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## Is Silence Golden When It Comes to Auditing?, 36 J. Marshall L. Rev. 57 (2002)

Darin Bartholomew

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# IS SILENCE GOLDEN WHEN IT COMES TO AUDITING?

DARIN BARTHOLOMEW\*

## INTRODUCTION

Enron Corporation, an energy trading company, is embroiled in one of the largest bankruptcy filings in United States history.<sup>1</sup> The Securities and Exchange Commission (SEC) began investigating Enron in October of 2001.<sup>2</sup> Arthur Andersen, one of the big-five accounting firms, was convicted for obstructing a federal investigation because of Andersen's destruction of documents related to its public audit of Enron.<sup>3</sup> Arthur Andersen has since astronomically reduced its workforce and has arranged for the sales of segments of its accounting practice to other accounting firms.<sup>4</sup> Needless to say, it is questionable whether

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\* Darin E. Bartholomew is a Senior Attorney with Deere & Company, currently handling intellectual property licensing and transactional matters. He has practiced in the areas of commercial law, securities law and patent law since 1993. Mr. Bartholomew is a graduate of Northwestern University, The John Marshall Law School, and Georgetown University Law Center. This article is dedicated to the memory of the late A. A. Sommer, Jr., an illustrious attorney, professor and former Commissioner of the Securities and Exchange Commission, who once said, "Fraud is impossible to eliminate – it is a part of human nature." The author's views are solely expressed herein and are not attributable to any corporation, business, or other entity.

1. Robert O'Harrow Jr., *Creditors War Over Attorney-Enron Links, Judge Asked to Disqualify Law Firm*, WASH. POST, Mar. 23, 2002, at E01. Enron was once the seventh-largest U.S. company and entered into the largest bankruptcy in U.S. history as of Dec. 2, 2001. Marcy Gordon, *Former Enron Auditor Deflects Blame*, ASSOCIATED PRESS (Jan. 17, 2002), available at [http://senrs.com/former\\_enron\\_auditor\\_deflects\\_blame.htm](http://senrs.com/former_enron_auditor_deflects_blame.htm) (last visited Nov. 6, 2002). Enron's bankruptcy filing was later dwarfed by WorldCom Inc. when it filed the largest Chapter 11 bankruptcy filing in U.S. history on July 21, 2002. Jon Van, *WorldCom's Troubles Top \$7 Billion*, CHI. TRIB., Aug. 9, 2002, § 1, at 1. WorldCom Inc. disclosed over seven billion dollars in accounting irregularities that dated from 1999 until the filing, and that resulted in criminal fraud charges against several WorldCom executives. *Id.*

2. Jonathan D. Glater & Michael Brick, *Ex-Official Says Enron Employees Shredded Papers*, N.Y. TIMES, Jan. 22, 2002, at A1.

3. *The Fall of Andersen*, CHI. TRIB., Sept. 1, 2002, § 1, at 1; David S. Hilzenrath, *Andersen's CEO to Resign, Move Comes Days After Volcker Urged Changes at Top*, WASH. POST, Mar. 27, 2002, at A01.

4. *The Fall of Andersen*, *supra* note 3, at 1; Susan Schmidt and David S. Hilzenrath, *Andersen to Cut Jobs, Try to Shed Non-Audit Work*, WASH. POST,

either Enron or Arthur Andersen will survive as a viable business.<sup>5</sup>

According to THE WASHINGTON POST, an internal document evidenced Arthur Andersen's concern about potential accounting irregularities at Enron and outlined Andersen's considerations of ending the business relationship as early as February 6, 2001.<sup>6</sup> This internal document discussed the accounting treatment of partnerships that were used to exclude Enron's true level of debt from published financial statements.<sup>7</sup> In addressing potential changes to auditing, Arthur Andersen commented, "If a company just 'squeaks by,' the auditor can go to the board of directors through the audit committee. But if the board supports management's accounting choices, the auditor's only option is to remain silent or resign."<sup>8</sup> Andersen subsequently chose to remain silent regarding Enron's accounting practices after it debated dropping Enron as an audit client in the February 6, 2001 document.<sup>9</sup> In 2001, Enron paid Arthur Andersen over fifty-two

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Mar. 29, 2002, at E01; *The Question Remains: Will Andersen Fall?*, WASH. POST, Mar. 31, 2002, at H02.

