining why so few reports had been filed, the Commission expressed concern that auditors were failing to comply with their duties. Perhaps one of the reasons why auditors may be failing to comply with 10A is the ambiguous nature of its language. Specifically, the phrase “financial statements” within the statute is not defined and, thus, may refer only to the actual audited financial statements or to the audited and non-audited financial statements that contain fraud discovered during an audit.

This Note examines the general mechanics of financial statement fraud, its effect on investors, and the government’s battle to stop it. It will focus on the government’s recent attack on financial fraud, via 10A, and, in particular, how the phrase “financial statements” within the statute could be used as a means of circumventing the act’s requirements. Part II of this Note discusses how past audit failures to detect and report fraud and the need for the auditor as part of a “multi-party gatekeeper enforcement regime” led to the passage of 10A. Part III describes some of the most notorious accounting ploys and discusses

28. Id.
29. See id.
30. See id.
31. See id.
32. See Riesenberg, supra note 25, at 1445-46.
33. See id. at 1445 n.149.
34. Peter C. Kostant, Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice, 84 MINN. L. REV. 1213, 1235-40 (2000) (defining the multi-party gatekeeper regime as a group of corporate insiders, namely directors and members of the audit committee, and outsiders, namely independent auditors, who are responsible for “detecting and preventing corporate wrongdoing”).

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the mechanics of the most common type of accounting fraud, improper revenue recognition. Part IV explains the statutory ambiguity that exists within 10A and Part V describes the reasons for interpreting the phrase “financial statements” to mean both year-end and quarterly financial statements. Part VI concludes by discussing how closing the 10A loophole will affect fraud detection in the future.

II. WHY CONGRESS PASSED 10A

Auditors are the crucial component of the “multi-party gatekeeper regime” that has become necessary in providing a check on improper corporate governance. Part of an auditor’s duty as gatekeeper is to provide for “accurate financial disclosure of public corporations.” The auditor’s gatekeeper duties were legalized in the Supreme Court’s decision in United States v. Arthur Young & Co., which explained that auditors have a primary duty to the investing public to ensure accurate financial reporting. The duty stated in Arthur Young was reiterated in 1987 by the Report of the National Commission on Fraudulent Financial Reporting (“Treadway Commission”). In its report, the Treadway Commission stated that financial fraud was prevalent in the corporate world. One of its recommendations was to create corporate gatekeeper duties for auditors. The gatekeeper function of the auditor is paramount to the goal of protecting the investing public from fraudulent financial reporting. As stated earlier, without the independent auditor, investors would have to rely mostly on insiders (i.e., management, the audit

35. Id. at 1215-16 (discussing the auditor’s role as a watchdog for corporate malfeasance); see Coffee, Jr., supra note 4, at 1405 (defining gatekeepers as “reputational intermediaries who provide verification and certification services to investors”). Coffee goes on to state the main corporate gatekeepers, which include independent auditors, debt-rating agencies, securities analysts, and, to a lesser extent, corporate lawyers. See id.

36. Kostant, supra note 34, at 1215; see Coffee, Jr., supra note 4, at 1405 (describing the gatekeeper’s duties as “assess[ing] or vouche[ing] for the corporate client’s own statements about itself or a specific transaction”).


38. See Kostant, supra note 34, at 1225 n.51.

39. See id.

40. See id. at 1238 n.107.

41. See Bernhard Grossfeld & Werner Ebke, Controlling the Modern Corporation: A Comparative View of Corporate Power in the United States and Europe, 26 Am. J. Comp. L. 397, 421 (1978) (stating that devices such as shareholder derivative lawsuits are rarely ever used to enforce “directors’ and officers’ liability”).
committee, and the board of directors) to provide for accurate financial reporting. However, relying on insiders is often a bad idea because they have incentives to intentionally misstate financial statements. These incentives arise from the fact that corporate managers’ compensation, and oftentimes their jobs, depend on meeting certain profit figures. Because of the importance of the auditor, Congress has passed laws attempting to ensure that they meet their duty to the investing public.

A. Section 10(b) of the Securities Exchange Act of 1934 and Its Effect on Auditors

The most widely known antifraud provision of the securities laws is section 10(b) of the Securities Exchange Act of 1934 ("10b"). 10b makes it illegal to "employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . ."[46] Under this section, a fraudulent actor must have acted with "scienter" in order to be found liable. Scienter is a term that

42. Although independent auditors have a very important gatekeeper role because of their independence, independent audit committee members need to become increasingly involved in the oversight of corporate financial managers. See Kostant, supra note 34, at 1235-43. The Blue Ribbon Committee, a committee established to report on improving the effectiveness of corporate audit committees, has suggested that audit committees be composed of only independent directors. See Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 54 BUS. LAW. 1067, 1072 (1999). This report recognized the importance of having independent audit committees work side-by-side with outside auditors as participants in the "multi-party gatekeeper regime" Kostant, supra note 34, at 1215. Perhaps as a result of the Blue Ribbon Committee's report, Congress now requires that audit committee members be independent. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. § 78f (2002)).

43. See Schroeder, supra note 14.

44. See id.

45. 15 U.S.C. § 78j(b) (2003). This statute is otherwise known as section 10(b) ("10b") and states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

46. Id.

requires an actor to have acted with "intent to deceive, manipulate, or defraud." Thus, negligent actors will not be liable under 10b. Furthermore, reliance under 10b is presumed and, thus, does not have to be proven by plaintiffs.

