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How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgment, and Materiality of the Auditor's Report

Arthur Acevedo

I. INTRODUCTION

For many individuals, the auditor's report symbolizes the hallmark of professional integrity, independence and due care.¹ However, the public's trust and confidence in the auditor's report came to a crashing halt when a wave of financial scandals plagued the American landscape during 2001 and 2002. Public trust in the auditor and the auditor's report quickly eroded as company after company announced corrections of restatements of earlier audited financial statements.

Responding to this breach of public trust by the audit profession, Congress passed the Sarbanes Oxley-Act ("SOA").² The enactment of the SOA is intended to make the audit profession more accountable and to restore public confidence in the audit profession. The SOA introduced many reforms aimed at improving and enhancing financial reporting and at regulating the accounting and audit professions. However, in its enthusiasm to pass the SOA, Congress overlooked an opportunity to enhance the auditor's report and clarify its role within the context of an audit.

The Securities Act of 1933³ ('33 Act) and the Securities Exchange Act of 1934⁴ ('34 Act) both require the inclusion of an auditor's report to validate the financial statements accompanying the required disclosures. Ironically, however, the auditor's report has become the source of dashed expectations, confusion, and misplaced reliance by the public.⁵

1. See Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, FLA. ST. U. L. REV. 17, 59-60 (2003) (stating, "[t]he auditor's opinion on the financial statements is like an expert's stamp of approval to the public and the capital markets.").

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

3. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C §§ 77a – 77aa (2005)).

4. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78nn (2005)).

5. As used in this note, the terms "public" and "user" are used interchangeably to include any person or entity who may come to rely on the auditor's report including but not limited to investors, creditors, suppliers and the general public.

Since its introduction into the American business community, the auditor's report has created different expectations concerning the scope of its use.⁶ Businesses secure it as objective evidence that their financial statements are accurate, third parties rely on it as a gauge that the business is capable of meeting its obligations, and auditors provide it as part of their professional services to the client. All too frequently, however, conflicts concerning the scope and use of the auditor's report between the public, on the one hand, and auditors, on the other, have led to litigation with plaintiffs charging the auditor with negligence, gross negligence or in some cases fraud.

Add to the mix the little known fact that corporate management ("Management") has considerable discretion⁷ in determining which accounting rules⁸ to adopt when measuring its financial results, plus the poorly understood fact that the auditor exercises a substantial degree of discretion and professional judgment at every stage of the audit process,⁹ plus the fact that the number of people reading the auditor's report has increased,¹⁰ and you have the elements for a likely dispute between the auditor and the public.

Part I of this note states the problem. Part II of this note examines the legal and regulatory framework within which the audit profession works. Part III of this note examines the history of the audit profes-

6. See Steven E. Stark, *Rosenblum v. Adler: Auditors' Liability For Negligent Misrepresentation* – "The Explosive Power Resident in Words," 38 U. MIAMI L. REV. 939, 955 (1984)

The *Rosenblum* court . . . discussed the expanding role of the audit function and recognized that an accepted use of audited statements is to provide them to third parties. The court found that 'proper business purposes' include such uses as submission of the statements to banks and other lending institutions that might advance funds, and to suppliers of goods and services that might advance credit.

Id. (citing *Rosenblum v. Adler*, 461 A.2d 138 (N.J. 1983)).

7. See Darin Bartholomew, *Is Silence Golden When It Comes To Auditing?*, 36 J. MARSHALL L. REV. 57, 64 (2002) (stating, "[c]orporations may lawfully manage their earnings in compliance with GAAP. In addition, corporations may place their financial disclosure in a favorable light that does not misrepresent their true financial position to investors.").

8. Accounting can be defined as a process which involves "identifying, [financial] events and transactions that affect the entity. Once identified, these items are measured, recorded, classified and summarized in the accounting records." WILLIAM BOYNTON ET AL., *MODERN AUDITING* 44 (7th ed. 2001); see also DONALD E. KIESO ET AL., *INTERMEDIATE ACCOUNTING 2* (10th ed., 2001), (defining accounting "by describing, the three essential characteristics of accounting: (1) identification, measurement and communication of financial information about (2) economic entities to (3) interested persons." In simple terms, accounting is a process which identifies, measures, records and reports financial information to the public.).

9. One commentator has described "[a]uditing [as] a mix[t]ure of judgment and technique which may result in certain pitfalls. Feinman, *supra* note 1, at 22. Audit procedures require that an auditor plan his audit. It is conceivable that based on the audit procedures selected and tests conducted, two different auditors auditing the same client may arrive at different conclusions.

10. Consider the fact that the "modern securities markets, literally involv[e]. . . millions of shares changing hands daily. . ." Basic, Inc. v. Levinson, 108 S.Ct. 978, 995 (1988).

sion, the evolution of the audit opinion and provides the reader with a basic understanding of the auditing function and its processes.¹¹ Part IV of this note examines the applicable case law and the evolution of the legal standards affecting the auditor. Part V of this note concludes with a recommendation that aggressive action be taken by Congress to prevent further abuses in financial reporting by corporate management and the audit profession. The recommended action includes reforming the auditor's report so that minimum content disclosure rules are adopted, disclosing the limitations of the auditor's report, adopting Plain English rules to enable increased comprehension and better decision making by the public,¹² and expanding the scope of the SOA to include all audit reports affecting interstate commerce.¹³

II. DISCUSSION AND ANALYSIS

A. *Legal and regulatory framework of the audit profession after the SOA*

Early attempts to federally regulate the auditing profession at the start of the 20th century met with considerable resistance from a then fledgling audit profession.¹⁴ These attempts at regulation were in response to a growing perception and a need for uniform auditing standards and standardized reporting. The "formation of [the] Federal

11. The goal of this section is to provide the reader with a basic understanding of the conceptual principles applicable to an audit without burdening the reader with an overwhelming amount of financial and audit information. A comprehensive understanding of accounting and auditing is beyond the scope of this work.

12. Increased reporting and disclosure will enable shareholders to better assess whether the managers they hired are properly managing the business. Shareholders, out of sheer personal interest, can act as an early warning system that something is wrong with the company. See Mary Alexander, *Corporate Greed*, 38 OCT. TRIAL 9 (2002) (crediting shareholders of World Com, Tyco and Rite Aid as acting as an early warning system of the looming financial doom).

13. Currently, the scope of the SOA applies only to audit reports issued by publicly held companies. See Sarbanes-Oxley Act of 2002, *supra* note 2, §2(a)(7) (defining "issuer" to mean "...an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. §§ 77a-77aa), and that it has not withdrawn.").

14. The content of financial statements became federally regulated in 1934. See George J. Benston, *The Regulation Of Accountants and Public Accounting Before and after Enron*, 52 EMORY L.J. 1325, (2003)

Until passage of the Securities Act of 1933, the contents of financial statements included in prospectuses were regulated only by some state laws and securities exchanges' listing agreements. The contents of periodic financial statements of corporations were regulated only by securities exchanges until passage of the Securities Act of 1934, which also established the Securities and Exchange Commission (SEC).

Id.

Reserve Board (“FRB”) in 1913 and the Federal Trade Commission (“FTC”) in 1914 played an important role in the movement that fostered standardized audit reporting . . . [T]he FRB and the FTC shared a strong dissatisfaction with financial statements audited by public accountants.”¹⁵ The American Institute of Accountants (“AIA”), a predecessor organization to the American Institute of Certified Public Accountants (“AICPA”), deliberated with the FRB and FTC about the need for standardized reporting. The AIA urged the FRB and the FTC “that federal regulation of the accounting profession was not warranted”¹⁶ The FRB and the FTC “yielded to the pressure of the AIA with the understanding that the AIA would “provide adequate guidelines [to] independent accountants that would address their concerns.”¹⁷ This early concession by the FRB and FTC was a striking victory for the auditor because it meant the auditor retained the right to self regulation.

Over the next 85 years the audit profession grew in size and influence.¹⁸ The audit profession established standards of practice, known as generally accepted accounting principles (“GAAP”),¹⁹ and generally accepted auditing standards (“GAAS”).²⁰ “GAAS . . . represent the industry standard for measuring the performance of an [audit] examination by an [auditor].”²¹ GAAP is the standard used to measure and report a company’s financial transactions. The audit profession

15. Marshall A. Geiger, *Setting The Standard For The New Auditor's Report: An Analysis Of Attempts To Influence The Auditing Standards Board*, 1 STUDIES IN MANAGERIAL AND FINANCIAL ACCOUNTING 12 (1993).

16. *Id.* .

17. *Id.*

18. “In 1900, there were fewer than 250 CPA’s in the United States and no more than 1,000 persons employed in all the nation’s accounting firms. Today, there are over 500,000 licensed CPA’s in the United States.” BOYNTON, *supra* note 8, at 9.

19. See *In re Enron Corporation Securities, Derivative & Erisa Litigation*, 235 F. Supp. 2d 549, 573 n.11 (S.D. Tex. 2002) (“GAAP, or Generally Accepted Accounting Principles, ‘are the official standards adopted by the American Institute of Certified Public Accountants (the “AICPA”), a private professional association, through three successor groups that it established, the committee on Accounting Procedure, the accounting Principles Board (the “APB”), and the Financial Accounting Standards Board (the “FASB”).” (quoting *In re K-tel Intern., Inc. Securities Litigation*, 300 F.3d 881, 889 (8th Cir. 2002); see also, KIESO, *supra* note 8, at 6 (elaborating that “[t]he term ‘generally accepted’ means either that an authoritative accounting rule-making body has established a principle of reporting in a given area or that over time a given practice has been accepted as appropriate because of its universal application.”).

20. See *Enron*, 235 F. Supp. 2d 549, 674 n. 106 (“GAAS are standards established by the Auditing Standards Board of the American Institute of Certified Public Accountants for the conduct of auditors in the performance of an [audit] examination.”).

21. *Enron*, 235 F. Supp. 2d 549, 611. But see James L. Costello, *The Auditor's Responsibilities For Fraud Detection And Disclosure: Do The Auditing Standards Provide A Safe Harbor?*, 43 ME. L. REV. 265, 282 (1991), for an excellent discussion exploring “the fallacy that compliance with GAAS creates a safe harbor for the auditor.”

also helped establish the CPA Examination, which is a uniform examination administered twice a year for individuals desiring to practice as certified public accountants.²²

However, a flurry of accounting restatements²³ during 2000, 2001, and 2002,²⁴ and an ambush of accounting scandals²⁵ prompted Congress to enact the SOA, thereby federally regulating the audit profession. As a direct consequence of the SOA, the auditing profession lost its right to self-regulation. By enacting the SOA, Congress sought to stabilize the capital markets and restore public confidence in the economic system.²⁶

The roots of the 2001-2002 financial crisis can be attributed to several factors: aggressive accounting practices,²⁷ the increased use of pro-forma financial statements,²⁸ and the misplaced belief by investors in the never-ending climb of the Dow Jones.²⁹ Millions of investor dollars poured into the economy, primarily in the dot-com and in-

22. Individuals desiring to practice as a certified public accountant (CPA) must successfully pass a uniform examination and meet local state licensing requirements before they can be designated a CPA.

23. An accounting restatement is a correction of a previously issued financial statement.

24. During the years 2000, 2001 and 2002, many companies including Enron, Tyco and WorldCom announced they were restating their earnings because of accounting irregularities. See also Letter from Lynn Turner, SEC Chief Accountant, to Charles Bowsher, Chairman, Public Oversight Board (July 18, 2001), available at <http://www.sec.gov/info/accountants/staffletters/pob071801.htm> (last visited September 7, 2004) (asking "why is there nothing showing up in the reports from the peer reviews regarding" the increase in restatements?).

25. During the period January 1, 1997 and June 30, 2002, the GOA published a report "listing 919 restatements . . . identified as . . . accounting irregularities." Letter from Davi M. D'Agostino, Director, Financial Markets and Community Investment, GAO, to Senator Paul S. Sarbanes (January 17, 2003) available at <http://www.gao.gov/new.items/d03395r.pdf> (last visited September 18, 2004). Investors immediately lost "\$100 billion" in market value as a result of the accounting restatements. *Id.* See also James D. Cox, *Reforming The Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L.Q. 301, n.4 (2003) ("Earnings restatements are symptomatic of the aggressive and opportunistic use of accounting principles. Opacity and lacunae in accounting metrics were shamelessly exploited by the firms' managers. Too frequently, it appears, the public accountants accorded their audit clients the benefit of any ambiguity in accounting principles.").

26. See Larry Cata Backer, *The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior*, 76 ST. JOHN'S L. REV. 897, 947 (2002) ("The American financial system is based on an acceptance of the 'facts' of transparent and liquid markets in which all traders are engaged in the market with equal information and the information fairly represents the relative condition of all market issuers." (emphasis added)).

27. See Manning Gilbert Warren III, *Revenue Recognition and Corporate Counsel*, 56 SMU L. REV. 885, 909 (2003) (giving an excellent discussion concerning the more common revenue deception techniques used by companies to inflate earnings).

28. "Pro-forma information is useful to individuals interested in assessing the trend of earnings over a period of time." KIESO ET AL., *supra* note 8, at 1258.

29. See Alan Greenspan, *The Challenge of Central Banking in a Democratic Society*, Address at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington, D.C. (Dec. 5, 1996) available at <http://www.federalreserve.gov/>

ternet stock sectors. However, when the economic bubble burst during 2001, it left in its wake, lingering economic and social consequences that will be felt for many years to come.

When Congress faced a similar economic crisis following the 1929 stock market crash, it responded with legislation designed to restore confidence in the capital markets. Although the reasons for the 2001-2002 financial crisis differ from those that caused the 1929 stock market crash, the economic and social consequences are similar - namely, unemployment, lost fortunes, mistrust, and lack of investor confidence.³⁰ Following the stock market crash in 1929, investors lost confidence as fraud and manipulation of the capital markets brought ruin to millions of individuals. Determined to address the devastating economic and social hardship created by the 1929 crash, Congress passed the '33 Act and the '34 Act to restore confidence in the American economy and in the capital markets.

The '33 Act was designed to provide investors with "full and fair disclosure of the character of securities sold in interstate . . . commerce . . . and to prevent frauds in the sale thereof . . ."³¹ The '33 Act protects investors against fraud by unscrupulous dealers and imposes severe civil liabilities on violators. A significant feature of the '33 Act is that it requires that an auditor's report accompany any prospectus³² filed with the SEC.³³ The presence of the auditor's report lends credibility to the accompanying financial statements.³⁴

One year later, Congress passed the '34 Act to protect investors against the manipulation of stock prices by regulating transactions upon securities exchanges and in over-the-counter markets. The '34

boarddocs/speeches/1996/default.htm (last modified Jan. 5, 2005) (Where Greenspan made his now famous remarks regarding the "irrational exuberance" of investors).

30. See Bartholomew, *supra* note 7, at 106.

Investors may lose confidence in the U.S. equity markets if changes in financial reporting do not take place to illuminate true financial conditions. The SEC has warned of a corrosive deterioration of U.S. market leadership because of the current prevalent gimmickry and attendant reduced transparency of financial reporting. If investors are unaware of the true financial conditions of corporations, the investors are not able to allocate their capital in a rational and efficient manner.

Id.

31. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (Preamble).