5. *The Question Remains*, *supra* note 4, at H02. See also Press Release, Enron Corporation, *Enron Files Voluntary Petitions For Chapter 11 Reorganization; Sues Dynegy for Breach of Contract, Seeking Damages of at Least \$ 10 Billion*, (Dec. 2, 2001), available at <http://www.enron.com/corp/pressroom/releases/2001/ene/PressRelease11-12-02-01letterhead> (last visited Nov. 6, 2002). Arthur Andersen exited the public accounting business on August 31, 2002. *Consumer Spending Up 1%*, WASH. POST, Aug. 31, 2002, at E2.

6. Kathleen Day & Peter Behr, *Andersen Considered Severing Enron Ties, Feb. E-mail Shows Concerns About Accounting*, WASH. POST, Jan. 17, 2002, at A01; *Andersen's Woes Worsen Over Enron Debacle*, REUTERS (Jan. 17, 2002), available at [http://biz.yahoo.com/rb/020117/business\\_enron\\_andersen\\_memo\\_dc\\_1.html](http://biz.yahoo.com/rb/020117/business_enron_andersen_memo_dc_1.html) (last visited Nov. 6, 2002).

7. *Andersen's Woes Worsen*, *supra* note 6. Enron management approved the formation of the partnerships and controlled the partnerships "to manage its financial risk." John R. Emshwiller & Kathryn Kranhold, *Publicized Letter to Lay Involved Struggle Over Enron's Direction*, WALL ST. J., Jan. 16, 2002, at A4. "Enron hid its true financial picture and, most important, its true creditworthiness from Standard & Poor's," said Ronald M. Barone, Managing Director of Standard & Poor's Corp. Martha McNeil Hamilton, *Enron Hid Debt, Rating Agency Officials Say*, WASH. POST, Mar. 21, 2002, at A10.

8. Press Release, Patrick Dorton, *Arthur Andersen Worldwide CEO outlines additional reforms in firms U.S. audit practice*, (Feb. 5, 2002), available at <http://andersen.com/website.nsf/content/MediaCenterNewsReleaseArchiveAuditReforms02052002> (last visited Nov. 6, 2002).

9. See, e.g., Carrie Johnson and Peter Behr, *Andersen Guilty of Obstruction, Accounting Firm Will End Audit Work*, WASH. POST, June 16, 2002, at A1. Andersen approved Enron's pre-bankruptcy financial statements that obscured billions in debt and losses. *Id.* On October 16, 2001 in a press release, Enron initially disclosed the losses of the off-the-book partnerships against Andersen's recommendations. *Id.* Later, on Nov. 8, 2001. Enron itself disclosed that it was cutting reported profits by almost 600 million dollars over five years because of accounting errors. Hamilton, *supra* note 7, at A10. At

million dollars in auditing and consulting fees<sup>10</sup> in exchange for that “golden” silence.

Could this financial disaster have been avoided if the Sarbanes-Oxley Act of 2002<sup>11</sup> were in effect or if different regulatory measures were in place? First, this article will present the regulatory scheme and the SEC’s role will be reviewed. Second, this article will propose several improvements to prevent or discourage similar breakdowns in auditing. The proposed improvements build on existing self-regulatory organizations and represent pro-active measures for reducing the regulatory burden on the SEC.<sup>12</sup>

Most publicly traded corporations strive to present their financial conditions lawfully in the most favorable light to the public.<sup>13</sup> Sometimes, corporations make extreme financial

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least one public auditor at Arthur Andersen allegedly worked in an environment where voicing disagreement with the audit client was discouraged. Susan Schmidt, *Andersen Yanked Advisor Off Enron, Partner’s Complaints Irked Energy Firm*, WASH. POST, Apr. 2, 2002, at E01. An auditor at Arthur Andersen was removed from the Enron project when he disagreed with Enron’s accounting treatment and Enron later complained about him. *Id.*

10. Day & Behr, *supra* note 6, at A01.

11. H.R. 3763, 107 Cong. (2002). Although the Securities and Exchange Commission Chairman (now former Chairman), Harvey L. Pitt, indicated that the Sarbanes-Oxley Act was unnecessary, Congress approved a modified version of the bill with an overwhelming majority of votes on July 25, 2002. Albert B. Crenshaw, *Congress Sends Corporate-Reform Bill to Bush*, WASH. POST., July 26, 2002, at A16; David S. Hilzenrath, et al., *How Congress Rode a Perfect “Storm” to Corporate Reform*, WASH. POST., July 28, 2002, at A01. The Sarbanes-Oxley Act might be the most important new federal securities laws since the Securities and Exchange Commission was created in the 1930’s, although some of the stiff criminal penalties for executives may amount to little more than “election-year fluff.” Jim VandeHei & David S. Hilzenrath, *Hill Leaders Agree on Corporate Curbs*, WASH. POST., July 25, 2002, at A01; Crenshaw, *supra* (quoting Columbia University law Professor John C. Coffee Jr.).