Although 10b was enacted to deter financial fraud, its scienter requirement made it difficult to apply to auditors. Plaintiffs found it difficult to accuse auditors of having the requisite fraudulent intent, since they usually have no role in the creation of a company's financial statements, they merely check those numbers for accuracy. In response to plaintiffs' complaints, the courts imputed aider and abettor liability in 10b cases. Although most aiders and abettors do not possess the requisite level of fraudulent intent required by 10b, the courts justified the inclusion of aider and abettor liability by citing to the remedial purposes of the securities laws. The introduction of aider and abettor liability in the securities laws had a chilling effect on the accounting industry. Such liability made it possible for auditors to be held equally as liable for accounting fraud as the managers who actually orchestrated such frauds. The threat of 10b liability provided an incentive for auditors to scrutinize financial statements with the level of independence required by the investing public. This threat, however, dissipated with the Supreme Court's 1994 decision in Central Bank of Denver v. First Interstate Bank of Denver.

In Central Bank, the Court ruled that implying aiding and abetting liability in 10b was not within the legislative intent of the statute. In denying such liability, the Court stated that, even though the language of 10b includes actors who both directly and indirectly participate in fraud,

48. Id. at 193.
50. For discussion about auditor's liability under 10b, see generally Robert A. Prentice, Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(B), 75 N.C. L. REV. 691 (1997).
52. See Brennan, 259 F. Supp. at 680-81 (stating that the imposition of aider and abettor liability was to "emphasize that a statute with a broad and remedial purpose such as the Securities Exchange Act of 1934 should not easily be rendered impotent to deal with new and unique situations . . .").
53. 511 U.S. 164 (1994). The decision in Central Bank has been described as one of the most important securities law decisions in a number of years due to the effect it would have on chilling securities law suits. See Prentice, supra note 50, at 694-95.
“aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity.” With the decision in *Central Bank* now etched in stone, investors that want to sue auditors for financial fraud must allege that they were active participants and possessed the requisite mental state.  

B. **Section 18(a) of the Securities Exchange Act of 1934**

A much narrower remedy for aggrieved investors is section 18(a) of the Securities Exchange Act of 1934 ("18a"). 18a provides that a person may be found liable for making or causing to be made "materially misleading statements in any reports or other documents filed with the Commission . . . ." The Supreme Court has stated that an auditor who allows materially misstated financial statements to be filed with the Commission may be liable for damages under 18a. The purpose of 18a is to encourage reliance on documents filed with the Commission and, thus, the section is limited to only such documents.

55. At least one commentator has argued that such a line between primary and secondary liability for auditors, for the most part, does not exist and, thus, there would be no need to provide additional evidence of an auditor’s participation in a financial fraud if it can be proven that the corporation being audited (primary actor) committed a fraud. The argument centers around the fact that auditors are so involved in the process of disseminating information about a company to the public that they are essentially primary actors and should be held equally as liable. See generally Prentice, *supra* note 50, at 696. The author does admit, however, that most lower courts have delineated a difference between primary and secondary liability with respect to auditors. See id. at 723-25.
56. 15 U.S.C. § 78r(a) (2003) otherwise known as section 18(a) ("18a") states, in pertinent part:

(a) Persons liable; persons entitled to recover; defense of good faith; suit at law or in equity; costs, etc.

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. . . ."

Id.

57. Id.
The statute also allows for a “due diligence” defense if an auditor acted in “good faith and had no knowledge that [a] statement was false or misleading.” The Court has said that such a defense raises the requisite mental state for the section to something “more than negligence.” The Court’s statement suggests that an auditor would have to be grossly negligent in her audit in order to be liable. Such a standard knocks on the door of a scienter requirement and, thus, makes it very difficult for any auditor to be found liable for violating 18a. An additional difficulty is the requirement that plaintiffs prove actual reliance on the misstated financial statements. Proving reliance requires evidence that investors purchased securities based on reviewing a company’s Commission filings, many of which are voluminous and indecipherable to the untrained eye. Such a scenario is extremely unlikely due to the size of the investing public and the number of security trades conducted on a daily basis.

Although auditors may be found liable under both 10b and 18a, each section has its own, unique hurdles. Reliance under 10b is presumed, however, proving an auditor was a primary actor acting with scienter may be difficult. Alternatively, the mental state requirement under 18a is a little lower than 10b, but one must prove actual reliance on Commission filings. Thus, each section insulates auditors in its own special way. The ineptitude of each section as it relates to auditors has forced Congress to impose affirmative duties on auditors to report frauds to a company’s board of directors and, possibly, the Commission. These new duties materialized in 10A.

C. Legislative History of 10A

The legislative history of 10A dates back to 1986 and the Financial Fraud Detection and Disclosure Act. This act was a response to the savings and loan crisis and required auditors to establish audit procedures to detect financial fraud as well as “report [fraudulent
activities] to appropriate regulatory and law enforcement authorities.\(^6^4\)

The sponsor of the Financial Fraud Detection and Disclosure Act, then Representative (now Senator) Ron Wyden, stated that the purpose of the legislation was to "provide assurances to Congress and the public that illegal and irregular activities . . . [would] be discovered and reported to the proper regulatory authorities . . . .\(^6^5\) The auditing industry opposed the new requirements to detect illegal acts because of the resulting increase in audit costs.\(^6^6\) Alternatively, the industry proposed that it address the problems through non-legislative means.\(^6^7\) In addition to the accounting industry, the bill met criticism from the Commission.\(^6^8\) The Commission felt the act would ""inhibit candid communication with the client [and] create an adversarial relationship between the auditor and his client."\(^6^9\)

Another issue was the broad language of the statute. As originally proposed, the statute covered ""any illegal or irregular

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64. See Riesenberg, supra note 25, at 1423 (citing the Hearings on Detecting and Disclosing Financial Fraud Before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, 99th Cong. 302 (1986)).