32. A prospectus is defined as a "printed document that describes the main features of an enterprise (esp. a corporation's business) and that is distributed to prospective buyers or investors. . ." BLACK'S LAW DICTIONARY 1238 (7th ed. 1999).

33. 15 U.S.C. §§ 77g, 77aa (2005).

34. The SEC has the statutory authority to establish the accounting rules to be followed by companies who are required to register their financial statements with the SEC. See Securities Act of 1933, *supra* note 3, § 77s(a) and Securities Exchange Act of 1934, *supra* note 4, § 78m(b)(1) (2005).

Act also imposed regular information reporting requirements on companies who listed their stock on national securities exchanges. The '34 Act requires that public companies file an annual report³⁵ within 90 days following the end of the fiscal year.³⁶ The '34 Act also requires that the "annual report [be] certified . . . by independent public accountants."³⁷ Public companies must also file quarterly reports within 45 days following the end of each quarter.³⁸

Congress now seeks to influence the practice and behavior of the audit professions through the SOA. The SOA's principal reforms include the creation of the Public Company Accounting Oversight Board ("Board"); establishing standards for auditing, attestation, quality control and ethics within the audit profession; requiring certification of financial statements and internal controls by the corporate officers; enhanced real time reporting/disclosure requirements; strengthening auditor independence; requiring that auditors report to the audit committee; and the enactment of penalties for certain securities related crimes. The passage of the SOA represents the most comprehensive legislation affecting the capital markets since the passage of the '33 Act and the '34 Act.³⁹

B. *The Public Companies Accounting Oversight Board*

Section 101(a) of the SOA creates the Public Companies Accounting Oversight Board ("Board"). The purpose of the Board is to "oversee the audit of public companies that are subject to the securities laws . . . in order to protect the interests of investors and *[to] further the public interest in the preparation of informative, accurate, and independent audit reports* for . . . investors."⁴⁰ The Board is mandated to "provide . . . more effective oversight" and regulation of the audit profession.⁴¹ The creation of the Board marks the end of the era of self regulation by the audit profession because the Board is now charged with overseeing the audit profession. Prior to the creation of the Board, the audit profession was a self-regulating industry.

35. Annual reports are filed on Form 10-K, quarterly reports are filed on Form 10-Q.

36. See Securities Exchange Act of 1934, *supra* note 4, §78m(a).

37. See *id.* § 78m(a)(2).

38. 17 C.F.R. §240.13A-13 (2005). See also Form 10Q, General Instructions, at A.1.

39. Additional securities statutes passed by Congress since passing the '33 Act and the '34 Act include the Public Utility Holding Company Act of 1935, 15 U.S.C. §79 (2005); the Trust Indenture Act of 1939, 15 U.S.C. §77aaa (2005); the Investment Advisers Act of 1940, 15 U.S.C. §80b-1 (2005); and the Securities Investors Protection Act of 1970, 15 U.S.C. §78aa (2005).

40. Sarbanes-Oxley Act of 2002, *supra* note 2, § 101(a) (2002) (emphasis added).

41. See S. REP. NO. 107-205, at 4 (2002).

The Board consists of five members⁴² who “shall be . . . appointed from . . . prominent individuals of integrity and reputation,⁴³ who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports . . .”⁴⁴ The five members of the Board are appointed by the SEC.⁴⁵ Only two of the five members shall be (or shall have been) certified public accountants.⁴⁶ The Board is solely dedicated to fulfilling the objectives of the SOA and is authorized to hire a qualified staff to help it achieve its objectives.

The SOA vests the Board with broad authority empowering it to regulate public accounting firms. Principle among its newly created powers is the ability of the Board to “register public accounting firms,”⁴⁷ “establish . . . auditing, quality control, ethics, independence and other standards *relating to the preparation of audit reports . . .*,”⁴⁸ “perform such other duties or functions as . . . are necessary or appropriate . . . to improve the quality of audit services,”⁴⁹ “conduct investigations and disciplinary proceedings,”⁵⁰ and “enforce compliance with the Act.”⁵¹

42. See United States General Accounting Office Report to Congressional Requesters, Securities and Exchange Commission, Actions Needed to Improve Public Company Accounting Oversight Board Selection Process, GAO-03-399 (2002), available at <http://www.gao.gov/new.items/d03339.pdf> (last visited September 25, 2004) (describing the challenges the SEC faced in appointing the initial Board and the GOA recommendation that the “SEC define and reach agreement on the PCAOB appointment process). The current members of the Board are William J. McDonough- Chairman, Kayla J. Gillan – Member, Daniel L. Goelzer – Member, Bill Gradison – Member, Charles D. Niemeier – Member.

43. Reasonable minds may differ as to what a “prominent individual of integrity and reputation” means. Consider for example, that Kenneth Lay, former CEO of the now defunct Enron Corporation, touted at one time as one of the preeminent CEO’s in the world, would have qualified under the standards set forth by the SOA.

44. Sarbanes-Oxley Act of 2002, *supra* note 2, § 101(e)(1).

45. *Id.* at § 101(e)(4)(A).

46. Section 101(e)(2) of the Sarbanes-Oxley Act reads “Two members, and only 2 members, of the Board shall be or have been certified public accountants pursuant to the laws of 1 or more States, provided that, if 1 of those 2 members is the chairperson, he or she may not have been a practicing certified public accountant for at least 5 years prior to his or her appointment to the Board.” *Id.* § 101(e)(2).

47. *Id.* § 101(c)(1).

48. *Id.* § 101(c)(2) (emphasis added).

49. Sarbanes-Oxley Act § 101(c)(5).

50. *Id.* § 101(c)(3).

51. *Id.* § 101(c)(4). It bears mentioning that although the statute empowers the Board with the power to enforce compliance with the Act, any such hearings “shall not be public, unless otherwise ordered by the Board for good cause shown, with the consent of the parties to such hearing.” *Id.* § 105(c)(2); see also the SEC regulation which provides that “[u]nless otherwise

The SOA empowers the Board with the authority to require public accounting firms to “describe in each audit report the scope of the auditor’s testing of the internal control structure and procedures of the [company] and [to] present (in such report or in a separate report) the findings of the auditor”⁵² The auditor is also required to provide an evaluation as to “whether [the] internal control structure and procedures . . . provide[s] reasonable assurance that [the] transactions are recorded as necessary to permit the preparation of the financial statements in accordance with GAAP.”⁵³ Simply stated, the Board has the authority to require that the auditor report whether the company’s internal control system is working and whether such internal controls make it possible to for the company to prepare its financial statements in accordance with GAAP.

Public accounting firms⁵⁴ must register with the Board if they want to continue auditing publicly held companies.⁵⁵ Public accounting firms are also required to “submit an annual report to the Board . . . to update the information contained in its application for registration”⁵⁶ Information received from public accounting firms by the Board is available for public inspection. However, certain confidential and proprietary information “reasonably identified” by the accounting firm shall be protected from public disclosure.⁵⁷ In the end, the loss of self-regulation coupled with increased oversight by the Board is expected to create a more transparent audit environment that is ultimately intended to provide enhanced protection for the average investor.

ordered by the Commission, all formal investigative proceedings shall be non-public.” 17 C.F.R. § 203.5 (2003).

52. Sarbanes-Oxley Act § 103(a)(2)(A)(iii)(I).

53. *Id.* § 103(a)(2)(A)(iii)(II)(bb).

54. Section 2(a)(11) of the Sarbanes-Oxley Act defines a public accounting firm as a “legal entity . . . engaged in the practice of public accounting or preparing or issuing audit reports.” *Id.* § 2(a)(11)(A).

55. *See id.* § 102(a).

56. *Id.* § 102(d).

57. *Id.* § 102(e). In the interest of full disclosure and transparency, due consideration should be given to making the confidential reports publicly available for inspection after a reasonable period of time. It is in the public interest, defined broadly to include investors, creditors, suppliers, the insurance industry, and the audit profession, that audit deficiencies previously identified, be disclosed and corrected. The pressure of public disclosure and scrutiny will help ensure that corrections are made.

C. *Standard setting authority - Section 103 (and regulating the auditor's report)*

Section 103 of the SOA vests the Board with the authority to “establish . . . auditing and related attestation standards, . . . quality control standards, and . . . ethics standards . . . used by registered public accounting firms *in the preparation and issuance of audit reports . . .*”⁵⁸ The Board has the authority to establish such standards “. . . as may be necessary or appropriate in the public interest or for the protection of investors.”⁵⁹ This mandate has broad implications because at least since 1940, “the SEC [consciously] refrained from establishing separate auditing procedures and decided to let the accounting profession develop auditing standards.”⁶⁰

Using its mandate under § 103, the Board has the authority to significantly change GAAP, GAAS, and the reporting standards used by the audit profession. The SOA has already commissioned the study of accounting principles used by auditors.⁶¹ However, to complete the SOA’s objective of “protect[ing] investors by improving the accuracy and reliability of corporate disclosures,”⁶² the auditor’s report must also be critically examined. Specifically, the Board should use its broad grant of authority to conduct a review of and enact improvements to the auditor’s report. If one reflects upon the objective of the SEC disclosure rules, namely to ensure that fair disclosure is made to investors, then the goal of drafting an auditor’s report that itself is comprehensible and meaningful to the average investor is consistent with the SEC’s policy of disclosure.

Any change to the GAAP, GAAS, and reporting standards adopted by the Board must include a careful assessment of current standards. The Board is required to cooperate “on an ongoing basis”⁶³ with professional groups of accountants when evaluating standards. Presumably the professional groups of accountants will include the Financial Accounting Standards Board (“FASB”).⁶⁴ Additionally,

58. Sarbanes-Oxley Act § 103(a)(1) (emphasis added).

59. *Id.* § 103(a)(1).

60. Matthew J. Barrett, *The SEC and Accounting, In Part Through the Eyes of Pacioli*, 80 NOTRE DAME L. REV. 837, 870 (2005).

61. Section 108(d) of the Sarbanes-Oxley Act requires “a study on the adoption by the United States financial reporting system of a principles-based accounting system.” Sarbanes-Oxley Act § 108(d). The report can be found at <http://www.sec.gov/news/studies/principlesbasedstand.htm>.

62. *See id.* p.mbl.

63. Section 103(c)(1) of the Sarbanes-Oxley Act provides in relevant part that “[t]he Board shall cooperate on an ongoing basis with professional groups of accountants . . . in the examination of the need for changes in any standard.” *Id.* § 103(c)(1).

64. The FASB website describes “[t]he mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and

the Board may include “representatives of other interested groups” when evaluating standards.⁶⁵ The Board is also required to report “the results of its standard setting responsibilities” to the SEC on an annual basis.⁶⁶ No rule of the Board can take effect without the prior approval of the SEC.⁶⁷ As a final safeguard against overreaching changes by the Board, the SEC reserves to itself the right to override any rule enacted by the Board.⁶⁸

Prior to the enactment of § 103, the SEC, through Regulation S-X, provided limited guidance concerning the content of the auditor's report.⁶⁹ Regulation S-X requires only that the auditor's report “[be dated . . . , be signed manually . . . , indicate the city and State where issued . . . , and identify . . . the financial statements covered by the report.”⁷⁰ Regulation S-X further provides that the auditor's report “[s]hall state whether the audit was made in accordance with [GAAS].”⁷¹ Regulation S-X, however, does not require a definition of GAAP or GAAS within the body of the auditor's report, nor does it require any discussion within the auditor's report concerning the impact of materiality (or its consequence to the financial statements),⁷² the presence of “audit risk,”⁷³ or Management's discretion to choose among alternative GAAP treatments when preparing a company's financial statements.⁷⁴ Disclosing these items within the body of the auditor's report would make it more meaningful and informa-

education of the public, including issuers, auditors, and users of financial information.” <http://www.fasb.org/> (last visited Apr. 15, 2005).

65. Section 103(a)(4) of the Sarbanes-Oxley Act, captioned “ADVISORY GROUPS,” provides in relevant part that “The Board shall convene, . . . such expert advisory groups as may be appropriate, which may include practicing accountants and other experts, as well as representatives of other interested groups . . . to make recommendations concerning the content of auditing . . . standards.” Sarbanes-Oxley Act § 103(a)(4).

66. *Id.* § 103(d).

67. *Id.* § 107(b)(2).

68. *Id.* § (b)(5).

69. Regulation S-X governs the disclosure of financial information in the auditor's report. 17 C.F.R. §§ 210.1-01 to .3-11 (2003); *see also* Regulation S-K, 17 C.F.R. §§ 229.101-406 (2003) (governing the disclosure of non-financial information). Throughout the history of the auditor's report, the audit profession, acting through the AICPA and its predecessor organizations, took the lead role in evaluating and determining the form and content of the auditor's report.

70. 17 C.F.R. § 210.2-02(a) (2004).

71. *Id.* § 210.2-02(b).

72. *See* discussion of the concept of materiality *infra* Part C.

73. *See* discussion of audit risk *infra* Part C and note 181.

74. Examples of alternate GAAP treatments available to Management include choosing between straight line depreciation or accelerated depreciation methods when recording depreciation expense attributable to an asset (e.g., equipment) for the year. Another example of an alternative GAAP treatment available to Management includes choosing the last in first out (LIFO) or the first in first out (FIFO) basis when calculating inventory costs.

tive to the public. Disclosing these items would also increase the auditors' credibility as a "public watchdog."

The discontent with the lack of clear audit and accounting standards is not a new phenomenon. At the start of the 1900's there existed a strong dissatisfaction with the lack of uniformity and standardization of the auditor's report. The "wide disparity in . . . [auditing] practice and [the wide disparity in the auditor's] report form and content created difficulties for the early audit report reader. In some cases, the audit report was a relatively useless document."⁷⁵

Responding to the criticism concerning the lack of standards the AIA, in 1912, "developed a booklet entitled *A Memorandum on Balance Sheet Audits . . .*"⁷⁶ This booklet intended to establish standards which were to be followed by manufacturing companies and their auditors.⁷⁷ A debate between the fledging audit profession and the federal government developed as both sides attempted to persuade the other as to who was better qualified to establish standards for the audit profession. The debate was settled in 1914 when the Federal Reserve Bank ("FRB") yielded its standard setting authority to the AIA,⁷⁸ thereby leaving the development of GAAP,⁷⁹ GAAS,⁸⁰ and

75. Geiger, *supra* note 15, at 7, 10

76. *Id.* at 12.

77. *Id.*

78. The SEC clearly has the authority to establish accounting standards. See Securities Act of 1933, 15 U.S.C.A. § 77s (West 2005); Securities Exchange Act of 1934, 15 U.S.C.A. § 78m (West 2005); see also LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTAL OF SECURITIES REGULATION 190 (5th ed. 2004) (stating that "the [SEC] long chose to rely on the accounting profession to establish generally accepted accounting principles.").

79. See AU § 411.05 for an established hierarchy to be consulted when determining if a principle is "generally accepted." "[T]he determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles." *Id.* But see *In re Enron Corp. Sec., Derivative and ERISA Litig.*, 235 F. Supp. 2d 549, 573 (2002), where the court states that "[t]here are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question. Thus GAAP are far from being a canonical set of rules that will ensure *identical accounting treatment of identical transactions*. Rather, GAAP tolerates a range of 'reasonable' treatments, leaving the choice among alternatives to management." *Id.* (emphasis added) (citations omitted).