12. Harvey Pitt, former Chairman of the Securities and Exchange Commission, indicated a preference for using existing self-regulatory organizations and increasing proactive compliance measures, rather than enforcement activity, of the SEC. Day & Behr, *supra* note 6, at A01; David S. Hilzenrath, *Two SEC Views of Industry, Ex-Head Levitt Attacked; New Chief Pitt Vows Respect*, WASH. POST, Dec. 5, 2001, at A25. However, Former Chairman Harvey Pitt resigned on November 5, 2002, after tergiversating in his initial selection of the eminent John Biggs for the head of the new Public Company Accounting Oversight Board created under the Sarbane-Oxley Act of 2002. David S. Hilzenrath, *Besieged Pitt Quits as SEC Chairman*, WASH. POST, Nov. 6, 2002 at A2; Jane Bryant Quinn, *Is Reform a Bad Joke?*, NEWSWEEK, Oct. 14, 2002, at 43.

13. See, e.g., *Nightly Business Report: Interview, Ralph Larsen, Chairman of the Board and CEO, Johnson & Johnson Corporation* (PBS television broadcast, Mar. 25, 2002) transcript available at <http://www.nbr.com/ranscript/2002/trnsrpt032502.htm#STORY1> (last visited Nov. 27, 2002)

maneuvers that fall within the scope of technical accounting rules, but result in the press criticizing the realism of the financial portrayals of the corporations' health.<sup>14</sup> The incessant pressure on corporations to increase shareholder value occasionally tests the fringes of the accounting rules. While some corporations are able to meet market expectations through forthright presentation of financial statements, other corporations are not and may resort to creative accounting that violates the federal securities laws.<sup>15</sup> The SEC is concerned about creative accounting; particularly where it rises to the level of fraud or misrepresentation under the federal securities laws. Former Chairman of the SEC, Arthur Levitt, recognized that financial performance manipulation of corporations needed to be addressed squarely: "Today, American markets enjoy the confidence of the world. How many half-truths, and how much accounting sleight-of-hand, will it take to tarnish that faith?"<sup>16</sup>

#### LIABILITY FOR FINANCIAL PERFORMANCE MANIPULATION

During the Clinton administration, Arthur Levitt intensified the SEC's measures against financial performance manipulation, which is sometimes referred to as earnings management.<sup>17</sup> Broadly defined, financial performance manipulation refers to an issuer's manipulation or window-dressing of financial statements

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(mentioning corporate governance, board governance, and accounting principles in reference to the efforts companies must use to remain viable). Larsoen stated:

The fact is the CEO's that I know, virtually all of them break their backs to run clean companies and do the right thing. And we certainly try to do that at Johnson & Johnson. So I think this raises, once again, for all of us, the need to be alert, to be attentive, to pay attention to your business and to stay a mile away from any practices that might be called into question.

*Id.*

14. Bernard Conden, *Pick a Number, Any Number*, FORBES, Mar. 23, 1998, at 124. Krispy Kreme used a "synthetic lease" to artificially and lawfully reduce on-sheet capital expenditures during 2002. Seth Lubove & Elizabeth McDonald, *Debt? Who me?*, FORBES, Feb. 18, 2002, at 56. "A synthetic lease is an off-balance sheet trick in which a corporation has all of the practical effects of a heavily mortgaged piece of real-estate but tells its shareholders that it neither owns the property nor owes debt on it." *Id.*

15. Companies that engage in creative accounting may lack sufficient internal controls and may experience extreme financial pressure to achieve acceptable results. HOWARD M. SCHLIT, FINANCIAL SHENANIGANS; HOW TO DETECT ACCOUNTING GIMMICKS & FRAUD IN FINANCIAL REPORTS 7, 11-12 (McGraw-Hill 1993).