65. Reiss, supra note 21, at 1282 n.110 (citing the preamble of H.R. 4886, The Financial Fraud Detection and Disclosure Act).


67. See id. at 442 (stating that the accounting profession had suggested, in response to Congressional scrutiny, establishing "a wide variety of non-legislative reforms, including more stringent professional standards for the detection and disclosure of fraudulent financial reporting . . . .") The AICPA, American Institute of Public Accountants, has passed auditing standards that require auditors to establish procedures to detect fraud. See Jeanne Calderon & Rachel Kowal, Auditors Whistle an Unhappy Tune, 75 DENV. U. L. REV. 419, 430-39 (1998) (discussing the provisions for reporting illegal acts set forth in AICPA Statement of Auditing Standards ("SAS") No. 53 & 82). These provisions require auditors to separately assess the risk of fraud and design audit procedures to detect it; however, they do not require an auditor to report fraud to parties outside the audit client unless a separate legal duty requires them to do so. See id.

The self-regulatory aspect of the auditing industry came under tremendous criticism during the Enron scandal. See Nanette Byrnes et al., Accounting In Crisis, BUS. WK., Jan. 28, 2002 at 44, 45-46. One of the criticisms was the fact that the Public Oversight Board ("POB"), which was "charged with ensuring that the public interest is considered in the oversight of auditors" was entirely funded by auditing firms. Id. at 45. The problems with the system were so serious that even members of the accounting industry had admitted that it needed change. See id. at 46. This change occurred in 2002 with the passage of the Sarbanes-Oxley Act. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. § 78j-1 (2002)). The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board ("PCAOB"), which replaced the POB as the main regulator of public auditing firms. See id. The PCAOB is funded entirely from mandatory fees from public companies, rather than from the auditing industry. See id.

68. See Riesenberg, supra note 25, at 1422 (citing testimony from the SEC and Corporate Audits (Part 6): Hearings on Detecting and Disclosing Financial Fraud Before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, 99th Cong. 302 (1986)).

69. Id.
activity’” and critics worried that such a standard would require auditors to report such things as “parking ticket[s] or stolen pencil[s].”

Responding to the criticism, Wyden amended his original proposal to incorporate only those illegal acts that were deemed “material.” Furthermore, the amended bill would allow a company’s management to be put on notice of any material, illegal acts being reported to regulators. Although these changes should have quelled the statute’s critics, the statute was never passed.

Wyden tried again in 1990, this time with the assistance of Representative John Dingell. The 1990 bill was drafted to mirror the auditing industry’s own fraud detection standards and was passed by the House of Representatives as part of a larger bill. The Senate version of the larger bill, however, did not include Wyden’s amendments and his amendments never made it into the ultimate bill drafted by the Conference Committee.

Wyden’s persistence finally paid off in the end. In 1995, Congress again addressed the issue of fraud detection by including a provision to detect and report fraud in the PSLRA. The PSLRA was eventually passed in 1995 and 10A became the statutory embodiment of Wyden’s desire to add an extra layer of investor protection against fraud in financial statements.

### III. ACCOUNTING FRAUD

Enron and WorldCom are just a couple of big name companies that have been involved in accounting scandals. During 1999, fifty-five percent of securities class action cases were based on accounting fraud. Furthermore, as of July 2001, the Commission was conducting nearly 260 investigations for accounting fraud. Historically, the number of accounting fraud cases has increased twenty-eight percent over the past

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70. Id. at 1423 (citing 132 Cong. Rec. E2986 (daily ed. Aug. 15, 1986)).
71. Id. (citing H.R. 5439, 99th Cong. § 2 (1986)).
72. See id.
73. See id.
74. See id.
75. See id. at 1424.
76. See id.
77. See id. at 1426-28.
78. See id.
79. See Schroeder, supra note 14.
80. See Walker, supra note 11.
81. See Schroeder, supra note 14.
three years and the high number of investigations is not limited to small companies but includes many of the nation's largest corporations.\textsuperscript{82}

When an accounting fraud is made public, investors lose millions of dollars as stock prices tumble.\textsuperscript{83} However, before the act is made public, fraudulently inflated earnings may artificially increase the price of a stock.\textsuperscript{84} Since many corporate executives' compensation packages are tied to the price of their company's stock, there is a huge incentive to manipulate reported earnings.\textsuperscript{85} Additionally, when the overall stock market is thriving, companies may need to manipulate earnings in order to meet heightened profit projections to maintain the price of their stock.\textsuperscript{86} These incentives have allowed accounting fraud to transcend government regulations and remain a thorn in the side of regulators and the investing public alike.