80. SAS no. 95 — *Generally Accepted Auditing Standards* ("GAAS"), J. ACCOUNTANCY, Feb., 28, 2002, at 83, 2002 WLNR 5094201 [hereinafter SAS no. 95], is comprised of the following 10 audit standards:

General Standards:

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and preparation of the report.

Standards of Field Work:

4. The work is to be adequately planned and assistants, if any, are to be properly supervised.

the auditor's report, to the audit profession.⁸¹ Self-regulated and unsupervised, the audit profession fashioned accounting standards, audit standards, and an auditor's report to their liking.

The early 1900's was a period of dramatic change for the auditor. During this period, the audit profession began to move beyond its historic role of auditing for fraud to its new role of auditing on a test basis.⁸² Test basis auditing meant that an auditor no longer examined every transaction but, instead, selected representative financial samples upon which to base a judgment. This change in audit philosophy was prompted in part by increasing demands from the business community for audit services. As a result, a lack of understanding developed between what auditors actually did and what the public perceived the auditor was doing ("expectation gap"). The expectation gap increased as more auditors moved from fraud auditing to test auditing while the public's expectation of the auditor's role remained unchanged.

In addition, another more subtle change occurred. During the first half of the twentieth century, accounting principles were primarily characterized as principles only. However, as the decades unfolded,

5. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

6. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting:

7. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

8. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

9. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

10. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, reasons therefore should be stated. In all cases where the auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

81. There are generally four different species of auditor's opinion contained within the standard auditor's report. The four variants are an unqualified opinion, a qualified opinion, a disclaimer opinion and an adverse opinion. The unqualified opinion is desired by all audit clients because it is perceived to be a bill of clean health. A full review of the reasons for and uses of the different opinions is beyond the scope of this work.

82. VINCENT M. O'REILLY ET AL., *MONTGOMERY'S AUDITING* 1•9 (12th ed. 1998) [hereinafter *MONTGOMERY'S AUDITING*]. "Gradually, American audits evolved into 'test audits' as procedures were adapted to rapidly expanding American business, which considered British-style detailed checking of footings and postings too time-consuming and expensive." *Id.*

accounting standards evolved from a principles only focus to a rules based focus. This evolution in accounting standards was in direct response to the demands of an increasingly complex economy and the auditor's desire to minimize his exposure to the public.⁸³

Principles only accounting is characterized by reporting and disclosing financial results based on broadly defined principles of accounting. Proponents of this school argue that principles based accounting leads to better disclosure. Opponents, however, argue that principles based accounting requires increased reliance on the auditor's professional judgment and that in its final analysis, principles based accounting is, itself, subject to a higher degree of manipulation because it relies heavily on interpretation. Examples of principle based standards include determining the impairment of a long-lived asset,⁸⁴ or identifying when revenue should be recognized.⁸⁵

In direct contrast, rules based accounting is characterized by sheer technical compliance with a stated rule. Rules based accounting is devoid of any meaningful consideration as to whether the financial information reported is reasonably presented. As a consequence, satisfying rules based accounting principles may bear little relation to the substance of the underlying transaction.⁸⁶ Proponents of rules based accounting argue that it leads to better comparability and provides certainty in financial reporting. Opponents, however, argue that rules based accounting rewards financial engineering. Examples of rules based accounting include lease accounting⁸⁷ and stock based

83. "GAAP has increasingly become rules-rather than principles-based. In large part, this may be due to the auditing profession's belief that IPAs (independent public accountants) can successfully avoid being sued if they can show that their clients and they followed the rules." Benston, *supra* note 14, at 1344.

84. SEC REPORT, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM, pt. II.B.iii, <http://www.sec.gov/news/studies/principlesbased-stand.htm> (last visited Sept. 18, 2004) [hereinafter STUDY].

85. Under the accrual basis of accounting, revenue is recognized when the rights to receive the revenue are fixed and determinable. In contrast, under the cash basis of accounting, revenue is recognized when the cash is received by the company. Both policies are technically correct but may result in significantly different financial statements.

86. A clear example would be the accounting treatment for stock options. The current accounting standard, FASB Statement No. 123, permits a company to choose between two methods when valuing the cost of stock options. The first method, the intrinsic value method, generally results in a lower value than the second and preferred standard, the fair value method. The rules permit a company to minimize the economic cost of the stock options it issues.

87. When classifying a lease as a capital lease, it must meet one of four tests; two of which contain strict percentage thresholds (75% and 90%). STUDY, *supra* note 84, pt. II.B.i.

compensation,⁸⁸ which adhere to mechanical principles for purposes of financial reporting and auditing.

As of this writing, there are over 150 accounting pronouncements, some principles based and others rules based, which provide guidance to both Management and the auditor on a how to record a particular transaction for purposes of financial statement disclosure. All of these pronouncements are asserted to be GAAP. Yet, despite the creation of new accounting standards, the auditor's report has remained essentially unchanged. The public, generally unaware how financial transactions were being measured and recorded in the first place, continues to read and rely upon the auditor's report without so much as a warning that the underlying accounting rules evolved from a principles based to a rules based approach,⁸⁹ or that the auditor's focus had shifted from a fraud focus to a test basis.

In an attempt to resolve the continuing debate over accounting principles, Congress commissioned an analysis of the accounting principles used in the United States as part of the SOA reforms ("Study").⁹⁰ The Study attempts to establish a harmonized approach

88. *Id.* The Study cites additional rules based standards (consolidation 50%, consolidation of special purpose entities 3%, smoothing gains or losses on defined benefit plans – 10%). *Id.* Stock based compensation presents an especially abusive example of rules based accounting because by complying with the rules, a company can avoid disclosing to the investor the hidden expense of the full compensation program. Indeed, it was partly through the use of rules based accounting that Enron was able to manipulate its financial statements to be technically compliant with GAAP but deceptively deficient to the public. As long as 3% of Enron's capital came from a third party, the accounting rules permitted that the liabilities of a special purpose entity can be kept off the consolidated financial statements.

89. The Cohen Commission Report provides that "[o]ne effect of using a standard report is that as a person becomes familiar with its words, he tends to stop reading it each time he sees it. He relies on his memory of what it says and his impression of what it means. . . . The entire report comes to be interpreted as a single, although complex, symbol that is no longer read." THE COMM'N ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS (1978) [hereinafter COHEN COMMISSION REPORT]. Consider whether the auditor's report has risen to the level of a quasi-trademark such that its continued use by the audit profession and good faith reliance by the public should subject the audit profession to legal exposure using principles similar to deceptive advertising. The report came to be "known as the Cohen Commission, after its chairman, Manuel C. Cohen." MONTGOMERY'S AUDITING, *supra* note 82, at 1•12.

90. Section 108(d) of Sarbanes-Oxley Act provides in relevant part that

[t]he Commission shall conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system. The study . . . shall include an examination of—

(i) the extent to which principles-based accounting and financial reporting exists in the United States;

(ii) the length of time required for change from a rules-based to a principles-based financial reporting system;

(iii) the feasibility of and proposed methods by which a principles-based system may be implemented; and

to establishing accounting standards and resolve the debate over the accounting principles to be used by companies when reporting their financial results and by auditors when evaluating the financial statements.⁹¹

The Study begins by examining how accounting standards were established by the accounting profession and how they evolved over time. The Study declares that the SEC “has the responsibility [in developing] accounting standards to be used by public companies.”⁹² This is “[d]espite the fact that the [SEC] has consistently looked to the private sector for assistance”⁹³ in determining accounting standards. The Study analyzes the history and development of the accounting standards and its effect on users, companies, auditors, and the SEC. Specifically, the Study examined the development and use of principles only and rules based standards. Favoring neither approach, the Study “found that imperfections exist when standards are established on either a rules based or principles only basis.”⁹⁴

According to the Study, principles only standards are deficient because they “. . . provide little guidance or structure for exercising professional judgment by preparers and auditors.”⁹⁵ As a consequence, a principles only standard requires “preparers and auditors to exercise significant judgment in applying overly broad standards to more specific transactions and events”⁹⁶ Additionally, a principles only standard does “not provide a sufficient structure to frame [a] judgment that must be made”⁹⁷ concerning the resolution of a specific issue. Instead, the exercise of judgment by an auditor when interpreting the various standards may lead to “retrospective interpretational differences”⁹⁸ over the accounting principle and the possibility of increased litigation among auditors, clients, regulators, and the public.

Next, the Study also found rules based standards deficient because they “provide a vehicle for circumventing the intention of the [ac-

(iv) a thorough economic analysis of the implementation of a principles-based system.

Sarbanes-Oxley Act § 108(d).

91. See STUDY, *supra* note 84.

92. *Id.* pt. II.A.iv; see also Benston, *supra*, note 14, at 1325 (where the author comments that “[t]he Securities Act of 1934 gave the SEC the authority to dictate both accounting and auditing standards.”).

93. STUDY, *supra* note 84, pt. II.A.iv.

94. *Id.* Exec. Summ

95. *Id.*

96. *Id.*

97. *Id.*

98. STUDY, *supra* note 84, pt. V.G.

counting] standard.”⁹⁹ The Study found that “rules-based standards can provide a roadmap [for the] avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of the standards.”¹⁰⁰ Rulesbased standards are “not representationally faithful to the underlying economic [transaction].”¹⁰¹

The Study rejected both principles only accounting and rules based accounting standards in favor of a new standard, an “objectives-oriented [standard].”¹⁰² The Study concluded that both the principles only approach and the rules based approach contained deficiencies in determining the appropriate standards for reporting financial transactions.¹⁰³ The Study concludes that an objectives-oriented standard will result in improved transparency of the financial transactions and lead to less reliance on judgment by the company and the auditor.¹⁰⁴

The new objective-oriented standard contains the following characteristics: It should “[b]e based on an improved and consistently applied conceptual framework; [c]learly state the accounting objective of the standard; [p]rovide sufficient detail and structure so that the standard can be operationalized . . . ; [m]inimize exceptions from the standard; [a]void use of percentage tests”¹⁰⁵ The Study recognizes that “objective-oriented standards place greater emphasis on the responsibility of both management and auditors to ensure that the financial reporting captures the objectives of the standard”¹⁰⁶ The goal of the objectives-oriented standard is *to provide better disclosure to the public* (emphasis added). It is the Study’s expectation that “good companies [will be incented] to be more forthcoming in providing clear and transparent information to investors.”¹⁰⁷

Despite its ambitious undertaking to resolve accounting principles, the Study’s final recommendation and implementation will have little influence on the behavior of the average investor. This is because the current auditor’s report continues to make only passing reference to the GAAP and GAAS standards without fully alerting the reader what these standards represent. The continued use of an audit report

99. *Id.* Exec. Summ.

100. *Id.*

101. *Id.* pt. I.C

102. *Id.* Exec. Summ

103. *STUDY*, *supra* note 84.

104. *Id.*

105. *Id.* Exec. Summ

106. *Id.*

107. *Id.* pt. III.I.ii.

that is poorly understood will perpetuate the public's misunderstanding of the audit process. This lack of understanding by the public in turn diminishes confidence and credibility in the auditor, the audit process, and ultimately, in the capital markets, thereby frustrating the overall purposes and goals of the '33 Act, the '34 Act and the SOA. If the SOA's objective of "protecting investors and further[ing] the public interest in . . . audit reports" is to acquire a meaning beyond the inner sanctum of auditors, CFO's and professional investors, then the auditor's report needs to be rewritten so that concepts such as GAAS,¹⁰⁸ GAAP,¹⁰⁹ materiality, and audit risk acquire a concrete meaning for the average investor.

D. *Enhanced reporting and frequency*

Section 401 of the SOA enhances the periodic disclosure requirements with two meaningful changes. First, § 401 requires that public companies who file their annual SEC report ". . . reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles"¹¹⁰ Second, public companies are now required to disclose in "each annual and quarterly financial report required to be filed with the [SEC] . . . all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the [company] . . . that may have a *material* current or future effect on financial condition . . ." of the company.¹¹¹

The enhanced reporting rules of § 401 are a marked improvement to the reporting structure formerly used by companies. Before § 401, the public was not aware of the possible financial impact that either a correcting adjustment or an off-balance sheet transaction may have on the company. Technical compliance with GAAP rules made it possible for companies to present financial statements that were engineered to comply with GAAP while simultaneously not disclosing the

108. GAAS provides the auditor with a fair degree of flexibility in designing the audit to be performed. GAAS itself is vague because it does not mandate a quantum of evidence to be examined or a procedure to be undertaken. Rather, it leaves the determination of these to the auditor's professional judgment which can vary based on the auditor's experience and tolerance level for risk, and can further vary based on the audit client's level of complexity.

109. GAAP gives management the various tools to use in reporting financial information. Thus, in a perfect world, management chooses the accounting treatment and the auditor confirms whether or not the treatment is consistent with GAAP. Management may not be aware of the alternative treatments and feeling the pressure to report profitable growth, may turn to the auditor for help in choosing a treatment that will present the financial statements in a favorable light.

110. Sarbanes-Oxley Act § 401(a)(i).

111. *Id.* § 401(a)(j) (emphasis added).

substance of the underlying transaction.¹¹² Technical compliance with GAAP also permitted auditors to opine, without further explanation, that the financial statements were GAAP compliant. In the end, rules based accounting made it possible for financial engineers to fabricate a particular result without violating GAAP. Now, as a result of § 401, users of financial statements are expected to gain a better understanding of “material”¹¹³ transactions or “off-balance sheet transactions”¹¹⁴ that affect the company.

However, despite this reform concerning enhanced periodic disclosure, one must consider whether in this day of instant information, data which may be as much as three months old, remains timely and relevant to the public. Businesses do not expect their corporate managers to wait 30, 60, or 90 days to receive financial information from the company before responding to the competitive environment. Therefore, is it reasonable to expect that the public to wait, in some cases up to 90 days, for the issuance of quarterly financial reports upon which to help them base an economic decision? Information which is relevant to the average investor should be released immediately. If a continuum of disclosure were imagined, information which is disseminated daily would arguably have the greatest value to the public. In stark contrast, information which is disseminated annually would have the lowest value.

In order to make the enhanced disclosure rules more meaningful to the public, the enhanced disclosure rules should be amended to include a requirement that public companies make available, their monthly financial results.¹¹⁵ This is justified on the basis that all of the Fortune 500 companies have websites which can easily allow for instantaneous posting by the company and easy access by the public to monthly financial information. Managers at many publicly traded companies receive financial information on a monthly basis, if not more frequently. Auditors would benefit also from the monthly disclosure because they could identify interim audit procedures that may become necessary sooner. The public could compare the monthly information to the reported quarterly information and, ultimately, to the audited financial statements. The practice of issuing monthly op-

112. Indeed, it was Enron's technical compliance with a 3% GAAP standard that permitted it to technically hide its off-balance sheet obligations while remaining in compliance with GAAP.

113. Sarbanes-Oxley Act § 401(a)(j).

114. *Id.*

115. The monthly operating results would include, at a minimum, a monthly balance sheet and a monthly profit and loss statement.

erating results should help surface reporting issues, as well as help in preventing the manipulation of financial results.