16. Arthur Levitt, Chairman, Securities and Exchange Commission, *The "Numbers Game"*, Speech at the New York University Center for Law & Business, New York, New York (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt> (last visited Nov. 27, 2002).

17. *Id.*

that improperly exaggerates or improperly misstates the issuer's true financial condition. If an issuer of securities publishes misleading financial disclosure or fails to keep adequate accounting records, the issuer may face liability for financial performance manipulation. For example, liability for financial performance manipulation may flow from misleading information in a reported financial statement, press-release, or otherwise in accordance with Rule 10b-5 of the Securities and Exchange Act of 1934.<sup>18</sup> In the context of a primary offering, illicit financial performance manipulation may lead to liability because of misleading information in a registration statement under section 11 of the Securities Act of 1933<sup>19</sup> or misleading information in a prospectus under section 12(2) of the 1933 Act.<sup>20</sup>

#### ACCOUNTING PROVISIONS OF THE EXCHANGE ACT

While Rule 10b-5 has dominated federal securities law over the last several decades,<sup>21</sup> the SEC's activities in curbing financial performance manipulation have resulted in a number of administrative releases that address the books and records provision and internal accounting controls provision of the Exchange Act.<sup>22</sup> Thus, liability for financial performance

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18. Rules and Regulations under the Securities Exchange Act of 1934 § 10(b), 17 C.F.R. § 240.10(b)-5 (2002); *see, e.g.*, Platinum Software Corp., Exchange Act Release No. 37185, 1996 SEC LEXIS 1282 (May 9, 1996) [hereinafter "Platinum Release"] (examining fraudulent accounting practices in misstating revenue and net income, among other violations). Often, a financial performance manipulation violation includes a misleading statement in a financial report that allows a private right of action under Rule 10b-5. *See, e.g.*, Cendant Corporation Litigation, 182 F.R.D. 144 (D.N.J. Sept. 4, 1998) (examining a shareholder action against a corporation for the reporting of accounting irregularities, which resulted in large decrease in stock price).

19. Securities Act of 1933 § 11, 15 U.S.C. § 77k (2000). *See, e.g.*, Cendant Corporation Litigation, 182 F.R.D. at 146 (examining allegations by plaintiffs of violations of the 1993 Act in conjunction with registration statements).

20. Securities Act of 1933 § 12(2), 15 U.S.C. § 77l (2000); *see, e.g.*, Cendant Corporation Litigation, 182 F.R.D. at 146 (alleging violations of 1933 Act in conjunction with filed prospectus).

21. *See generally* ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS (West Group 2002) (authoring a six volume treatise dedicated to Rule 10b-5 jurisprudence).

22. *See, e.g.*, Albert Glenn Yesner, Exchange Act Release No. 39916, 1998 SEC LEXIS 785 (Apr. 27, 1998) [hereinafter Yesner Release] (alleging improper revenue recognition in order to manipulate quarterly profits with respect to Sensormatic Electronics Corporation); Joy Lynn Schneider Green, Exchange Act Release No. 39792, 1998 SEC LEXIS 520 (Mar. 25, 1998) [hereinafter Green Release] (alleging improper recognition of revenue based on back-dating and resetting of computer clocks with respect to Sensormatic Electronics Corporation); Donnkenny, Inc., Exchange Act Release No. 41012; 1999 SEC LEXIS 219 (Feb. 2, 1999) [hereinafter Donnkenny Release] (examining the engagement in financial fraud to create an illusion of financial results that exceeded analyst expectations of company's profits).

manipulation is not necessarily predicated on fraud because these accounting provisions and ethical standards of accountants provide firm ground for SEC action.<sup>23</sup>

The books and records provision refers to section 13(b)(2)(A) of the Exchange Act; the internal controls provision refers to section 13(b)(2)(B) of the Exchange Act.<sup>24</sup> Collectively, sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act are referred to herein as the accounting provisions of the Exchange Act. The accounting provisions protect investors against inadequate accounting management and procedures in the corporation that might ultimately lead to fraudulent or misleading disclosure. Section 13(b)(2)(A) requires an issuer to keep books and records that accurately reflect its financial transactions and the disposition of its assets.<sup>25</sup> Section 13(b)(2)(B) requires an issuer to develop and maintain a system of internal accounting controls that are adequate to prepare financial statements in accordance with Generally Accepted Accounting Principles ("GAAP").<sup>26</sup> If the SEC focuses its enforcement activity on the accounting provisions, the public may benefit because of the potential for these provisions to deter prospective financial performance manipulation or fraud before misleading financial disclosures are publicly disseminated into the market.<sup>27</sup>