There are five major types of accounting fraud that have been the focus of Commission investigations.\textsuperscript{87} The types of fraud, some of which are colorfully named, include: "'Big Bath Charges,'" "'Merger Magic,'" "'Cookie Jar Reserves,'" "'abuse of the definition of materiality,'" and "inappropriate revenue recognition practices."\textsuperscript{88}

In a Big Bath Charge, a company will overestimate one-time restructuring charges in the hopes of adding the overestimated amount into income in future years.\textsuperscript{89} When a company restructures itself, either by closing certain plants and facilities or laying off employees, accounting rules dictate that the costs related to the restructuring usually be reported, in full, in the period in which they are incurred.\textsuperscript{90}

\begin{thebibliography}{99}
\bibitem{82} See id.
\bibitem{83} See Holman W. Jenkins, Jr., Accounting for When Dreams Become Reality, \textit{WALL ST. J.}, June 13, 2001, at A21 (discussing the fate of companies such as Cendant and MicroStrategy and how shareholders lose most of their investment due to accounting improprieties).
\bibitem{84} See, e.g., The SEC Casts a Wide Net, \textit{BUS. WK.}, Oct. 11, 1999, at 50 (stating that a scheme to inflate earnings resulted in a significant amount of stock trading profits).
\bibitem{85} See Schroeder, supra note 14 (stating that "[t]he pressure to assure maximum compensation, which is tied to share price, is tempting more financial executives to play games to manage earnings . . . ").
\bibitem{86} See id. (stating that when companies miss analysts' quarterly earnings targets, stock prices can tumble).
\bibitem{88} Id.
\bibitem{89} See id; see also \textit{ARTHUR LEVITT, TAKE ON THE STREET} 160-61 (2002).
\bibitem{90} See Staff Accounting Bulletin No. 100, 64 Fed. Reg. 67, 154, 67, 155 (Dec. 1, 1999) (codified at 17 C.F.R. pt. 211) (stating that "the term 'restructuring charge' is not defined in the existing authoritative literature," but that "restructuring charges" usually include costs related to "the consolidation and/or relocation of operations, or the disposition or abandonment of operations..."
\end{thebibliography}
Oftentimes, companies restructure during times of economic difficulty, therefore, restructuring charges usually will not depress a stock price any further than the current financial condition of the firm has already. Accordingly, an overestimation of restructuring charges in one year can be added to earnings in subsequent years, thus inflating future earnings.

In Merger Magic accounting fraud, a company will expense non acquisition-related research and development costs as "in-process research and development" charges. In-process research and development represents the value of purchased research and development projects from acquired companies. The value of the acquired research and development projects may have been written off, in full, on the consummation date of an acquisition. Since other merger related costs are not expensed immediately but are capitalized and expensed over a period of time, classifying non in-process research and development costs as in-process research and development allows a company to immediately expense costs that would otherwise have to be expensed in the future. The benefit of expensing future costs in the year

or productive assets" and that the charges are usually incurred "in connection with a business combination, a change in an enterprise's strategic plan, or a managerial response to declines in demand, increasing costs, or other environmental factors"). The bulletin further states that "restructuring charges" are expensed either when management commits to a restructuring plan or when the costs are actually incurred. See id.

91. See id. (stating that a company usually restructures itself when management responds to "declines in demand"); see, e.g., Charles Gasparino, Rebuilding Wall Street: Bear Stearns Will Announce Big Staff Cuts, WALL ST. J., Oct. 18, 2001, at C1 (stating that investment bank Bear Stearns had to restructure itself by laying off workers due to poor economic conditions).

92. See Colleen P. Mahoney et al., Accounting, Fraud, Earnings Management and the Role of the Auditor, 27, 34 (PLI Corp. Law & Practice Course, Handbook Series No. B0-0002, 2000), WL 1203 PLI/Corp 27 (stating that companies may attempt to classify future expenses as one-time restructuring charges in the hopes that investors will ignore the charges).

93. See id.

94. See supra note 87, at 382.


96. See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the New York Stock Exchange, Inc. Relating to Amendments to the Listed Company Manual Regarding Original and Continued Listing Criteria and Procedures, 64 Fed. Reg. 23, 710-01, 23, 719 (May 3, 1999); see also KIESO & WEGYANDT, supra note 95, at 586.

97. KIESO & WEGYANDT, supra note 95, at 572-73. The largest expense that is created in a business combination, generally, is goodwill. Goodwill represents the excess of the purchase price over the value of the book value (assets minus liabilities) of the target company. See RICHARD E. BAKER ET AL., ADVANCED FINANCIAL ACCOUNTING 12 (4th ed. 1999). Prior to 2001, under APB Opinion No. 17, the cost of goodwill purchased in connection with a business combination had to be
of an acquisition is that a stock price is likely to be lower anyway in that year due to other acquisition related charges. Expensing more costs in the year of acquisition would, thus, have only marginal effects on a stock price.

Companies create Cookie Jar Reserves with accounting provisions that allow them to estimate certain expenses that have technically been incurred in one period but the actual amount of which is not yet known. Accounts such as “bad debts” and “warranty costs” are estimated because the actual amounts of these accounts may not be known until subsequent periods. The opportunity exists for companies to manipulate future earnings by intentionally over estimating the amounts for these accounts in one year and dipping into the “cookie jar” in subsequent years to add back overestimated amounts into future earnings.

The next type of accounting fraud results from a firm abusing materiality requirements. Accounting rules state that financial statement errors below a certain amount need not be changed for they are considered “immaterial.” Companies have been able to manipulate materiality standards by intentionally recording errors that fall under amounts considered “material.”

All of the aforementioned frauds are avenues for earnings management, or, as former Chairman of the Commission Arthur Levitt put it, “the practice of using accounting tricks to mask true operating performance.” One of the most popular ways to manage earnings is by improperly recognizing revenue. “In fact, more than half of

expensed (amortized) over a period not to exceed forty years. See id. at 14-15. However, in 2001, the Financial Accounting Standards Board changed the rules for amortizing goodwill. See Ernst & Young LLP, FASB Votes Unanimously to Approve New Business Combination Rules, 5 No. 3 M&A LAWYER (2001). Currently, goodwill does not have to be expensed systematically over a certain number of years but rather is subject to an “impairment” test every year. See id.