Opponents of this proposal will argue that monthly financial information is not yet finalized, its release may create undue reliance by investors and assembling the information will create additional cost and burden to the company. In response, it can be contended that the information may be issued with a proper disclaimer indicating that it is preliminary financial information and that such information is subject to change.¹¹⁶ Additionally, the administrative burden the company will bear as a result of monthly distributions should be negligible given that monthly financial statements are already created as a routine business practice.¹¹⁷

III. ACCOUNTING AND AUDITING

A. *History of the audit profession*

The origins of auditing can be traced back to the ancient Egyptian, Chinese and Greek civilizations. The ancient Egyptians used auditing procedures to provide "independent checks . . . [for] . . . recording of tax receipts."¹¹⁸ "The government accounting systems of the Zhao Dynasty¹¹⁹ in China included an elaborate budgetary process and audits of all government departments."¹²⁰ In ancient Greece, public officials were generally distrusted and were, therefore, required to subject themselves to an audit of the accounts.¹²¹ Throughout these early times, audits were performed primarily as a check upon public officials entrusted with public financial responsibilities and as a tool to help maintain control of valued resources.

During the Middle Ages, auditing continued to be used as a tool for control. According to one auditing textbook, "[t]he City of London

116. By its very nature, most items which are material will be obvious to the company. In the few instances where the question of the materiality is in doubt, or not known, a disclaimer surrounding the uncertainty of the item should suffice.

117. The social benefit of frequent disclosure cannot be sufficiently emphasized. An investor should have the confidence that the company he owns is constantly monitoring and evaluating its own system of internal controls. Additionally, the practice of releasing monthly information further enhances the objectives of Section 302 of the SOA, which requires that the officers certify the quarterly and annual disclosures, by ensuring that the monthly information is not being manipulated by a company.

118. BOYNTON, *supra* note 8, at 9.

119. The period of the Zhao Dynasty ran from 1122 B.C. to 256 B.C.

120. MONTGOMERY'S AUDITING, *supra* note 82, at 1*7

121. GEORGE J. COSTOUIROS, CTR. FOR INT'L EDUC. AND RESEARCH IN ACCOUNTING, ACCOUNTING IN THE GOLDEN AGE OF GREECE: A RESPONSE TO SOCIOECONOMIC CHANGES 77 (1979) ("[P]riests and priestesses [were also] subject to audit . . .").

was audited at least as early as the 1200s.”¹²² Additionally, audits conducted during this period held “a hearing of the accounts” before the public.¹²³ “By the middle of the sixteenth century, auditors . . . often annotated the accounts they audited with the phrase ‘heard by the auditors undersigned.’”¹²⁴

Modern auditing was born in the 19th century during the Industrial Revolution.¹²⁵ The separation of ownership of the company from the management of the company fueled the evolution of auditing, as absentee owners¹²⁶ sought to hold hired managers accountable for the results of the enterprise.¹²⁷ In similar fashion, the increase in trade and expansion of economies from a regional to a national basis helped form the evolving role of the auditor.

During the middle of the 19th century, American breweries and steel companies were among the first companies to begin using the services of an auditor.¹²⁸ American companies initially engaged the more experienced British auditors to conduct the audit.¹²⁹ As the economy grew and more investors entered the market, demand for audits increased. Bankers also contributed to the growing role of the auditor during this period “by requiring audit examinations” of their debtors.¹³⁰ American companies increasingly sought the advice and expertise of auditors. British auditors, seeing a new market opportu-

122. MONTGOMERY'S AUDITING, *supra* note 82, at 1•7.

123. *Id.* The practice of “hearing the accounts” originated during the days when few people could read. This practice continued until the seventeenth century. *Id.*

124. *Id.*

125. See *id.* at 1•8, where the authors report that “[b]efore 1850, audits were a minor part of an accountant's practice and were not performed routinely.”

126. Corporate shareholders must demonstrate a “proper purpose” before they will gain access to a corporations books and records. See 805 ILL. COMP. STAT. ANN. 5/7.75 (West 2005), where a shareholder must state a “proper purpose” before he will be granted the right to see his corporations books and records. Consider whether the system of separating ownership of a corporation from the management of a corporation was ever intended to keep the legal owners of the company away from the auditors.

127. Absentee owners turned to the auditor to help detect and protect against employee fraud. See O. ROY WHITTINGTON & KURT PANY, PRINCIPLES OF AUDITING AND OTHER ASSURANCE SERVICES 8 (13th ed. 2001) [hereinafter WHITTINGTON].

128. PETER L. McMICKLE & RICHARD G. VANGERMEERSCH, THE ACAD. OF ACCOUNTING HISTORIANS, THE ORIGINS OF A GREAT PROFESSION 142 (1987).

129. *Id.* The authors also cite the observations of James T. Anyon, an English Bred CPA and first treasurer of the American Association of Public Accountants that, “[t]he average accountant of that day ‘lacked personality and impressiveness. He failed to convey to the businessman the conviction that he was an expert in his profession, or that he was especially expert in anything. He knew of his business in a simple elemental way but possessed few ideas and little or no vision.’” *Id.* at 141-42.

130. *Id.* at 142.

nity, exported their services and helped established the early American auditing firms.¹³¹

During the first half on the 20th century, the American audit profession matured. The auditors' defining moment in American business came soon after the stock market crash of 1929 when Congress enacted the '33 Act and '34 Act. Both Acts required the inclusion of an auditor's report. Congress sought to restore confidence and tranquility in the capital markets by pressing the auditor, and the auditor's report, into service on behalf of the American public.¹³² Congress perceived that the auditor possessed the necessary skill, independence and judgment to evaluate a company's financial information and express his independent opinion through the auditor's report.

During the second half of the 20th century, the accounting profession continued to develop into the profession we recognize today. Following the post World War II era, American businesses began to expand from regional markets to national markets. Similarly, the audit profession evolved from regional markets to national markets. In particular, the last quarter of the 20th century witnessed unprecedented growth in American businesses and corporate combinations. "M&A"¹³³ became a standard buzz-word in the legal and business community. The auditing profession, itself a for-profit industry, was not spared the relentless march toward increased profitability and efficiency. The auditing profession itself went through a period of intense competition and consolidation during the 1980's as the firms competed for increased market share and revenue. The continuing pressure to increase profits and remain competitive pressed the audit firms to expand the scope of services from audit into other areas including tax and consulting services.¹³⁴ The first tier national accounting firms went from the Big Eight, then to the Big Six, then to the Big Five, and finally to what is presently the Big Four.¹³⁵

131. Early audit firms formed the American Accounting Association, a predecessor organization to the FASB.

132. See James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 31-32 (1959). Congress adopted a disclosure based system to help investors evaluate securities. Congress required the inclusion of the auditor's report to provide investors with objective evidence of an evaluation of management's assertions. (couldn't match with source)

133. The abbreviation "M&A" means "merger and acquisition".

134. Cox, *supra* note 25, at 301, 310-11. The auditing "industry was dominated by a few national players – first the Big Eight, then the Big Five, and now the Final Four." *Id.* at 311. The author also suggests the theory that the audit profession used audits as a "loss leader" to gain entry in the "more competitive and extremely lucrative consulting segment." *Id.* at 312.

135. *In re Ikon Office Solutions, Inc.*, 277 F.3d 658, 662 n.1 (3d Cir. 2002). "The "Big Five" accounting firms are Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP,

However, despite its noble veneer and dignified origins,¹³⁶ the audit profession suffered a shameful and shocking fall from grace as it found itself in the middle of a financial scandal whose wake rippled through the American economy.¹³⁷ The ensuing financial disasters, many created with the assistance of the audit profession, are now indelibly etched on the pages of American history. The once noble and prestigious profession is now viewed by the public as an outlaw whose unsuspecting weapon consisted of the very tool Congress selected on two earlier occasions to restore the public trust, the auditor's report.

B. *History, evolution and purpose of the auditor's report.*

The origin of the modern auditor's report can be traced to late 19th century British audit reporting practices.¹³⁸ British influence figured prominently in the formation of early American audit reports. These early American audit reports were referred to as "certificates" and, in direct contrast to the current auditor's report, opined on the "accuracy" of the financial report. The following is a sample of an early auditor's report issued between 1900 and 1920:¹³⁹

We have audited the books and accounts of the XYZ Company for the year ended December 31, 1915, and *we certify* that, in our opinion, the above balance sheet *correctly sets forth* its position as of the termination of that year, and that the accompanying profit and loss account *is correct*.¹⁴⁰

KPMG LLP and PricewaterhouseCoopers LLP. For many years, the accounting industry was dominated by eight national firms. In 1989, the "Big Eight" was reduced to six members with the mergers of Ernst & Whinney and Arthur Young into Ernst & Young and Touche Ross and Deloitte Haskins & Sells into Deloitte & Touche. In 1998, the "Big Six" became the "Big Five" as Price Waterhouse merged with Coopers Lybrand to become PricewaterhouseCoopers." *Id.* The "Big Five" became the "Big Four" following the demise of the Arthur Andersen firm in 2002.

136. "Before professional organizations were formed, individuals who had strong reputations for probity and financial experience made attestations." Benston, *supra* note 14, at 1330 n.17.

137. The Wall Street Journal published a table of companies with accounting irregularities. The following is a brief synopsis of the table: Adelphia – allegedly failed to properly disclose \$3.1 billion in loans and guarantees to its founder's family; Bristol-Meyers – allegedly inflated revenues by as much as \$1 billion through the use of sales incentives; Merck – improperly recorded \$12.4 billion in revenue that were never collected; Rite Aid – allegedly inflated revenue by \$1.6 billion; Tyco International – created "cookie-jar" reserves and "spring loaded" earnings from acquisitions by accelerating their pre-merger outlays. The complete table can be found at: HAROLD S. BLOOMENTHAL SARBANES-OXLEY ACT IN PERSPECTIVE app. E (2002-2003 ed. 2002).

138. Geiger, *supra* note 15, at 7.

139. The "[s]tandardization of the report developed because many auditors' reports were confusing." COHEN COMMISSION REPORT, *supra* note 89, at 72. Changes to the report over time were made in part, as a defensive measure to counter the auditors' liability. *See infra* Part IV.

140. Geiger, *supra* note 15, at 8-9 (emphasis added).

Early audit reports did not have a required format. Auditors had considerable discretion to write their audit reports to accommodate the circumstances. Variants of the early auditors' reports state that the auditor "finds the [accounts] *to be correct*," that "the books and accounts . . . *are correctly prepared* . . ."¹⁴¹ The common characteristic among these early reports is that they convey to the reader that they "certify" the accounts and state that the information is "accurate."¹⁴² A reader of an early auditor's report is led to the conclusion that the financial information as reported is accurate. This is no longer the case with the auditor's report currently in use today.¹⁴³

The first attempt by the federal government to standardize the audit report occurred in 1917 when the Federal Reserve Board published its bulletin, *Uniform Accounting: A Tentative Proposal*.¹⁴⁴ In that bulletin the FRB recommended that the audit report read as follows:

I have audited the accounts of Blank & Company for the period from . . . to . . . and *I certify* that the above balance sheet and statement of profit and loss have been made in accordance with the plan suggested and advised by the Federal Reserve Board and in my opinion set forth the financial conditions of the firm at . . . and the results of its operations for the period.¹⁴⁵

The 1917 recommended audit report retained the reference to the certification of the financial statements, but eliminated any express reference to their accuracy.¹⁴⁶ The audit profession believed this version of the auditor's report was more responsive to the increasing needs of the American business community. In addition, the audit profession also believed that this report alerted "the . . . reader [as to] . . . the inexactness of the financial reporting process."¹⁴⁷

141. *Id.* (emphasis added).

142. Before 1900, audits often included an evaluation of "all or almost all recorded transactions" for a company. WHITTINGTON, *supra* note 127, at 9. Today, audits are conducted on a test basis, which simply means selecting a limited sample of transactions on a predetermined basis and determining if the sample chosen is properly recorded.

143. The current text of the standard auditor's report does not opine on the accuracy of the financial statements. Instead, the auditor's report opines that the financial statements "present fairly." This notion of "presents fairly" is an interesting concept because reasonable minds will differ as to when the financial statements "presents fairly" its results. The point at which financial information no longer "presents fairly" will differ based upon the judgment, experience, and tolerance level of the auditor.

144. Geiger, *supra* note 15, at 12. The text of the FRB's publication was adopted from a booklet published earlier by the American Institute of Accountants ("AIA"). *Id.*

145. *Id.* at 13 (emphasis added).

146. *Id.*

147. *Id.* at 13 (alteration in original).

Seventeen years later, in 1934, the AIA published a pamphlet that included a revised audit report.¹⁴⁸ The auditor's report evolved into a standard two paragraph format and included substantial changes from its 1917 predecessor. The word "audit" was replaced by the word "examined" in the belief that this change better informed the public that the auditor was not examining every single transaction nor verifying every management assertion¹⁴⁹ presented. The word "certify" was eliminated in an attempt to clarify that the audit report is not a guarantee.¹⁵⁰

The revised 1934 standard auditor's report reads:

We have made an examination of the balance sheet of the XYZ Company at December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith, we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

In our opinion, based upon such examination, the accompanying balance sheet and related statements of income and surplus *fairly present, in accordance with accepted principles of accounting* consistently maintained by the company during the year under review, its position at December 31, 1933, and the results of its operations for the year.¹⁵¹

The revised 1934 audit report added the phrase "fairly present, in accordance with accepted principles of accounting"¹⁵² to the auditor's report. To this day, this phrase is a source of continuing debate and controversy over its intended meaning. Does the phrase "fairly present" mean that (i) the financial statements fairly present the underlying economic and (ii) the financial results of the company? Or, does the phrase mean that the financial statements are technically GAAP

148. *Id.* at 15. The 1934 revised audit report was prompted in large measure in response to the audit report at issue in *Ultramares*. *Id.* at 14. "Perhaps the *Ultramares* case will be the means of bringing about a reform which will eliminate the words certify and certificate." *Id.* at 15.

149. One commentator has described management assertions as "The Auditor's Achilles' Heel" because of "the auditors' penchant for undue reliance on [management's] representations in lieu of gathering objective evidence." FELIX POMERANZ, *THE SUCCESSFUL AUDIT, NEW WAYS TO REDUCE RISK EXPOSURE AND INCREASE EFFICIENCY* 85 (1992), Business One Irwin, Homewood, Illinois; see also *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 703 (S.D.N.Y. 1968), where the court criticized the auditor for being "too easily satisfied with glib answers" by management in conducting its audit, suggesting that the auditor is duty bound to objectively confirm answers offered by Management. *Id.*

150. Geiger, *supra* note 15, at 15.

151. *Id.* (emphasis added).