#### GAAP VIOLATIONS

Earnings management may violate GAAP or represent a too aggressive interpretation of GAAP.<sup>28</sup> GAAP is generally defined by

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23. Yesner Release, *supra* note 22, at 2; Green Release, *supra* note 22, at 10; Donnkenny Release, *supra* note 22, at 12; *see, e.g.*, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), PROFESSIONAL CODE OF CONDUCT (2001), available at <http://www.aicpa.org/about/code/index.htm> (last visited Nov. 27, 2002) (outlining the ethical standards for accountants).

24. Securities Exchange Act of 1934 §§ 13(b)(2)(A)-13(b)(2)(B), 15 U.S.C. § 78m (2000); Platinum Release, *supra* note 18, at 14.

25. Securities Exchange Act of 1934 § 13(b)(2)(A), 15 U.S.C. § 78m (2000); Green Release, *supra* note 22, at 13.

26. Securities Exchange Act of 1934 § 13(b)(2)(B), 15 U.S.C. § 78m (2000); Green Release, *supra* note 22, at 10.

27. In the context of sections 13(b)(2)(A) and 13(b)(2)(B), the SEC's enforcement activity is not supplemented by civil litigation. Sections 13(b)(2)(A) and 13(b)(2)(B) do not expressly provide for a private right of action. Securities Exchange Act of 1934 §§ 13(b)(2)(A)-(B), 15 U.S.C. § 78m (2000). Further, most courts have not found a private-right-of-action for section 13(b)2. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 420 (3d ed. 1996) (citing *McLean v. International Harvester Co.*, 817 F. 2d 1214 (5th Cir. 1987) and *Eisenberger v. Spectex Industries, Inc.*, 644 F. Supp. 48 (E.D.N.Y. 1986)). Compare *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (recognizing a private right of action under Rule 10b-5 because of a thirty-year precedent of judicial recognition).

28. Letter from Lynn E. Turner, Chief Accountant, United States Securities and Exchange Commission, to Thomas Ray, Director, Audit and Attest

current statements and interpretations issued by the Financial Accounting Standards Board (FASB) since 1973, some opinions issued by the Accounting Principles Board (APB) from 1959 to 1973, some documents authored by the Committee on Accounting Procedure from 1939 until 1959, and various documents issued by private sector accounting bodies.<sup>29</sup> Although the SEC primarily defers to the private sector in developing and maintaining GAAP, the SEC has issued regulation S-X on the form and content of financial statements, Accounting Series Releases (ASR's) on matters not generally addressed by the private sector, and unofficial Staff Accounting Bulletins as guidance for disclosure requirements.<sup>30</sup> Rules 13a-1 and 13a-3 are promulgated under section 13(a) of the Exchange Act and require section 12 issuers to file annual and quarterly reports on Forms 10K and 10Q, respectively, that comply with regulation S-X and GAAP.<sup>31</sup> Accordingly, the SEC may address earnings management that does not comply with GAAP under Rules 13a-1 and 13a-3. Under the Sarbanes-Oxley Act of 2002, the chief executive officer and the chief financial officer of a publicly traded company must certify that the financial statements in the quarterly or annual report "fairly present in all material respects the financial condition and results of operations of the issuer" based on each officer's knowledge and review of the financial report.<sup>32</sup>

GAAP provides companies with wide discretion in the application of accounting standards so that companies are able to run their businesses without the accounting standards unduly interfering with business decisions. An issuer can select various accounting policies, such as inventory method, amortization

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Standards, American Institute of Certified Public Accountants 1 (Oct. 9, 1998) available at <http://www.sec.gov/info/accountants/staffletters/aclr1009.htm> (last visited Nov. 27, 2002) [hereinafter Turner Letter].

29. CHARLES H. MEYER, ACCOUNTING AND FINANCE FOR LAWYERS IN A NUTSHELL 46-51 (1995).

30. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 418-419 (3d ed. 1996).

31. Advanced Medical Products, Inc., Exchange Act Release No. 37649, 1996 SEC LEXIS 2274, \*16-17 (Sept. 5, 1996) [hereinafter Advanced Medical Release]. The SEC may establish a violation of the reporting requirements of § 13(a) of the Exchange Act without showing scienter of the wrongdoer. SEC v. Wills, 472 F. Supp. 1250, 1268 (D.D.C. 1978).