98. Mahoney, supra note 87, at 382; see also LEVITT, supra note 89, at 163-64.
99. See KIESO & WEYGANDT, supra note 95, at 84 (stating that certain account items are considered "estimated items because the amounts are not exactly determinable at the time they must be recorded.").
100. id. at 84, 642.
101. See Mahoney, supra note 87, at 34.
102. See id.
104. See Mahoney, supra note 87, at 34.
105. id. at 33.
106. See Jenkins, Jr., supra note 83.
accounting lawsuits revolve around what's tactfully known as 'premature revenue recognition.'”

According to accounting rules, revenue cannot be recorded until it is “realized or realizable and earned.” By recognizing revenue before or after it is actually earned, companies are able to manipulate financial data to either make up for earnings shortfalls or defer gains until subsequent periods. In order for revenue to be “earned,” there must exist persuasive evidence of a contractual arrangement, delivery of goods must have occurred or services must have been rendered, the seller must have a fixed and determinable price, and collectibility must be reasonably assured. If one of the above four criteria is not met, revenue cannot be reported on a company’s financial statements. However, companies may manipulate the revenue recognition rules in order to meet Wall Street earnings estimates. This type of manipulation necessitates stronger laws requiring auditors to report financial accounting fraud. 10A is such a law; however, it may be rendered moot in some cases if certain loopholes are not closed.

IV. STATUTORY AMBIGUITY WITHIN 10A

The ambiguity within 10A deals with its effect on frauds that are only material to quarterly financial statements but are not identified until the year-end audit. Auditors establish materiality thresholds when performing audits in order to prevent them from scrutinizing insignificant financial data. After these
considerations, an auditor will set a materiality threshold that is usually a percentage of net income and net assets.\textsuperscript{114} For example, after considering the risks of misstatement in the audit, an auditor may establish a materiality threshold of two percent of net income. This threshold will become the benchmark for what is considered material during the audit. Also impacting the materiality determination will be qualitative factors such as "illegal payments, irregularities, and contingencies."\textsuperscript{115} However, qualitative factors, such as fraud, may not, in and of themselves, be material to the financial statements. When considering whether qualitative factors are material, an auditor must evaluate their overall effect on the financial statements.\textsuperscript{116} Thus, whether a fraud is considered material will depend on the quantitative effects it has on a company's financial statements.

As stated in 10A, if a likely illegal act is not material to the financial statements, the auditor is only required to report it to management and does not have to report it directly to the board of directors or the Commission.\textsuperscript{117} Thus, the auditor's 10A duties are contingent upon quantitative aspects of the illegal act, which is a function of the amount of net income reported in the financial statements. The statute, however, is unclear as to which set of financial statements the materiality standard applies.

A. The Commission Required Reporting Periods

Securities laws require publicly traded companies to file both annual and quarterly financial statements with the Commission. The Commission requires auditors to scrutinize each set of financial statements (quarterly and year-end) to insure their accuracy. The level of scrutiny required varies depending on the type of financial statement.

An annual set of financial statements must be filed with the Commission within a certain number of days after the end of a fiscal year.\textsuperscript{118} Annual statements must be "audited" by an auditor.\textsuperscript{119} An audit is an extensive procedure that consists of substantive test work to verify

\begin{itemize}
  \item \textsuperscript{114} See id.
  \item \textsuperscript{115} Id. at 122.
  \item \textsuperscript{116} See id. at 122.
  \item \textsuperscript{118} See 17 C.F.R. § 210.3-01 (2003).
  \item \textsuperscript{119} See id.
account balances within a set of financial statements. The objective of an audit is to determine the existence, completeness, rights, valuation, and presentation of financial statement accounts. This objective is realized by scrutinizing physical, documentary, mathematical, analytical, and hearsay evidence. The most extensive scrutiny financial statements receive is during an audit and auditing procedures are far more pervasive than other accounting procedures.

Requiring auditors to implement fraud detection measures during an audit comports with the level of scrutiny required by one and the comprehensive nature of audits allow for their implementation with little additional cost. The combination of fraud detection procedures and substantive test work provide the most thorough avenue by which auditors may detect accounting fraud.

In addition to annual statements, the Commission requires reporting companies to file interim financial statements every fiscal quarter. Commission rules require auditor's to "review" quarterly statements. A review is a less detailed examination than an audit and includes little substantive test work. Consequently, reviewed financial statements do not receive the same level of scrutiny as audited ones. Therefore, requiring auditors to implement fraud detection procedures in the review process would be onerous, due to its limited scope.

Perhaps because of the extensive amount of resources devoted to an audit, 10A applies only to frauds detected during the course of one. However, 10A does not indicate whether the fraud has to only be material to the audited financial statements (year-end financial statements) or whether the standard also applies to frauds uncovered during an audit, but only material to a quarterly financial statement.

120. See WHITTINGTON & PANY ET AL., PRINCIPLES OF AUDITING 4 (10th ed. 1992) (defining an audit as a process by which auditors "undertake to gather evidence and provide the highest level of assurance that the financial statements follow generally accepted accounting principals ... [a]n audit involves searching and verifying the accounting records and examining other evidence supporting those financial statements").

121. See id. at 111-14.

122. See id. at 114.


125. See KONRATH, supra note 112, at 664 (defining a "review" as a process that "consists mainly of performing inquiry and analytical procedures" and the scope and detail of which is "less than an audit").