152. *Id.* at 16.

compliant notwithstanding the underlying economics? Whatever the intended meaning, the public is not aware of the subtle distinction in meaning. As a result, a segment of the public believed that the auditor's report is a certification of a fact and not an expression of opinion based upon professional judgment.¹⁵³

The AICPA recognized that there existed a misunderstanding between the public and the auditor concerning the objective and function of an audit (referred to as an "expectation gap"). In order to remedy this misunderstanding, the AICPA formed the Commission on Auditors' Responsibilities in 1974 ("Cohen Commission") to address the apparent gap in understanding. The AICPA charged the Cohen Commission with determining "whether a gap *may exist*¹⁵⁴ between what the public expects . . . and what auditors can and should reasonably [be] expect[ed] to accomplish."¹⁵⁵

Four years later, in 1978, the Cohen Commission issued its report.¹⁵⁶ The Cohen Commission concluded that an expectation gap "does exist."¹⁵⁷ It further concluded (a) "the principal responsibility does not appear to lie with the users of financial statements," (b) "users expectations are generally reasonable,"¹⁵⁸ and (c) "the burden of narrowing the gap between performance and expectations falls primarily on [the] auditors."¹⁵⁹ The Cohen Commission Report states that "research suggests that many users misunderstand the auditor's role and responsibilities, and the present standard report only adds to the confusion."¹⁶⁰ The public is generally unaware ". . . of the limitations of the audit function and . . . confused about the distinction between the responsibilities of management and those of the auditor."¹⁶¹

Ten years after the Cohen Commission issued its report the audit profession, in 1988, revised and issued the following auditor's report in response to the concerns identified by the Cohen Commission:

153. See generally *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So.2d 315 (Miss. 1987) (auditor's report is an expression of professional opinion).

154. COHEN COMMISSION REPORT, *supra* note 89, at xi (emphasis added). It is interesting to note that the Commission Report is couched in the tentative ("may exist") despite the continued debate at that time (i.e. 1974 - 1978) within audit profession concerning the role and function of the auditors.

155. *Id.*

156. *Id.*

157. *Id.* at xii.

158. *Id.* The Cohen Commission report indicates that "many users [of financial statements] appear to misunderstand the role of the auditor and the nature of the service he [provides]". *Id.* (alteration in original).

159. COHEN COMMISSION REPORT, *supra* note 89, at xii.

160. *Id.* at 171.

161. *Id.*

Independent Auditor's Report

To the Board of Directors and Stockholders

ABC Company

We have audited the balance sheets of ABC Company at December 31, 20X2 and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company at December 31, 20X2 and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ CPA firm (signed by audit engagement partner)

Date

The 1988 audit report attempts to address some of the concerns raised by the Cohen Commission. However, it fails to correct the uncertainties of the predecessor 1934 auditor report – uncertainties which continue in use today. In particular, the revised auditor's report fails to address the presence of audit risk, fails to speak to materiality, or clarify the objective of an audit.¹⁶² The reintroduction of the word "audit" in the opening sentence of the revised auditor's report may actually mislead the public into believing the audit is more comprehensive than an auditor would admit, thereby continuing, instead of dissipating, the expectation gap. Additionally, the original misunderstanding remains - namely, the lack of understanding concerning the role of the auditor, the scope of the audit, and the limitations of the auditor's report.

162. See *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992), where the California Supreme Court states that "an audit report is not a simple statement of verifiable fact that . . . can be easily checked against uniform standards of indisputable accuracy. Rather, an audit report is a professional opinion based on numerous and complex factors." *Id.* at 763 (citations omitted).

As currently drafted, the auditor's report, with its hidden implications,¹⁶³ will continue to be understood only by a select group of individuals. This pool of individuals will continue to diminish with each passing pronouncement issued by the AICPA unless the auditor's report is reformed. The social costs of misunderstanding the auditor's report can lead to devastating financial consequences for the public. Individual bankruptcies and pension bailouts all have an individual and a social cost. Now more than ever, understanding the auditor's report, and its limitations, is of increasing importance as a growing percentage of the public interact with the securities markets.

C. *The auditing function and process*¹⁶⁴

Audits are intrusive, disruptive, and costly. Why then, do companies undergo an audit?¹⁶⁵ In the case of publicly held companies, audits are conducted to comply with SEC requirements.¹⁶⁶ In the case of closely held companies, audits are conducted to satisfy a demand made by an investor, a bank, or a supplier.¹⁶⁷ At a fundamental level, there exists a question of trust – namely, whether the financial statement representations made by management are genuine and credible. Therefore, the underlying function of an independent audit is to reassure investors, creditors, and suppliers that the financial statements presented by Management are bona fide.¹⁶⁸

163. The meanings of "present fairly," "GAAP," "GAAS," "materiality," and "audit risk."

164. One commentator has described the auditing process as "a mix[tur]e of judgment and technique which may result in certain pitfalls." See Feinman, *supra* note 1, at 22 (2003).

165. Additional reasons for undergoing an audit include lowering the cost of capital, enabling access to capital markets, and improving financial and operational controls. See BOYNTON, *supra* note 8, at 47-48.

166. See 15 U.S.C. §78j-1 (2005) (establishing the audit requirements for publicly held companies).

167. For example, investors or creditors generally require closely held companies to secure audited financial statements as a condition to securing financing. JERRY R. STRAWSER & ROBERT H. STRAWSER, *AUDITING THEORY AND PRACTICE* 1-4 (Dame Publ'ns, Inc. 8th ed. 1997). However, consideration must be given to the fact that "[e]ven an unqualified audit report . . . does not guarantee that the financial statements are entirely accurate, that the client has not committed fraud in their preparation, or that the company's financial past is a reliable predictor of its future." Feinman, *supra* note 1, at 54.

168. Cohen Commission Report notes that

Because financial statements are one of the means used to evaluate its performance, management may select and apply accounting principles that give a biased portrayal of the entity's financial position and earnings. The auditor evaluates the appropriateness of management's selection and application of accounting principles. The principal value of the independent auditor's opinion on financial statements is that his judgment is not influenced by self-interest in the measurement of the performance of the entity presented in the statements.

COHEN COMMISSION REPORT, *supra* note 89, at 14.

Management of a corporation makes certain representations about the financial status of the company through its financial statements.¹⁶⁹ An investor, creditor, or supplier evaluating the performance of a company will read the financial statements and learn the state of the company's financial performance for a given period. A knowledgeable investor, creditor, or supplier will also look to see whether an audit report accompanies the financial statements. The presence of an audit report suggests to the reader that the financial statements have been evaluated by an independent auditor. The absence of an auditor's report signals to most readers that the financial statements have not been independently reviewed and, therefore, calls into question whether the financial information is objectively presented.

1. Comprehension

Attorneys advising and counseling clients on the implications of the SOA will be expected to possess a basic understanding of the auditing function and the audit process.¹⁷⁰ To comprehend the audit process, the advising attorney must gain an appreciation of the following five concepts - accounting, auditing,¹⁷¹ audit evidence, audit risk, and materiality - as well as understanding how these concepts interrelate within the context of an audit.

First, accounting can be described as the process of identifying, measuring, recording, and reporting financial transactions affecting a company.¹⁷² Accounting is not an exact measurement of all the financial transactions affecting a company. Instead, accounting is a process

169. Within the audit community, a management representation is called a "management assertion." Management asserts, through its financial statements, that (1) a financial transaction has occurred, (2) the financial statements are complete, (3) the company has the rights or obligations indicated in its financial statements, (4) the financial transactions have been identified, measured and recorded in accordance with generally accepted accounting principles and (5) all relevant and material disclosures have been made. See WHITTINGTON, *supra* note 127, at 136.

170. For example, Section 303 of the SOA provides in relevant part that "[i]t shall be unlawful for any officer or director of an issuer, , to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements." Sarbanes-Oxley Act § 303. What is the "action" contemplated by Section 303? When is an auditor "engaged in the performance of an audit of the financial statements? Or consider Section 404 of the SOA which may require an attorney to advise his client whether the auditor's evaluation of management's self assessment of its internal control structure is proper. *Id.* § 404.

171. This requires understanding that audits are conducted on a test basis (meaning, sampling and extrapolating instead of examining 100% of the financial transactions), what auditing is, and most importantly, what auditing is not.

172. See KIESO, *supra* note 8, at 2, where the authors state that "[a]ccounting may best be defined by describing the three essential characteristics of accounting: (1) identification, measurement and communication of financial information about (2) economic entities to (3) interested persons."

of combining calculated assumptions and concrete facts to record and report economic transactions affecting an entity for a specified period of time. Management is allowed considerable discretion in selecting among the alternate GAAP rules when preparing its financial statements.¹⁷³ The public may not be aware of Management's discretion.

Second, auditing can be described as a process whereby an auditor confirms the information reported by Management on the company's financial statements. The audit process requires that the auditor review the accounting principles selected by Management when preparing the company's financial statements and analyze selected financial transactions to determine if the company's internal controls¹⁷⁴ are properly functioning. It is a fundamental tenet of auditing that Management, not the auditor, is responsible for the information reported through the financial statements. An audit is not a guarantee of financial statement accuracy.¹⁷⁵ Instead, an audit is meant to provide reasonable assurance, as distinguished from absolute assurance, that the financial information presented is reasonably accurate and that the financial statements are free from material misstatement.

Third, the theory of "audit evidence" requires understanding that an auditor need only obtain "sufficient competent evidential matter"¹⁷⁶ during the performance of the audit to enable the auditor to evaluate the evidence and to form an opinion regarding the financial statements.¹⁷⁷ Typical audit procedures used by auditors include

173. For example, management has the discretion to choose which inventory method (Last-in, First out (LIFO), First-in, First-out (FIFO), weighted average or specific identification), or depreciation method (straight line depreciation, declining balance depreciation, sum of the year's digits) to adopt. The method selected will ultimately have a considerable impact on the earnings reported to investors. Management may also use bunching, acceleration or deferral techniques for either income or expense items with the objective of improving the financial results reported.

174. See STRAWSER, *supra* note 164, at 4-2, where the authors define internal controls as "[a]n entity's . . . policies and procedures implemented by management to ensure that transactions are recorded accurately and that assets are adequately safeguarded."

175. See *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 (9th Cir. 1979), where the Ninth Circuit recognized that "an accountant is not a guarantor of the reports he prepares and is only duty bound to act honestly, in good faith and with reasonable care in the discharge of his professional obligations." *Id.*

176. SAS no. 95, *supra* note 80, item number 6.

177. Most individuals' experience with an audit comes within the context of an income tax audit where a tax auditor has the authority to examine every single line item and scrutinizing every single document if necessary. In point of fact however, financial audits differ from tax audits because of differing objectives. The objective of a financial audit is to determine if the financial statements reasonably reflect the company's underlying financial performance. In sharp contrast, the objective of a tax audit is to ensure that taxpayers are properly reporting income and complying with the prescribed rules governing deductions and credits. Thus, the level of detail necessary and scrutiny required will vary between a tax audit and a financial audit. Consider also, *First Nat'l Bank of Commerce v. Monco Agency Inc.*, 911 F.2d 1053, 1058 (5th Cir. 1990), where the court recognizes that

“physical examination, re-performance, retracing, documentation, confirmation, analytical procedures, interviews and observation.”¹⁷⁸ An auditor is not required to evaluate every single financial transaction affecting a company when conducting an audit. Doing so would be cost prohibitive and of marginal benefit to the company and its shareholders.¹⁷⁹

Fourth, the concept of “audit risk”¹⁸⁰ requires understanding that there exists the possibility that the auditor may unintentionally issue the wrong audit opinion.¹⁸¹ For example, the auditor may issue an unqualified opinion (that is, a clean opinion)¹⁸² when the circumstances dictate that he should have issued a qualified opinion or a disclaimer opinion.

Fifth, “[t]he concept of materiality recognizes that [the disclosure of] some matters. . . are important for [the] fair presentation of [the] financial statements in conformity with [GAAP].”¹⁸³ The materiality

The situation is complicated by the fact that the interests of management, the financiers of the work product, are not necessarily consonant with those of the public. Management seeks to maximize stockholders' and creditors' confidence in the company, within the bounds of the accounting profession's Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS); whereas, the public demands a sober and impartial evaluation of fiscal performance.

Id.

178. WILLIAM F. MESSIER, *AUDITING A SYSTEMATIC APPROACH*, THE MCGRAW HILL COMPANIES, INC. 117 (1997).

179. The costs of conducting and reporting a 100% audit would outweigh the benefits. Consider the question, “what will result in a better audit?” Improved audit procedures? Enhanced audit disclosure? A more thorough audit will not necessarily result in a better audit. The real objective to be accomplished through the auditor's report is to provide the public with relevant information to help in the decision process. If the auditor's report alerts the public to the scope and limitations of the audit, then the public will adjust its expectations and reliance accordingly.

180. AU § 312.02 defines audit risk as “the risk that the auditor may unknowingly fail to appropriately modify his or her opinion of financial statements that are materially misleading.” Audit risk itself is the sum of three discrete risk components: inherent risk (“[t]he possibility of a material misstatement of an assertion before considering the client's internal control” environment), control risk (“[t]he risk that a material misstatement will not be prevented or detected on a timely basis by the client's internal control” environment) and detection risk (“[t]he risk that the auditors will fail to detect [a material] misstatement with their audit procedures.”). See WHITTINGTON, *supra* note 127, at 137. What is of peculiar note is that the audit profession appears to have found a way to objectively calculate what otherwise would appear to be wholly subjective determinations. See BOYNTON, *supra* note 8, at 293.

181. It is important to bear in mind that the auditor's “opinion”, in contrast to the auditor's “report”, is a statement of professional opinion made by the auditor within the body of the auditor's report regarding the type of opinion he expresses (e.g., “present fairly,” “except for,” “subject to”).

182. See *In re Ikon Office Solutions, Inc.*, Sec. Litig., 277 F.3d 658, 663 n.4 (3d Cir. 2002), where the court states that “[a]n ‘unqualified’ or ‘clean’ audit opinion is the highest level of assurance that an auditor can give on an organization's financial statements. Accountants will ‘qualify’ their opinion where discrepancies are identified in a client's financial statements.” *Id.*

183. AU § 312.03.

doctrine functions as a screening mechanism to help the auditor determine when the disclosure of an item is required so that the financial statements are not distorted or misleading. To satisfy the materiality requirement, an auditor is required to plan the audit in order to detect transactions that may have a material effect on the financial statements.¹⁸⁴ The auditor is required to establish "materiality levels" to help him decide when an item is to be considered material to the financial statements.¹⁸⁵

The auditing standards do not establish a percentage level for determining when a transaction is to be considered material. The absence of quantitative levels for evaluating materiality is consistent with the SEC's own position on materiality which prohibits the use of quantitative presumptions when evaluating materiality thresholds.¹⁸⁶ Comprehending how an auditor approaches materiality is now of increasing importance to the lawyer because the SOA itself mandates due consideration of materiality under certain provisions.

FASB Concepts Statement No. 2 provides the auditor with general guidance in determining when an item is to be considered material. It provides that an item is to be treated as material when "the [importance] of an omission or misstatement of accounting information . . . makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."¹⁸⁷ The auditor must consider "the magnitude of an omission or misstatement of accounting information that, in light of the surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been . . . influenced by the omission or misstatement."¹⁸⁸ While the audit standards do not prescribe quantitative guidelines for determining materiality threshold levels, certain industry "[r]ules of thumb . . . [have evolved when establishing materiality levels which] . . . include 5% to 10% of net income before taxes, ½ percent to 1 percent of total assets, and 1 percent of total equity."¹⁸⁹

184. See BOYNTON, *supra* note 8, at 286 (citing STAMFORD CONN, QUALITATIVE CHARACTERISTICS OF ACCOUNTING, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS xv (Fin. Accounting Standards Bd. 2nd ed., 1980)).