32. Securities Exchange Act of 1934 § 10(A), 15 U.S.C. 78f (2000), amended by the Sarbanes-Oxley Act of 2002 § 302(a)(2002). Officers, directors and signatories still must exercise due diligence in reviewing registration statements (e.g., S-1, S-2, and S-3 Forms) for registered offerings of securities to prevent misleading disclosure. Securities Act of 1933 § 11, 15 U.S.C. 77(k)(2000). In practice, section 11 liability and section 302(a) liability may overlap because registration Forms S-2 and S-3 incorporate by reference the company's annual report and other periodic reports filed under the Exchange Act.



period, and revenue recognition and still remain compliant with GAAP.<sup>33</sup>

Some executives may be tempted to exploit the breadth of the accounting rules to the very limits of legality. For example, vague definitions of “one-time” and “restructuring” under the FASB rules provide maneuvering room for creative accounting that may fall within the literal scope of the accounting rules, but outside of the spirit of those rules.<sup>34</sup> If a financial report is at the fringes of literal compliance with GAAP, the potential exists for liability under Rule 10b-5 as a misleading financial report.

#### CATEGORIES OF EARNINGS MANAGEMENT

Corporations 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 condition to investors. During Arthur Levitt’s term at the SEC, the SEC indicated that the following types of earnings management would receive close scrutiny for potential enforcement activity:

- (1) “big bath charges;”
- (2) creative acquisition accounting;
- (3) “cookie jar reserves;”
- (4) revenue recognition; and
- (5) materiality compliance.<sup>35</sup>

“Big bath charges” refer to a major one-time charge or an accumulation of write-offs taken during a single accounting period, which cleanse a corporation of poor financial results during the single accounting period in order to enhance future financial results.<sup>36</sup> For example, a major one-time charge may include a write-off for restructuring, worthless assets, lay-offs, obsolete inventory, an acquisition, permanently impaired manufacturing equipment, a plant closing, or otherwise.<sup>37</sup> “Big bath charges” may

33. SCHILIT, *supra* note 15, at 23.

34. Conden, *supra* note 14, at 124.

35. Levitt, *supra* note 16.

36. SCHILIT, *supra* note 15, at 120-22. “If you do these [one-time charges] right, you can really clean house,” said David Halford, a senior portfolio manager with Mosaic Funds in Madison, Wisconsin. Janet Kidd Stewart, *‘One-time’ items keep adding up*, CHI. TRIB., Mar. 24, 2002, § 5, at 2.

37. In 2001, JDS Uniphase Corp. took one-time charges for acquisitions and other unusual events that facilitated reporting a 50.6 billion dollar net loss for the fiscal year. Stewart, *supra* note 36, at 2. In 2001, Sears, Motorola, Baxter International, and CNA Financial took one-time charges that together totaled \$ 8 billion. *Id.* at 1. In 2001, Motorola took approximately 3.2 billion dollars

or may not be legal, depending upon the underlying circumstances.<sup>38</sup> Creative acquisition accounting may violate

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in special charges for employee severance, investment impairments, fixed-asset impairments, and potentially uncollectible finance receivables. *Id.* In 2001, CNA Financial took approximately 2.6 billion dollars in special charges including strengthening loss reserves, restructuring, Enron-related losses and World Trade Center losses. *Id.*

The financial records of General Motors (GM) provide another example of a “big-bath charge”. GM took an after-tax restructuring charge of four billion dollars during one quarter in 1998, including closing three factories and laying off about 3,000 workers. Conden, *supra* note 14, at 125. The four billion dollar charge during a single quarter amounts to almost twenty percent of GM’s aggregate reported earnings during the last five years. *Id.* From the perspective of an investor, the interpretation of GM’s reported financial performance during 1998 was at least complicated somewhat, but not necessarily rendered misleading, by the impact of the “big bath charges.” *Id.*

38. SCHILIT, *supra* note 15, at 122. See also Stewart, *supra* note 36, at 2 (probing the corporate practice of writing off one-time charges and lumping them into special charges to boost market and profit outlook). In examining the present quality of corporate financial reporting:

[T]here may be a darker side, with some analysts complaining of a creeping in the 1990’s, when companies began writing off expenses [as one-time or extraordinary charges] that previously would have been lumped into the cost of doing business. Accounting principles allow for some flexibility in characterizing certain items as special charges.