B. Examples of the Problem

Assume that Company X ("X") is a publicly traded company that produces widgets. At the beginning of the fiscal year, a well-respected securities analyst that tracks X issues her quarter-by-quarter earnings estimates. If the company fails to meet the analyst's quarterly earnings projections, the price of X's stock will likely decline. X has also established its own sales projections and learns that it will probably not meet the analyst's first quarter numbers, meet the second quarter, surpass the third quarter, and meet the fourth quarter. Thus, the comparison of the analyst's projections and the company's projections looks like this:

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANALYST'S SALES PROJECTION</td>
<td>$1,000,000</td>
<td>$2,000,000</td>
<td>$3,000,000</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>INTERNAL SALES PROJECTION</td>
<td>$800,000</td>
<td>$2,000,000</td>
<td>$4,000,000</td>
<td>$4,000,000</td>
</tr>
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In this scenario, X faces a dilemma in the first quarter. It will not be able to meet analyst's expectations for the first quarter and, thus, the stock price is in jeopardy. In order to meet the analyst's estimates for the first quarter, X decides to take orders not scheduled to be shipped until the third quarter and record them as sales in the first quarter. Because one of the criteria for recognizing revenue is that the goods must be shipped before recordation, X will have improperly recognized revenue in the first quarter.\(^{127}\)

At the end of the fiscal year, X's independent auditors conduct their annual audit. During the course of that audit, the auditors discover that X improperly recorded revenue in the first quarter that wasn't actually earned until the third quarter. The auditors, therefore, have discovered a fraud material to the first quarter financial statements during the annual audit.

Because the revenue was actually earned in the third quarter, X's year-end financial statements will probably contain no material misstatements. Assuming that the phrase "financial statements" in 10A

means only year-end financial statements, the auditor would not be required to report the fraud to the board of directors.\textsuperscript{128} Consequently, the Commission would never learn about it via 10A.\textsuperscript{129} If the phrase “financial statements” is interpreted to mean both quarterly and year-end statements, the fraud will most likely have to be reported to the board of directors, since it is likely that the first quarter numbers are materially misstated.

1. Commission Investigations

The aforementioned hypothetical resembles a recent Commission investigation. Microsoft Corporation ("Microsoft") was being investigated for possibly understating earnings in certain quarters in order to create reserves that could be used to boost future earnings.\textsuperscript{130} Specifically, the Commission was "concerned that Microsoft may have set up an accounting system that held back revenue in the form of certain cash reserves during some quarters, and then applied the reserves to future quarters to smooth out earnings."\textsuperscript{131} The investigation of Microsoft was initiated as a result of a wrongful termination suit filed by its former internal auditor.\textsuperscript{132} Had it not been for this whistleblower, the situation at Microsoft might never have been brought to the attention of the Commission.

In another recent Commission investigation, Nvidia Corporation ("Nvidia"), a computer chip manufacturer was being examined for possible accounting violations.\textsuperscript{133} The probe focused on whether "the company improperly shifted $3.6 million in costs from the first quarter of its 2001 fiscal year . . . to the second and third quarters . . . ."\textsuperscript{134} and is looking into the way the company recorded certain reserve accounts to achieve this expense shifting.\textsuperscript{135} Much like Company X in the above

\textsuperscript{129} See id. (stating that the Commission does not have to be notified, under 10A, for immaterial misstatements caused by illegal acts).
\textsuperscript{130} See Rebecca Buckman, SEC Continues to Investigate Microsoft, Asking Whether Profit was Understated, WALL ST. J., Feb. 13, 2002, at A3.
\textsuperscript{131} Id.
\textsuperscript{132} See id.
\textsuperscript{134} Id.
\textsuperscript{135} See id. Note that one possible way to shift expenses from one quarter to another is by using “Cookie Jar Reserves.” See supra notes 98-101 and accompanying text. A company could simply underestimate certain costs that were incurred in the first quarter but the actual amount of which is not known until the second quarter. See id.
example, Nvidia needed to increase its earnings in the first quarter of 2001 and, thus, may have shifted some expenses that were incurred in that quarter to other, stronger quarters.

Although the above alleged frauds were material to the companies' quarterly financial statements, they most likely were not material to the year-end statements. Thus, if 10A's materiality standard were interpreted to include only year-end financial statements, an auditor would never be required to report the above fraud to the Commission.

2. SEC v. Solucorp Industries Ltd.\textsuperscript{136}

Solucorp was a summary judgment action involving an auditor accused of failing to comply with 10A during an audit.\textsuperscript{137} In 1997, Solucorp Industries Ltd. (the "Company") intended to file a registration statement with the Commission which included the "unaudited financial statements for the quarter ended September 30, 1997."\textsuperscript{138} Included in the quarterly financial statements was revenue of $500,000 purportedly earned from a licensing agreement that "had a commencement date of June 1, 1997 and was ‘dated as of’ September 15, 1997."\textsuperscript{139} However, evidence existed that the actual licensing agreement wasn't finalized until later in the fiscal year and the Company was accused of backdating the contract in order to include it in the September 30th quarterly financial statements.\textsuperscript{140} The $500,000 posted in the September quarter represented forty percent of that quarter's revenues, certainly a material number by any means.\textsuperscript{141} However, the revenue was eventually earned in the 1997 fiscal year. Therefore, the year-end 1997 financial statements would contain no material misstatement. Although the court denied the auditor's motion for summary judgment, it did not rule on the definition of "financial statements" in 10A\textsuperscript{142} and that issue remains an avenue by which auditors may wiggle out of their 10A duties.