185. See STRAWSER, *supra* note 164, at 4-14.

186. SEC Staff Accounting Bulletin No. 99, Release SAB 99, 17 C.F.R. pt. 211 (Aug. 12 1999).

187. AU § 312.10

188. AU § 312.10

189. WHITTINGTON, *supra* note 127, at 194; see also BOYNTON, *supra* note 8, at 287 (5% to 10% of net income before taxes); KIESO, *supra* note 8, at 50 (stating that "Companies and their auditors for the most part have adopted the general rule of thumb that anything under 5% of net income is considered not material.").

To fully grasp the notion of materiality within an audit context, one must recall that the accounting process is itself an inexact process. Accounting involves, to varying degrees, measuring and recording financial transactions through the use of estimates.¹⁹⁰ One must also recall that the auditor is reviewing the financial statements prepared by the company, not preparing them. Therefore, the notion of materiality becomes increasingly important when the item under consideration, if omitted or misstated, would substantially distort the financial statements. Establishing when an item will be considered material "is a matter of professional judgment and *is influenced by [the auditor's] perception of the needs of a reasonable person who will rely on the financial statements.*"¹⁹¹

An auditor uses materiality as a financial yardstick to help determine whether an economic transaction, or a series of transactions or accounts, requires disclosure in the financial statements. The transaction generally involved is typically an accounting omission or accounting restatement. If, in an auditor's judgment, an item is deemed to have a material impact then the auditors will require a disclosure in the financial statements. Depending on the type of item, the disclosure may require adjusting the financial statements to reflect the economic impact of the considered item.¹⁹² Conversely, if an item is not deemed to have a material financial impact, then the auditors will not require an adjustment to the financial statements. Auditors may disregard the financial effects of a particular transaction if in the auditor's judgment, the omission or correction of the transaction is not material to the information reported on the financial statements taken as a whole.¹⁹³

190. See DONALD A. LESLIE, MATERIALITY: THE CONCEPT AND ITS APPLICATION TO AUDITING 8 (Canadian Inst. of Chartered Accountants ed., 1985), where the author describes the "accounting process . . . a collection of estimates and predictions."

191. AU § 312.10 (emphasis added).

192. Certain adjustments may simply take the form of a footnote disclosure (e.g. non-financial items such as a related party transaction.)

193. By way of example, a discrepancy of \$1 million dollars may not be material to the financial statements of many Fortune 500 companies and therefore, may not require adjusting the financial statements of such company. Thus, whether something is characterized as material from a quantitative perspective, depends on its context within the financial statements and the auditor's tolerance level for materiality. From an audit perspective as distinguished from an investor perspective, materiality has little meaning without financial statements against which to measure. Therefore, the statement within the auditor's report that the "financial statements. . . present fairly. . . in all material respects" has minimal value to the public, because without a known published standard against which to measure, any such reference to materiality is a pure abstraction absent of any significant meaning to the public. See complete text of auditor's report *infra* Part III.B.

What is considered material is ultimately a matter of the auditor's professional judgment. The challenge for regulators, auditors and lawyers following the enactment of the SOA, will be to arrive at a universal definition of materiality. Several newly adopted provisions of the SOA require the disclosure of material items.¹⁹⁴ Conflicts will inevitably arise between regulators, auditors, Management, and the public as each party will seek a definition that advances its own interest. At present, there is no case clearly defining what "materiality" means within the context of the auditor's report. However, two Supreme Court cases which analyzed the meaning of materiality within the context of the securities laws may be instructive.

a. *TSC Industries, Inc. v. Northway, Inc.*¹⁹⁵

In *TSC Industries, Inc. v. Northway, Inc.*, a minority stockholder brought suit against the defendants claiming that the defendants' joint proxy statement was incomplete and materially misleading in violation of §14(a) of the '34 Act¹⁹⁶ and Rules 14a-3a¹⁹⁷ and 14a-9.¹⁹⁸ The

194. Section 401(a) adds two new subsections to 15 U.S.C. § 78, which both rely heavily on the interpretation of the term "material." Sarbanes-Oxley Act § 401(a). New subsection (i), captioned "Accuracy of Financial Reports," provides that "[e]ach financial report that contains financial statements . . . shall reflect all *material* correcting adjustments . . . identified by a registered public accounting firm. . . ." *Id.* § 401(a)(i). In addition, Section 401(a) adds the requirement that is in accordance with generally accepted accounting principles and the rules and regulations of the Commission. New subsection (j), captioned "Off-Balance Sheet Transactions," provides in relevant part that

[n]ot later than 180 days after the date of enactment of the Sarbanes-Oxley Act of 2002, the Commission shall issue final rules providing that each annual and quarterly financial report required to be filed with the Commission shall disclose all *material* off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a *material* current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.

Id. § 401(a)(j) (emphasis added).

195. 426 U.S. 438 (1976).

196. *Id.* at 441 n.2. Section 14(a) provides in relevant part that

[i]t shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, 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, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78L of this title.

Id. (quoting 15 U.S.C. § 78n(a) (2005)).

197. 17 C.F.R. §240.14a-3 (1975).

198. 17 C.F.R. §240.14a-9 (1975). Rule 14a-9 provides that

[n]o solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, con-

plaintiff in this case was required to exchange his stock following a merger transaction. The plaintiff claimed that the defendants “omitted [disclosing in] the proxy statement [certain] material facts relating to the degree of . . . control”¹⁹⁹ they exercised over the acquired company. The plaintiffs also claimed the defendants withheld material information by failing “to state in the proxy statement that the transfer” of the minority shareholder’s interest to the majority shareholder had given the defendant control over the acquired entity.²⁰⁰ The plaintiffs also claimed that the defendants withheld material information by failing to disclose the favorable terms of their acquisition.²⁰¹

The Court framed its inquiry into its analysis of the materiality concept by stating that “[t]he question of materiality . . . is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.”²⁰² The Court examined the contrasting formulations of the materiality standard proposed by the Seventh Circuit Court of Appeals against the standard proposed by the Second and Fifth Circuits. The Seventh Circuit standard articulated a broad approach to materiality and declared that “material facts include ‘all facts which a reasonable shareholder *might* consider important.’”²⁰³ In contrast, the Second and Fifth Circuits articulated a narrower standard and adopted an inquiry-based approach in defining materiality, namely, “whether a reasonable man would attach importance to the fact misrepresented or omitted in determining his course of action.”²⁰⁴

The Court rejected the Seventh Circuit standard. The Court explained that adopting a standard that is so broad may lead to the disclosure by the company of “information [that] is of . . . dubious significance”²⁰⁵ By setting the

standard of materiality . . . unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management’s fear of exposing itself to substantial liability may cause it simply to bury the

taining any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Id. §240.14a-9(a).

199. *TSC Indus.*, 426 U.S. at 442.

200. *Id.*

201. *Id.* at 442-43.

202. *Id.* at 445.

203. *Id.* (Emphasis in original.)

204. *Id.*

205. *TSC Indus.*, 426 U.S. at 448.

shareholders in an avalanche of trivial information a result that is hardly conducive to informed decision making.²⁰⁶

Thus, too low a threshold for materiality might cause information overload.

The Court then articulated a materiality standard and declared that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider [the omitted fact] important in deciding how to vote.”²⁰⁷ The Court further stated that “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”²⁰⁸ This latter requirement helps safeguard against frivolous claims that information which is of dubious significance is material.

b. *Basic Inc. v. Levinson*²⁰⁹

Twelve years later, the United States Supreme Court once again examined the question of materiality in *Basic Inc. v. Levinson*. This time, the Supreme Court examined the meaning of a materiality within a pre-merger context under §10(b) of the ‘34 Act²¹⁰ and Rule 10b-5.²¹¹ At issue in *Basic* was whether the defendant’s intentional misstatements denying pre-merger discussions were materially misleading.

The plaintiffs in *Basic* brought an action under the ‘34 Act claiming that “the defendant issued three false or misleading public statements” in violation of §10(b) and of Rule 10b-5.”²¹² The plaintiffs alleged that they sustained economic injury as a result of selling their stock at an artificially depressed price.²¹³ The plaintiffs’ claim that they relied on the defendant’s intentionally misleading statements which denied that pre-merger discussions were in progress.²¹⁴ “Dur-

206. *Id.* at 448-49.

207. *Id.* at 449.

208. *Id.*

209. 485 U.S. 224 (1988).

210. 15 U.S.C. § 78j(b) (2005).

211. 17 C.F.R. § 240.10b-5 (1987). Rule 10b-5 provides in relevant part that

[i]t 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. . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . .

Id.

212. *Basic*, 485 U.S. at 228.

213. *Id.* at 228.

214. *Id.* at 227.

ing 1977 and 1978, the defendant made three public statements denying that it was engaged in merger negotiations."²¹⁵ In November 1978, the defendant went so far as to issue to its shareholders financial statements for the nine month period ending September 30, 1978, reporting that "[w]ith regard to the [surge in] stock market activity in the Company's shares, we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months."²¹⁶ On December 18, 1978, the defendant suspended "trading in its shares and issued a release stating it had been 'approached' by another company concerning a merger."²¹⁷ Two days later, on December 20, the defendant "publicly announced its approval of the . . . tender offer for all outstanding shares."²¹⁸

The Court's analysis reiterated that the purpose of the '34 Act is "to protect investors against manipulation of stock prices"²¹⁹ and that a key objective of the '34 Act is to "implement[] a philosophy of full disclosure."²²⁰ The Court cautioned that the policy of full disclosure is not tantamount to a paternalistic view of investors.²²¹ Rather, the policy is meant to provide investors with information to make an informed decision.²²² The Court then reaffirmed its earlier standard for materiality.²²³ The Court held that it "expressly adopt[s] the . . . standard of materiality" announced in TSC for purposes of §10(b) and Rule 10b-5.²²⁴ The Court further clarified that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information."²²⁵

As the case law demonstrates, the Supreme Court's approach to materiality is conceptually similar to the auditor's notion of materiality. When evaluating the relative importance of a material item, both the Supreme Court and the GAAS materiality standards make reference to the omitted or misstated fact,²²⁶ both refer to an "objective"

215. *Id.*

216. *Id.* at 227 n.4.

217. *Id.* at 227-28.

218. *Basic*, 485 U.S. at 228.

219. *Id.* at 230.

220. *Id.*

221. *Id.* at 234.

222. *Id.*

223. *Id.* at 232.

224. *Basic*, 485 U.S. at 232.

225. *Id.* at 240.

226. The Supreme Court uses "an omitted fact;" the audit standards use "an omission or misstatement." See *Basic*, 485 U.S. at 231.

standard,²²⁷ and both purport to assess the degree of influence the omitted fact would have had on the investor²²⁸ as relevant factors to a materiality inquiry.

The challenge following the enactment of the SOA is reconciling the practical differences when applying the materiality standard. "Accountants have generally viewed the materiality doctrine as a mechanism that protects corporate clients and themselves against their own mistakes and not as a concept that facilitates a full disclosure system for the protection of investors."²²⁹ A leading textbook on auditing theory asserts that "materiality represents a cushion that the auditor allows for the necessary imprecision in applying auditing procedures to detect misstatements of the financial statements."²³⁰ In stark contrast, the SEC pursues a policy of full disclosure when interpreting materiality in order to expand its enforcement powers and to protect the public interest. Reconciling both approaches will be even more important given that the SEC now has direct oversight responsibility over the audit profession and the auditor's report.

IV. CASE LAW ANALYSIS AND APPLICABLE LEGAL STANDARDS

The question of responsibility and liability is intensely debated in any profession. However, the auditor may find himself legally exposed to a broader group of plaintiffs who will claim to have relied to their detriment on the auditor's report simply by issuing the audit report. The distinguishing characteristic of the auditor's report, when compared to other professionally issued reports, is that the auditor's report is widely distributed. The auditor's report, therefore, can influence the decisions of a vast group of individuals whether they lay in the comfort of their bedroom or sit in a boardroom.²³¹

The AICPA, recognizing the social responsibility and public influence the auditor exerts, pronounced that:

[a] mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity

227. The Supreme Court uses "reasonable shareholder;" the audit standards use "reasonable person." See *Basic*, 485 U.S. at 231.

228. The Supreme Court uses "would consider;" the audit standards use "influenced." See *Basic*, 485 U.S. at 231.

229. Warren, *supra* note 27, at 899.

230. *Id.* at 899-900.

231. See STRAWSER, *supra* note 164, at 1-4. "Three major groups of individuals are involved in the audit process: (1) the entity whose financial statements are being evaluated (the client), (2) the auditor, and (3) third-party users." *Id.*

of certified public accountants to maintain the orderly functioning of commerce. This reliance [by the public on auditors] imposes a public interest responsibility on certified public accountants.²³²

One audit textbook, quoting a FASB pronouncement, states that “[t]he social purpose that independent audits serve[] . . . enhance the reliability or credibility” of the financial information presented.²³³

The U.S. Supreme Court, in a frequently quoted opinion, also recognized the social value of the auditor and stated that:

[b]y 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 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.²³⁴

The ability to affect and influence vast number of individuals translates into a near infinite range of possible legal actions against the auditor ranging from claims made by the audit client to claims made by unknown third parties.

Auditors are directly liable to their audit clients²³⁵ under contract and tort theories.²³⁶ In certain circumstances, auditor liability has extended from the audit client to third parties. The typical fact pattern

232. 2 AICPA PROFESSIONAL STANDARDS § 53.01 (1990). But see *Waters v. Autuori*, 676 A.2d 357 (Conn. 1996), where the issue under consideration was “whether the promulgation of professional accounting standards is sufficient, by itself, to impose upon the promulgating professional organization a duty of care to an unknown third party who relies on the opinion of a certified public accountant claiming to have followed those standards.” *Id.* at 358. The Connecticut Supreme Court examining this issue held that “the standards promulgated by the AICPA are, on their face, insufficient to establish a duty of care” to an unknown third party. *Id.* at 361. Thus, even though the AICPA acknowledges that it has a duty to protect the public, courts seem to be reluctant to find that a duty exists.

233. MONTGOMERY'S AUDITING, *supra* note 82, at 1•12 (quoting the Financial Accounting Standards Board in Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting By Business Enterprises*).

234. *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984). But see *Bily v. Arthur Young*, 834 P.2d 745, 762 (Cal. 1992), where the California Supreme Court maintains that “[a]n auditor is a watchdog, not a bloodhound.”

235. Justice Cardozo stated that auditors “owed to their employer (i.e. the audit client) a duty imposed by law to make their [audit] certificate without fraud, and a duty growing out of contract to make it with the care and caution proper to their calling.” *Ultramares Corp. v. Touche*, 174 N.E. 441, 444 (N.Y. 1931).

236. An aggrieved audit client can resort to two immediately available legal theories in its claim against the auditor. The first theory is for a breach of contract. Specifically, the client will assert that the auditor breached one of its express or implied promises and as a result of its breach, caused a harm to the audit client. The second theory available to the audit client is a tort action for either negligence, misrepresentation or gross negligence.

concerning an audit dispute between an auditor and a third-party involves a conflict that arises after the third-party loses money on an investment in the audited company as a result of a relying on the auditor's report. The third-party, typically an investor, creditor or supplier, claims to have relied on the auditor's report accompanying the financial statements, and will have advanced money or supplies to the audited company. Eventually, the audited company declares bankruptcy. The third-party invariably asserts a claim against the auditor in an attempt to recover his lost investment. Three schools of third-party auditor responsibility have evolved: the privity standard, the Restatement approach, and the foreseeable user approach.