*Id.* Determining the legality of “big bath charges” may turn on whether a particular accounting treatment of worthless assets is proper. Levitt, *supra* note 16. A worthless asset is properly written-off in one quarter, rather than over the original depreciation period or amortization period associated with the asset. SCHILIT, *supra* note 15, at 120. A corporation runs afoul of GAAP where worthless or impaired assets are written-off too slowly prior to the “big bath” fiscal quarter. *Id.* GAAP generally requires a corporation to write down the book value of assets if a permanent loss in value of the asset has occurred. MEYER, *supra* note 29, at 76.

For example, the corporation may improperly delay recognizing assets as worthless assets to intentionally time a write-off during the “big bath” quarter. SCHILIT, *supra* note 15, at 121. On the other hand, a corporation may violate GAAP where assets are mischaracterized as worthless assets or impaired assets; hence, written-off too quickly. *Id.*

If a corporation accumulates charges for a “big bath” by misallocating expenses to the wrong accounting period or improperly accelerating depreciation expenses, the corporation may violate GAAP. *Id.* at 118. For example, a corporation may improperly skew future expenses that should really apply to at least one later accounting period to an earlier accounting period. *Id.* at 120. In particular, the corporation may attempt to pay discretionary expenses in a current accounting period that would otherwise fairly apply to the next accounting period. *Id.* at 118.

A corporation may accelerate depreciation expenses by unrealistically shortening a depreciation period for tangible assets or an amortization period for intangible assets. *Id.* at 118-19. For example, the corporation may accelerate the write-offs of assets over a lower number of quarters than would ordinarily be used. Consequently, an earlier quarter during the write-off period looks grimmer than it would otherwise be, but the subsequent quarters after the write-off period characteristically provide artificially inflated earnings. *Id.* at 120. Future charges against earnings are reduced improperly

GAAP if a corporation takes an excessive write-off of in-process research and development.<sup>39</sup> For example, a corporation may improperly treat a substantial portion of the purchase price of a target company as an in-process research and development expense without a realistic assessment of the target company's actual research and development activity.<sup>40</sup>

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by the earlier write-off of assets. *Id.*

39. During the last decade, acquiring companies have written-off or attempted to write off in-process research and development for the acquired target in at least one-hundred and forty acquisitions. Lynn E. Turner, Chief Accountant, Office of the Chief Accountant, United States Securities and Exchange Commission, *Remarks at the Software and Service Industry Analyst Group* (Feb. 10, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch251.htm> (last visited Nov. 27, 2002) [hereinafter Turner Software Remarks] (citing Zhen Deng & Baruch Lev, *The Valuation of Acquired R&D* (Apr. 1998)). Acquiring companies may assert that almost the entire cost of a target company can be expensed during one fiscal year as in-process research and development. Lynn E. Turner, Chief Accountant, United States Securities and Exchange Commission, *Remarks at the Financial Executives Institute 1998 Annual Conference* (Oct. 22, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch231.htm> (last visited Nov. 27, 2002) [hereinafter Turner Financial Remarks]. For example, MCI WorldCom wanted to write off about seven billion dollars as in-process research and development costs for the merger between MCI and WorldCom. Justin Gillis, *Firm's Profits Survive Scrutiny of SEC Microscope*, WASH. POST, Apr. 27, 1999, at E1 and E6. Yet, the SEC determined that MCI WorldCom could properly write-off only 3.1 billion dollars. *Id.* See also MCI WORLDCOM 1998 ANNUAL REPORT (1999) at 2-3 (referencing "Notes to Selected Financial Data"). Similarly, the SEC allowed America On-line to write-off only twenty-one percent of its acquisition of Mirabilis, Ltd. with the remaining amount to be written off over the following five years. Gillis, *supra*, at E6. America On-line was seeking to write off virtually the entire cost of acquiring Mirabilis during the single year of the acquisition. *Id.* Instead of spreading the expense of the acquisition over several years, which would be detrimental to earnings, the drag on earnings is purged during one bad quarter upon completion of the acquisition. Levitt, *supra* note 16.