If the materiality standards of 10A are interpreted to include quarterly financial statements, auditors would be required to report accounting frauds relating to those financial statements directly to the Commission, thereby eliminating the need to rely on the press or

\textsuperscript{136} 197 F. Supp. 2d (S.D.N.Y. 2002).
\textsuperscript{137} See generally id.
\textsuperscript{138} Id. at 6.
\textsuperscript{139} Id. at 7.
\textsuperscript{140} See id. at 8.
\textsuperscript{141} See id. at 2.
\textsuperscript{142} See generally id.
company insiders. However, interpreting 10A to include only year-end numbers will allow most frauds to go undetected by the Commission.

V. FILLING IN THE GAP: 10A’S “FINANCIAL STATEMENTS” SHOULD INCORPORATE BOTH QUARTERLY AND YEAR-END FINANCIAL STATEMENTS

The confusion surrounding which financial statements should be included in 10A centers around the fact that the section only applies to frauds discovered during an audit. Since quarterly financial statements are not audited but merely reviewed, it would seem as if their inclusion was not intended by Congress. However, a closer look at the situation is required in order to determine exactly what Congress was thinking when drafting 10A.

A. The Audit Function

The main argument for including only year-end statements under 10A is that they are the only financials that are required to be audited. This analysis assumes that audits of year-end financial statements do not consider information contained within quarterly financials. Yet, when conducting an audit, auditors will consider information gathered throughout the year. Thus, an annual audit can be seen as an audit of that year’s previously reviewed quarterly financial statements. This analysis suggests that quarterly statements go through two testing phases. The first phase is the review that occurs at the end of each quarter and the second is the annual audit. The theory that an annual audit is simply an audit of previously reviewed financial statements comports with the Commission’s ruling that states that annual audits should consider information gathered throughout the year. Therefore, the “audited” financial statements, in essence, are merely a compilation of the audit year’s quarterly financials.

B. The Importance of Quarterly Financial Statements

A materially misstated quarterly statement can cause serious damage to investors since stock prices have become so sensitive to short-term profit fluctuations. Quarterly data has become increasingly

143. See 17 C.F.R. § 210.3-01 to 02 (2003).
144. See id.
145. See id.
important as managers continue to sacrifice long-term growth for short-
term profit maximization. Managers' unyielding desire to maximize
short-term profits has "translate[d] into an obsession with quarter-to-
quarter earnings." Management's desire to maximize short-term profits
is a result of a number of phenomenon that occurred during the last
decade. One such phenomenon was the introduction of stock options as
a form of compensation. Stock options motivated managers to focus on
short-term profit goals in order to maximize share value in a short period
of time. If a stock price appreciated accordingly with quarterly profit
estimates, executives could exercise their options and cash out, leaving
other shareholders with a company with no long-term prospects. Another
incentive for focusing on short-term value is the fact that many
corporate acquisitions are financed with stock. Maximizing share value
in the short-term would give managers more leverage in an acquisition if
the company's shares were to be used as currency.

Corporate management, however, is not totally to blame for the
current environment. Over the last few years, "companies have struggled
more and more desperately to meet analysts' expectations." Analysts'
requirement that the companies they follow meet quarterly earnings
projections originated when they began "challeng[ing] the companies
they covered to reach for unprecedented earnings growth"; missing their
estimates "by even a penny per share [could lead to] an immediate
stock price] plunge of 25 percent or more."

The fact that quarterly financial statements receive such a low level
of scrutiny in the review phase creates an interesting paradox. As stated
above, missing an analyst's quarterly profit estimate can result in a stock
price facing the proverbial stock market guillotine. Managers,
therefore, have a huge incentive to manipulate quarterly numbers and,
thus, most financial frauds probably occur within quarterly statements.
However, quarterly statements receive the lowest level of scrutiny by an
auditor. In order to remedy this problem, quarterly statements either
should be audited separately in order to detect fraud or should be

146. See David Millon, Why Is Corporate Management Obsessed with Quarterly Earnings and
147. Id.
148. See id. at 906-07.
149. See id.
150. See id. at 910-12.
151. Id. at 893.
152. Id. at 892-93.
153. See id. at 892-93.
considered when performing fraud detection procedures during the annual audit. Only until companies, analysts, and investors start focusing on a company's long-term financial prospects, rather than short-term numbers will the incentive to manipulate quarterly figures be eliminated and so too will the heightened need to scrutinize those numbers for fraudulent activity.

The current environment of short-term profit maximization has generated a cult following for quarterly earnings. The pressure to meet analysts’ earnings estimates plus management self interest has made manipulation of quarterly numbers a sport amongst executives. The losers of this sport, however, are individual shareholders who invest for the long term. These individual investors are who the securities laws are intended to protect and, therefore, those laws must not be rendered toothless by legal hairsplitting.

A. Increased Audit Costs Would Be Minimal

Although the inclusion of quarterly financial statement would technically increase the cost of an audit, the increase would be insubstantial at best. The reason why any additional cost imposed by 10A is likely to be minimal is that the statute applies only to frauds detected during audits.\textsuperscript{154} Since auditors already are required to implement fraud detection procedures in their audits,\textsuperscript{155} making the materiality standard apply to quarterly statements would not require the implementation of any additional procedures. All 10A would require is that if a material “illegal act” is detected, it be reported to management, the board of directors, and possibly the Commission.\textsuperscript{156} Therefore, the only additional cost would be the cost of preparing more reports to these bodies.