A. *The Privity Standard*

The first school of third-party auditor liability holds that an auditor is liable only to persons in privity of contract. The first school of third-party auditor liability, the privity approach, was initially announced in 1932 by Justice Cardozo in *Ultramares Corp v. Touche*.²³⁷ The auditor in *Ultramares* conducted an audit of the financial statements of Fred Stern & Company.²³⁸ The plaintiff was "engaged in business as a factor"²³⁹ and routinely relied on an auditor's report in conducting its business. As a condition to extending credit to the audit client, Fred Stern & Company, the plaintiff "insisted that it receive a balance sheet certified by public accountants."²⁴⁰ The Stern Company delivered an audit certificate prepared by the auditor to the plaintiff. The plaintiff, relying on the auditor's certificate, made a series of loans to the company.²⁴¹

The balance sheet for the Stern Company showed a healthy company.²⁴² However, it was eventually discovered that false entries were

237. *Ultramares*, 174 N.E. at 441.

238. *Id.* at 442.

239. *Id.* at 443. A "factor" is a business entity that purchases another company's accounts receivable in exchange for an immediate discounted cash payment.

240. *Id.*

241. *Id.*

242. The balance sheet for *Ultramares* reads:

'TOUCHE, NIVEN & CO.

'Public Accountants

'Eighty Maiden Lane

'New York

'February 26, 1924.

'Certificate of Auditors

'We have examined the accounts of Fred Stern & Co., Inc., for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that, subject to provision for Federal taxes on income, the said statement in our opinion,

posted to the accounts to create the impression of a strong company.²⁴³ The auditor's sparse audit procedures failed to detect the false entries.²⁴⁴ The accounts receivable, inventory and accounts payable examined by the auditors turned out to be incorrect.²⁴⁵ As a result, the balance sheet, *certified* by the auditor as "true and correct"²⁴⁶ turned out to be incorrect. The Stern Company declared bankruptcy on January 2, 1925.²⁴⁷ Shortly thereafter, the plaintiffs brought suit against the auditors, Touche Niven & Company, for negligence and fraud.²⁴⁸

Justice Cardozo held that the auditor did not owe a duty of care to the plaintiffs. Therefore, the auditor could not be held liable for negligence.²⁴⁹ Justice Cardozo reasoned that "[i]f liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."²⁵⁰ According to Justice Cardozo, only a party in privity with the auditor could assert a negligence claim against the auditor.²⁵¹ *Ultramares* became an almost impenetrable defense that was successfully used by auditors against third-party plaintiffs seeking to recover for damages caused by an auditor's negligent audit.

B. *Restatement Approach*

The second school of third-party auditor liability holds that an auditor is liable to a third-party if he negligently or falsely supplies information to a third-party. This approach emerged with the introduction of § 552 of the Restatements (Second) of Torts, § 552 ("Restate-

presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923.

'TOUCHE, NIVEN & CO.,
'Public Accountants.'

Ultramares Corp. v. Touche, 243 N.Y.S. 179, 183 (N.Y. App. Div. 1930) (emphasis added), *rev'd*, 174 N.E. 441 (N.Y. 1931).

243. *Ultramares*, 174 N.E. at 442.

244. *Id.*

245. There was a fictitious accounts receivable posting of \$706,000.00. *Ultramares* p 190

246. See language in the audit opinion where the auditors assert that the balance sheet "presents a true and correct view." *Ultramares*, 243 N.Y.S. at 183 (emphasis added).

247. *Ultramares*, 174 N.E. at 443.

248. *Id.*

249. *Id.* at 444-47.

250. *Id.* at 444.

251. *Id.*

ment") in 1977.²⁵² The Restatement sought to reconcile the competing goals of protecting auditors against the hazard of indeterminate liability while at the same time providing audit plaintiffs with relief from the privity standard declared in *Ultramares*. Section 552 of the Restatement provides the general rule that one who negligently supplies false information for the use of another person in his business is liable for losses caused to such person as a result of that person's reliance on the information.²⁵³ The Restatement limits the auditor's liability to the person, or a limited group of persons, for whom the information is intended to benefit.²⁵⁴ The Restatement requires that the information supplied to such person, actually influence the decision of the person and cause the person to rely on the information as a condition to finding an auditor liable to a third-party.²⁵⁵

Twenty-two jurisdictions have adopted the Restatement standard.²⁵⁶ The most notable adoption of the Restatement position is the California's Supreme Court opinion in *Bily v. Arthur Young & Com-*

252. RESTATEMENT (SECOND) OF TORTS § 552 (1977) [hereinafter RESTATEMENT]. Section 552, Information Negligently Supplied For The Guidance of Others, reads as follows:

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

253. *Id.*

254. *Id.*

255. *Id.*

256. See Jessica P. Gomez, Accountants' Accountability to Non Clients in Texas, *St. Mary's Law Journal*, (2003), *The Restatement (Second) of Torts § 552* is followed by twenty-two states including: Alabama, Alaska, California, Florida, Georgia, Hawaii, Iowa, Kentucky, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, North Carolina, Ohio, Oklahoma, Rhode Island, South Carolina, Tennessee, Texas, Washington, and West Virginia. Paul J. Masinter & Walter F. Wolfe, Non-Client Third Party Claims Against Accounting Firms, Network (ABA/BUS. Law Section), Spring 2002, at 3, 5, available at <http://www.abanet.org/buslaw/newsletter/0003/materials/tip1.pdf> (on file with the St. Mary's Law Journal). Mississippi and Wisconsin are the states that currently utilize the foreseeability standard. *Id.* Courts and legislatures in Arizona, Colorado, Connecticut, Delaware, District of Columbia, Maine, Maryland, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, Puerto Rico, South Dakota, U.S. Virgin Islands, and Vermont apparently have not tackled this issue and thus their standard remains unclear.

pany.²⁵⁷ The California Supreme Court also used *Bily* to engage in a critical examination concerning the scope of an auditor's liability to a third party.

Bily involved an action by a group of investors who relied on the auditor's report when making an investment in the Osborne Computer Corporation ("Osborne").²⁵⁸ Osborne was founded in 1980 at the start of the personal computer revolution.²⁵⁹ Osborne began shipping computers in 1981, and by fall of 1982, its sales soared to \$10 million per month.²⁶⁰ In anticipation of a financing transaction the company needed, Osborne retained Arthur Young & Company ("Arthur Young") to audit its financial statements for 1981 and 1982.²⁶¹ Arthur Young prepared and issued "100 sets" of unqualified audit reports.²⁶² The auditor's report accompanying the Osborne financial statements for 1981 and 1982 opined that Osborne's financial "statements 'presented fairly' the company's financial position."²⁶³

Relying on the audited financial statements, the *Bily* plaintiffs purchased financial warrants in Osborne to help it secure bridge financing early in 1983.²⁶⁴ By mid-1983, Osborne began experiencing production problems and increased competition.²⁶⁵ As a result, its sales began to lag. The company filed for bankruptcy protection on September 13, 1983.²⁶⁶

The *Bily* plaintiffs filed suit against Arthur Young alleging "fraud, negligent misrepresentation, and professional negligence."²⁶⁷ Specifically, the plaintiffs alleged that Arthur Young failed to conduct its audit examination in accordance with generally accepted auditing standards, that liabilities for the audited period had been understated by \$3 million dollars and that "[a]s a result . . . [the reported] \$69,000 operating profit [for 1982] was . . . [really] a[n operating] loss of \$3 million."²⁶⁸ The *Bily* plaintiffs also charged that Arthur Young failed to report material weaknesses in the company's internal controls to management.²⁶⁹

257. *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992).

258. *Id.* at 748.

259. *Id.* at 747.

260. *Id.*

261. *Id.*

262. *Id.*

263. *Bily*, 834 P.2d at 748.

264. *Id.* at 747.

265. *Id.* at 748.

266. *Id.*

267. *Id.*

268. *Id.*

269. *Bily*, 834 P.2d at 748.

Following a 13-week trial, the jury “exonerated Arthur Young with respect to the allegations of intentional fraud and negligent misrepresentation, but returned a verdict . . .” finding Arthur Young liable of “professional negligence.”²⁷⁰ The California Court of Appeals affirmed the trial court’s finding of professional negligence.²⁷¹ However, the California Supreme Court, citing Restatement § 552, reversed and held that the auditor could not be found liable for negligence.²⁷²

The court held that “an auditor’s liability for general negligence in the conduct of an audit of its client financial statements is confined to the client, i.e., the person who contracts for or engages the audit services.”²⁷³ The California Supreme Court reasoned that “[u]nder the Restatement rule, an auditor retained to conduct an annual audit and to furnish an opinion for no particular purpose generally undertakes no duty to third parties. Such an auditor is not informed ‘of any intended use of the financial statements;’”²⁷⁴ This reasoning echoes the Restatement’s requirement that an auditor be placed on notice before he can be found liable to a third-party.

One might argue that the auditing profession, through its literature, its pronouncements, and its studies, is fully aware of the power and influence its audit report has on the general public. Is it reasonable then, for an auditor to continue to market himself as a “public watchdog,” while at the same time maintain the claim that he did not intend to influence the economic decision of a third party?

The Restatement’s approach is troubling because, while the auditor may not know the third-party whom he is influencing, he is nonetheless aware that his report may influence a decision of a third-party who relies on the auditor’s report. One might argue that the auditing profession, through its literature, its pronouncements, and its studies, is fully aware of the power and influence its audit report has on the general public. Is it reasonable then, for an auditor to continue to market himself as a “public watchdog” while at the same time maintain the claim that he did not intend to influence the economic decision of a third party? As one commentator observes, “the Restatement standard reflects the accountant’s responsibility to those beyond the direct client, but does not protect the general public from

270. *Id.* at 749. The jury awarded the plaintiffs \$4.3 million in compensatory damages. *Id.*

271. *Id.*

272. *Id.* at 774.

273. *Id.* at 767.

274. *Bily*, 834 P.2d at 758.

the accountant's negligence."²⁷⁵ Requiring a plaintiff to prove that an auditor "intend[ed] to supply the information" to the plaintiff and to also prove that the information "influenced" an economic decision places a crushing burden on plaintiffs seeking recovery from negligent auditors.²⁷⁶

C. Foreseeable User Approach

The third school of third-party auditor liability, a minority position, holds that the auditor is liable to foreseeable users of the financial statements. In *Citizens State Bank v. Timm, Schmidt & Co.*,²⁷⁷ the Wisconsin Supreme Court framed the issue under examination as whether "an accountant [may] be held liable for the negligent preparation of an audit report to a third party [who is] not in privity [with the auditor but] who relies on the [auditor's] report."²⁷⁸

The auditor had issued unqualified opinions for calendar years ending 1974 and 1975 "stat[ing] that the financial statements fairly presented the financial condition [of the company] and that the statements were prepared in accordance with generally accepted accounting principles."²⁷⁹ Relying on these financial statements and the auditor's report, the plaintiff, Citizens State Bank, loaned CFA "approximately \$380,000."²⁸⁰

In 1977, employees of the defendant accounting firm, Timm, Schimdt & Company, discovered that CFA's previously audited financial statements for 1974 and 1975 contained "material errors totaling over \$400,000"²⁸¹ These errors were not previously discovered by the auditor during its regular audit. Upon learning of the errors, Citizens State Bank called in its loans.²⁸² CFA then filed for bankruptcy, was liquidated and eventually dissolved.²⁸³ Citizens State Bank sued the defendant accounting firm, and its insurer, General Casualty Com-

275. Paschall, *supra* note 275, at 724.

276. The audit profession knows that the public relies heavily on the auditor's report. Why then, persist in the fiction that auditors don't know who the intended user is going to be. At a minimum, it is reasonable to assume that an investor, creditor or supplier will be relying on the audit information. Therefore, it is likewise reasonable to maintain that the auditor owes a duty of reasonable care and fair disclosure to that person. Anything short of this approach transfers a towering burden of diligence and examination to a person who in all likelihood, is further removed from the audit client than is the auditor and is incapable of accessing critical information.

277. 335 N.W. 2d 361 (Wis. 1983).

278. *Id.* at 362

279. *Id.*

280. *Id.*

281. *Id.*

282. *Id.*

283. *Citizens State Bank*, 335 N.W.2d at 362.

pany of Wisconsin, to recover monies lost when it extended credit to the audit client in reliance on the auditor's report.²⁸⁴

In a case of first impression in Wisconsin, the Wisconsin Supreme Court examined the privity standard enunciated by *Ultramares*, the recently enacted Restatement and a then growing minority trend in the courts holding the auditor liable to third parties.²⁸⁵ The Wisconsin Supreme Court rejected the near privity standard set in *Ultramares* as well as the Restatement approach.²⁸⁶

The Wisconsin Supreme Court adopted the minority trend and held that an auditor can be held liable to foreseeable third parties.²⁸⁷ The court announced that "[t]he fundamental principle of Wisconsin negligence law is that a tortfeasor is fully liable for all foreseeable consequences of his act except those . . . limited by policy factors."²⁸⁸ The Wisconsin Supreme Court reasoned that "[u]nless liability is imposed, third parties who rely upon the accuracy of the financial statements will not be protected."²⁸⁹ Additional reasons mentioned by the court in support of its position include the increased costs for credit to the public and the auditor's ability to "spread the risk through the use of liability insurance."²⁹⁰

Although this minority position remains valid in Wisconsin and Mississippi,²⁹¹ its adoption by sister courts and expansion into other jurisdictions is doubtful given the trend by most state courts to adopt the Restatement position.²⁹²

284. *Id.*

285. *Id.* at 364-66.

286. *Id.* at 366. The Wisconsin Supreme Court rejected the Restatement approach on the basis that it is "too restrictive . . . to adopt." *Id.*

287. *Id.* at 365.

288. *Id.* at 366.

289. *Citizens State Bank*, 335 N.W.2d at 365.

290. *Id.*

291. The precedential value of the Mississippi's Supreme Court's decision in *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987), is of limited value because the court's discussion of the foreseeability doctrine is based on an unusual state statute and the court's finding of no liability on the part of the auditor was based on criminal conduct occurring after the audit was performed.

292. The minority position was initially adopted by the New Jersey Supreme Court. See *Rosenblu, Inc. v. Adler*, 461 A.2d 138 (N.J. 1983), where the court upheld a claim by the plaintiffs for negligent misrepresentation against the auditors who issued an unqualified audit report for financial statements that were subsequently found fraudulent. However, the New Jersey State Legislature subsequently rejected the foreseeability approach when it codified the Restatement approach in 1995. See 1995 N.J. Sess. Law Serv. 826 (West).

V. PLAIN ENGLISH RULES²⁹³ AND THEIR RELEVANCE TO THE AUDITOR'S REPORT

The SEC enacted plain English rules as part of its initiative to increase the public's understanding of reports filed by companies with the SEC.²⁹⁴ However, the auditor's report, a mandated accompaniment to financial statements filed with the SEC, has yet to adopt plain English principles.

Specifically, plain English rules provide that in order "[to] enhance the readability of the prospectus, [a company] must use plain English principles in the organization, language, and design of the front and back cover pages, the summary, and the risk factors section."²⁹⁵ The objective of the Plain English rules is to make it easier for the average investor to understand the information he is reading.²⁹⁶ Plain English rules require the use of short sentences; definite, concrete everyday words; active voice; tabular presentation or bullet lists for complex material; the avoidance of legal jargon or highly technical business terms; and the avoidance of multiple negatives.²⁹⁷

Concern over the public's comprehension of the auditor's report is not a new phenomenon. As evidence of the public's confusion with the auditor's report, the Cohen Commission Report²⁹⁸ confirmed that "many users misunderstand the auditor's role and responsibilities, and the present standard report only adds to the confusion. Users are unaware of the limitations of the audit function and are confused about the distinction between the responsibilities of management and those of the auditor."²⁹⁹ The use of vague and abstract phrases such as "present fairly . . . in conformity with generally accepted principles" have created confusion not only among laymen, but among professionals within the audit profession.³⁰⁰ How is an unwary investor expected to interpret this phrase when professionals themselves are debating its exact meaning? The lack of clear language defining the responsibilities and limitations contribute to the confusion and misun-

293. See Andrew T. Serafin, *Kicking the Legalese Habit: The SEC's "Plain English Disclosure" Proposal*, 29 LOY. U. CHI. L.J. 681 (1998).

294. See Plain English Disclosure, 63 Fed. Reg. 6370-01 (Feb. 6, 1998).

295. 17 C.F.R. § 230.421(d)(1) (1998).

296. See generally Plain English Disclosure, 63 Fed. Reg. at 6370-01; see also 17 C.F.R. § 230.421.

297. 17 C.F.R. § 230.421(d)(2).

298. The report was "also known as the Cohen Commission, after its chairman, Manuel F. Cohen." MONTGOMERY'S AUDITING, *supra* note 82, 1•12.

299. COHEN COMMISSION REPORT, *supra* note 89, at 71.

300. See COHEN COMMISSION REPORT, *supra* note 89, at 74, where the authors of the report state that "the phrase has been the subject of widely varying interpretations in the accounting literature." *Id.*

derstanding surrounding the scope and function of the auditor's report.

Confusion over the auditor's report is furthered when one considers that "[t]he standard [auditor's] report . . . is intended to convey several separate messages. Some [of its messages] are stated explicitly. However, other messages must be inferred."³⁰¹ For instance, "[t]he present [auditor's] report only hints that financial statements are representations of management, . . . that [the] accounting principles used [were] appropriate in the circumstances . . . , [and] that the auditor used [professional] judgment in audits."³⁰² Enhancing the readability of the auditor's report which is presently only comprehensible to an "elite priesthood"³⁰³ by clarifying abstractions,³⁰⁴ defining technical terms,³⁰⁵ and addressing implied meanings³⁰⁶ is consistent with the SEC's plain English principles mandate to "enhance the readability"³⁰⁷ of the prospectus.³⁰⁸ Clarifying the language so that the scope and function of the auditor's report is understood by a broader base of individuals will not only benefit the investor, but will also, absent neg-

301. *Id.* at 73-74.

302. *Id.* at 74.

303. Howard B. Weiner, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 235 n.4 (1983).

304. Perhaps the single most misunderstood phrase in the auditor's report is the reference that the financial statements "present fairly" the financial status of the subject company. The Cohen Commission Report recognizes that

[s]ome users may expect financial statements to measure financial position and earnings with a degree of precision that is not attainable. It is unreasonable to expect a short phrase in the auditor's report to convey that message. Thus we recommend that the phrase "present fairly" be deleted from the auditor's report.

COHEN COMMISSION REPORT, *supra* note 89, at 14. This position was later withdrawn when the AICPA issued its revised standard auditor's report in 1987 which returned to include the 1939 version the phrase "fairly presented."

305. Examples of technical accounting terms currently used in the auditor's report which are in need of definition include "generally accepted accounting principles" which one court recognized as having as many as seventeen different sources, "generally accepted auditing standards," "materiality" and "reasonable assurance."

306. One commentator maintains that the "[t]he phrase *in all material respects*" informs users that the auditor's opinion does not attest to the absolute accuracy of the financial statements." See BOYNTON, *supra* note 8, at 67.

307. 17 C.F.R. § 230.421(d)(1) (2005).

308. Almost all professions have their own specialized jargon. However, a key distinction separating the audit profession from most other professions is that the auditor, unlike other professionals, has the ability to influence the behavior of third parties in virtually every corner of the world with one audit report. In stark contrast, a physician's report or an attorney's report is intended to influence only the behavior of the intended recipient. Physicians and attorneys deal directly with identified clients and are immediately available to define or clarify the meaning of a particular statement. In contrast, an auditor is not readily available to every third party to answer questions nor has he given clarity to the auditor's report by including a glossary of defined terms to aid the user when reading of the auditor's report.

ligence by the auditor, benefit the auditor and the company by clearly placing the responsibility of the financial statements back where it belongs, onto the company.³⁰⁹

The SEC, through its rule-making power, should extend the plain English standards to the auditor's report. Given that "[t]he auditor's standard report is almost the only formal means used both to educate and inform users of financial statements concerning the audit function,"³¹⁰ there is much public benefit to be gained in having an auditor's report that is easier to understand, discloses its scope and discusses its limitations. "Plain English, rather than legalese or technical terms, enables lay investors to better understand the risks of investing in a security."³¹¹ To that end, the audit opinion can gain increased credibility among the general public if it is rewritten so that an average investor will fully appreciate the content of the audit opinion. There already exists a strong movement toward simplification and increasing understanding of legal documents.³¹² Therefore, consistency would dictate extending the plain English movement to cover the auditor's report.

The elements of a plain English auditor's report should follow the SEC's mandate and contain simple and clear statements indicating (i) what was examined, (ii) what an audit is and is not, (iii) the limitations of an auditor's report, (iv) the auditor's opinion, (v) the scope of materiality, (vi) the percentage of transactions reviewed (percentage declaration), and (vii) a table of defined terms.

Further, the plain English auditor's report should further explain (i) that accounting includes estimates, (ii) that the financial statements are a "snapshot" of the financial condition of the company as of a certain point in time, and (iii) that Management is responsible for the information reported on the financial statements. Finally, the plain English auditor's report should clearly disclose the presence and nature of audit risk and should adequately renounce any reliance on the auditor's report as an indicator of future performance.

The following plain English auditor's report is offered as a model auditor's report:

309. Arguably, the insurance industry which seeks to minimize its insured risks in part through disclosure mechanisms should take an active interest in an audit report that is simpler and easier to understand and that clearly describes the limits of an audit and allocates responsibility between the auditor, the company and the public.

310. COHEN COMMISSION REPORT, *supra* note 89, at 71.

311. Susumu Miyazaki, *Should Japan Adopt A Plain Language Rule?*, 13 MINN. J. GLOBAL TRADE 1, 8 (2004).

312. See George H. Hathaway, *Plain English in the Twenty Types of Legal Documents*, 75 MICH. B.J. 684 (July 1996).

REVISED AUDITOR'S REPORT

Date

To the shareholders of XYZ Inc.

What was examined.

We have audited the financial statements (i.e. balance sheet, income statement and statement of changes in financial position) of XYZ Inc., for the year ending December 31, 20xx. You should know that the financial statements are prepared using estimates that identify, measure and record financial transactions to reflect the financial activity of the company. You should also know that the objective of an audit is to evaluate and determine if the methods and estimates used to prepare the company's financial statements are reasonable. An audit does not examine every financial transaction affecting the company. Instead, an audit is meant to provide the company's shareholders with reasonable assurance that the financial statements represent a reasonable approximation of the financial activity of the company and that the financial statements are free of significant mistakes. You should also be aware that significant items affecting the financial statements may not have been reviewed or detected. We believe, however, that we have identified and reviewed all significant transactions which may substantially affect the information presented in the financial statements.

Standard of review and materiality.

We have conducted our audit in accordance with generally accepted auditing guidelines. These guidelines require that we plan the audit to review and evaluate enough financial information which, in our professional judgment, will enable us to form an opinion. You should know that financial transactions representing less than \$xxx / yyy% were considered as insignificant to the overall financial statements and were therefore, not reviewed by us. You should also know that we reviewed x% of the transactions, which represents approximately x% of the balance sheet and x% of the income statement.³¹³

Snapshot.

You should be aware that the financial statements provide a snapshot of a company's financial performance as of December 31, 20xx. Financial events occurring after this date will change the reported information. These financial statements reflect historical performance. The financial statements do not indicate future company performance.³¹⁴

313. Illustration: "You should also know that we reviewed 5% of the transactions, which represents approximately 50% of the balance sheet and 75% of the income statement."

314. The concept of including a disclaimer is not new. Justice Kennard, in his dissent in *Bily*, proposed that the auditor could limit his exposure by disclaiming in his audit opinion liability to third parties. See *Bily v. Arthur Young & Co*, 834 P.2d 745, 785-86 (Cal. 1992) ("Such disclaimers give fair notice to all potential report users and prevent third parties' reliance from being reasonable."). By providing a disclaimer, the auditor is placing all prospective parties on notice

Management's responsibility.

It is management's responsibility to identify, measure, record and report the financial transactions affecting the company. You should be aware that management has considerable discretion in selecting the accounting rules and estimates it uses in preparing financial statements. Management prepared these financial statements. Management believes these financial statements are a reasonable approximation of the financial status of the company as of December 31, 20xx.

Our responsibility and our opinion.

Our responsibility is to provide the shareholders with an opinion concerning whether the financial statements prepared by management are a reasonable approximation of the financial activity for the company as of December 31, 20XX in accordance with generally accepted accounting guidelines.³¹⁵ Accordingly, in our opinion, the financial statements of XYZ are substantially accurate and provide the company's shareholders with a reasonable approximation of the financial position of the company as of December 31, 20XX.

Limitations and audit risk.

Because we have not examined every transaction, there exists the possibility that we may have missed an item that may have a significant effect on the financial statements. There also exists the possibility that our opinion is incorrect. We believe however that we have planned and conducted the audit in such a manner as to minimize these risks to an acceptable level.

S/ABC Auditors

VI. CONCLUSION

In the days following the Enron collapse auditors found themselves under attack as scandal after scandal seeped from the halls of several prominent American corporations.³¹⁶ In the end, the misdeeds of a few companies and auditors, executed through financial statements and auditor's reports, created an economic crisis which manifested it-

that his opinion is not to be relied upon as an indicator of future performance because the audit was not conducted for that purpose.

315. The word "guideline" is being substituted for the word "principle," in the phrase, Generally Accepted Accounting Principle." The word "principle" may unintentionally mislead a reader into believing that the accounting methods used by a company are fixed and determinable. See RANDOM HOUSE WEBSTER'S UNABRIDGED DICTIONARY 1539 (2nd ed. 2001) (which defines "principle" as "an accepted or professed rule of action or conduct"). In contrast, the word "guideline" does not connote such a rigid application of the accounting methods selected by the company. Rather, "guideline" suggests to the user a more fluid application of a company's methods of accounting. See *Id.* at 849 (which defines guideline as "any guide or indication of a future course of action. . .").

316. Public companies that defrauded investors include: Enron, Adelphia, WorldCom, Xerox, Waste Management, Candant, Qwest, and Tyco.

self as a general lack of confidence in the American economy.³¹⁷ In response, Congress enacted the SOA to restore public confidence in the capital markets in general and the audit profession in particular. The implications of the SOA and its impact on the public, auditors, companies and attorneys have yet to be fully realized. What is undeniable, however, is that as a result of the SOA, attorneys as a group, must undertake to gain a deeper understanding of how financial statements in general, and an auditor's report in particular, bear upon the rights and responsibilities of their clients.³¹⁸

In order to realize the full social benefit of the SOA, the auditor's report must be reformed. Modernizing the auditor's report will enable the public to gain a better understanding of the audit process itself and become aware of the limitations and inherent risks associated with an audit. Accordingly, the following initiatives should be adopted by the Congress as continuing reforms to the SOA. First, the SEC must modernize its regulation of audit report disclosure. The SEC must establish minimum content reporting requirements so that the public is aware of the scope and limitations of the auditor's report. The framework of the minimum disclosure requirements can be expected to be the subject of debate among accountants, lawyers and management. Any debate over minimum reporting standards should be investor-focused and include a discussion concerning: what an audit is and what an audit is not; the objectives of an audit; the subjective nature of accounting and auditing; how much of the balance sheet and income statement is audited expressed in either percentage or dollar terms; a brief explanation of what GAAP and GAAS are; and the fact that the financial statements represent historical information as of a certain date.

Second, the auditor's report should be rewritten adopting plain English principles to increase its comprehension and readability by the public. Implicit meanings should be removed, technical terms should be defined and the audit scope, and limitations should be clearly expressed. Increased comprehension of the auditor's report gives the public the ability for better decision making. A plain English audit report is further justified given that the investor base has broadened

317. The names of Kenneth Lay, former Enron CEO and David Duncan, former audit partner of the now defunct Arthur Andersen, have become synonymous with corporate avarice and greed.

318. See Warren, *supra* note 27, at 922 (stating "that corporate counsel . . . have lost whatever comfort they have enjoyed in treating accounting standards as off-limits to their world of legal principles.").

as the result of more active and direct involvement by the public through day-trading and on-line trading activities.

Third, the SEC should exercise jurisdiction over any auditor's report issued by an auditor where the audit affects interstate commerce.³¹⁹ The federal government's jurisdiction can be justified on interstate commerce principles.³²⁰ Currently, the SOA reforms apply only to publicly held companies. This approach ignores the numerous reports that are issued by auditors in the context of privately held companies that directly affect interstate commerce.³²¹ Whether a company is publicly held or closely held, the auditor's opinion, if it affects interstate commerce, should be subject to regulation by the SEC.³²²

Today, the auditor's report takes on a greater sense of urgency because the SOA places increased emphasis on the auditors' practices and procedures. These practices and procedures ultimately get filtered to the public through the auditor's report.³²³ However, the auditor's report has yet to be reexamined in full by the SEC. When it does, the focus on reforming the auditor's report should be "not on whether [the auditor's] report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the [auditor's] report fairly presents the true financial position of [the company] to the untutored eye of an ordinary investor."³²⁴

319. In 1996 the federal government pre-empted many state laws concerning the registration of securities. See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996). The assumption of this responsibility by the federal government would not be without precedence.

320. See U.S. CONST. art. I, § 8, cl. 3, which provides in relevant part that "[t]he Congress shall have Power . . . to regulate commerce with foreign nations, and among the several States."

321. For instance, a California bank, relying on the strength of an auditor's report, might advance funds to an investor group based in New York for an investment in an Illinois closely held corporation.

322. "The contents of periodic financial statements of corporations were regulated . . . by securities exchanges until the passage of the Securities Act of 1934" when financial information became federally regulated. Benston, *supra* note 14, at 1325.

323. "[I]nvestors are 'the most overlooked and underrepresented interest group in America.'" Richard W. Painter, *Standing Up To Wall Street (And Congress)*, 101 MICH. L. REV. 1512, 1512 n.2 (2003),

324. Herzfeld v. Laventhol, 378 F. Supp 112, 121 (1974).