B. The “Plain Meaning” Rule

When interpreting a statute, “[i]t is elementary that the meaning of a statute must, in the first instance, be sought in the language in which the act is framed.”\textsuperscript{157} Using the language of the statute as the sole means

\textsuperscript{155} See supra note 67.
\textsuperscript{157} ABNER J. MIKVA & ERIC LANE, AN INTRODUCTION TO STATUTORY INTERPRETATION AND THE LEGISLATIVE PROCESS 9 (Aspen Law and Business 1997) (quoting a statement from the court’s decision in Caminetti v. United States, 242 U.S. 470, 485 (1917)).
of interpretation is known as the “plain meaning” doctrine. Since no
definition of the phrase “financial statements” exists in 10A, the next
logical source for a definition would be other sections within the
securities laws and Commission rules.

The Commission rule governing the filing of quarterly financial
statements is titled “Interim Financial Statements.” Since the
Commission has used the phrase “interim financial statements” when
describing quarterly figures, a blanket use of the phrase “financial
statements” would seem to encompass quarterly financial
statements. In other words, instead of putting a qualifier such as “year-end” or
“interim” in front of the phrase “financial statements”, Congress simply
used the generic phrase “financial statements” to express its intent that
the statute cover both quarterly and year-end financials.

Accounting textbooks have also broadly defined the phrase
“financial statements” to mean “statements that reflect the collection,
tabulation, and final summarization of accounting data.” This
definition is not specific as to the time period covered in a financial
statement. Thus, the definition includes both year-end and quarterly
data.

Finance textbooks also recognize quarterly reports as a type of
financial statement. One textbook defines an income statement as “a
financial statement showing a firm’s revenues and expenses during a
specified period.” This definition suggests that a quarterly income
statement would be considered a type of financial statement since it
shows a company’s revenue and expenses for a specified period, namely
three months (one fiscal quarter).

Black’s Law Dictionary also defines a financial statement as “[a]
balance sheet, income statement, or annual report that summarizes an
individual’s or organization’s financial condition on a specified period
by reporting assets and liabilities.” Since quarterly financial statements

158. See id. at 10.
anywhere within the statute).
160. See 17 C.F.R. § 210.10-01 (2003) (citing the phrase “interim financial statements” to
describe quarterly financial statements).
161. Id.
162. KIESO & WEYGANDT, supra note 95, at 70.
163. See id.
165. Id. at 353.
166. See id.
are reports summarizing the financial condition of an organization for a "specified period," those statements would be included within the legal definition of "financial statements."

Although the "plain meaning" rule has been advocated by the courts, it is not used in every situation. Sometimes, courts will not use the "plain meaning" rule if the result is in contravention with the legislative intent of the statute. However, the legislative intent of 10A was to prevent fraud from materializing on any financial statement and, therefore, it does not conflict with an all-encompassing definition of the phrase "financial statements." The "plain meaning" rule, therefore, should be used to interpret the statute.

C. The Legislative History of 10A

When Congress enacted 10A, its intent was to provide an extra layer of protection for the investing public against fraud. This additional protection was prompted by the continued practice of accounting fraud despite congressional and industry efforts to stop it. By interpreting the phrase "financial statements" to include only year-end statements, a loophole is created that allows frauds that are material only to quarterly statements to go unreported to the Commission. Such a loophole can have devastating consequences to investors since stock prices can fluctuate greatly based on quarterly results. Because its intent was to detect fraud, Congress did not wish to create such a loophole.

Congress's failure to define the phrase "financial statements" within 10A was most likely an oversight rather than an intentional act. Considering the legislative intent of the statute, it would be ridiculous to conclude that Congress intentionally created a loophole that would allow most frauds to go undetected by the board of directors or the Commission.

168. See MIKVA & LANE, supra note 157, at 10.
169. See id.
170. See supra part II.C.
171. See MIKVA & LANE, supra note 157, at 10.
172. See supra Part II.C.
173. See id.
174. See supra Part IV.
175. See Jenkins, Jr., supra note 83.
176. See supra Part II.C.
VI. CONCLUSION

The auditing industry is facing tremendous scrutiny by both the public and the government. The fall of Enron and WorldCom is simply a microcosm of the widespread infiltration of accounting fraud in corporate America and the auditing industry’s failure to detect it. This problem has become so rampant that investor confidence is being threatened and the fundamentals of our capitalist society are at risk. Those that were supposed to inoculate the individual investor from the ivory tower manipulations and deceit of corporate executives are becoming infected themselves. In order to rebuild investor confidence in the quality of financial reporting and in the auditing industry itself, the legislature must enact laws that ensure auditors are fulfilling their duty to the public and are not simply acting as corporate hand puppets. 10A is a step in the right direction; however, its effect will be nullified if unintended loopholes are not closed. Only until the phrase “financial statements” is adequately defined by the courts to close the loophole inherent in 10A will auditors have no choice but to abide by it and reassume their role as corporate America’s “public watchdog.”

Jamie A. Barber*

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177. See Kostant, supra note 34, at 1243.

* This Note is dedicated to my late grandmother, Lois “Dixie Jean” Schuckman, who passed away on March 17, 2003. I would like to thank Professors Peter Kostant and J. Scott Colesanti, for their invaluable insight and guidance, and the entire staff of the Hofstra Law Review, for their tireless efforts in bringing this Note to publication. I would also like to thank my parents and family for their unconditional love and support throughout all of my endeavors.