40. Turner Financial Remarks, *supra* note 39. If an acquiring company attempts to expense in-process research and development during a single fiscal quarter in excess of research and development expenditures previously reported by the acquired company, the SEC may consider the write-off improper. Arthur Levitt, Chairman, United States Securities and Exchange Commission, *Remarks to the Financial Executives Institute, New York, New York* (Nov. 16, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch227.htm> (last visited Nov. 27, 2002) [hereinafter Levitt Financial Remarks]. The SEC may be most concerned about companies assigning bogus valuations to acquired research and development that are disconnected from reality or violate common sense. Turner Software Remarks, *supra* note 39. Companies should properly consider the valuations and risks associated with the acquired research and development. Risks include acquiring research and development that turns out to be a technical dead end. *Id.* Risks also include the acquirer's ability to timely bring the completed research and development to market. *Id.*

Appraisals of in-process research and development should allocate a fair value to the existing commercial technology and associated good will of the

Under U.S. accounting rules, a corporation may properly set aside reserves only under limited conditions.<sup>41</sup> For example, an issuer may properly set aside reserves in an estimated amount sufficient to cover a potential, foreseeable warranty liability, an environmental liability, a tax liability or another estimated liability for later inclusion in earnings.<sup>42</sup> “Cookie jar reserves” refer to liberal use of reserves that lawfully or improperly shift sales revenue from an earlier accounting period to a later-designated accounting period.<sup>43</sup>

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acquired company. *Id.* In most cases, existing commercial technology and its underlying intellectual property should have a greater value than in-progress improvements on the existing commercial technology. *Id.* After all, the prospective market for a technological improvement is generally uncertain in comparison to the actual market for an existing product. *Id.* The value of in-process research and development may be estimated based on the cost to the acquiring company to independently develop the ultimate project involving the in-process research and development, rather than acquiring the research and development from the acquired company. *Id.* Valuations of the research and development should not conflict with presentations made to the board of directors or recorded in the corporate minutes. *Id.* Management’s due diligence of the acquired company should support the valuation of the in-process research and development, rather than conflict with the subsequent expensing by management. *Id.*

41. Improper reserves may be referred to formally as improper liability accruals. Improper liability accruals are either not foreseeable or not quantifiable in amount as required by FASB Statement No. 5. Inflated reserves, in effect, improperly delay the recording of revenue until after the accounting period in which the issuer earned the revenue. The latest time for properly recognizing revenue of a product may be upon expiration of a warranty and in the absence of a risk of the buyer returning the product. MEYER, *supra* note 29, at 67.

Inflated reserves that do not comply with FASB Statement No. 5 may be used to improperly smooth out earnings by saving excessive earnings during good times in preparation for bad financial times so that a continuous pattern of earnings growth can be presented to the public. SCHILIT, *supra* note 15, at 113; Turner Financial Remarks, *supra* note 39.

42. Walter P. Schuetze, Chief Accountant, Division of Enforcement of the SEC, Remarks at the Nineteenth Annual Ray Garrett, Jr., Corporate and Securities Law Institute, The Corporate Counsel Center of Northwestern University School of Law (Apr. 22, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch276.htm> (last visited Nov. 27, 2002) [hereinafter “Schuetze Securities Remarks”].

43. SCHILIT, *supra* note 15, at 112. Turner Letter, *supra* note 28. The FASB’s Emerging Issues Task Force (EITF) 94-3 and 95-3 may be used to justify setting aside “cookie jar reserves” in the context of restructuring or a merger. Schuetze Securities Remarks, *supra* note 42. EITF 94-3 permits recognition of involuntary termination benefits as a proper loss accrual liability to be paid to laid-off employees and recognizes future expenditures as proper loss accrual liabilities that are directly associated with a plan to exit an activity, if the termination benefits will have no future benefit and if other conditions are satisfied. *Id.* EITF 95-3 applies to acquisitions and permits recognition of expenses to relocate employees as a proper loss accrual liability. *Id.* The incentive to rely on EITF 94-3 is bolstered by a prohibition against

Revenue recognition problems refer to the premature counting of sales.<sup>44</sup> Revenue should be recognized once the earnings procedure is complete and an exchange has occurred, except for long-term contracts in which the percentage of completion method is used.<sup>45</sup> In an egregious case of revenue recognition involving Sensormatic Corporation, Walter P. Schuetze, former Chief Accountant for the Division of Enforcement of the Securities and Exchange Commission, remarked appropriately that "Sensormatic's income statement should have

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general reserves in FASB Statement No. 5.

In Jan. of 1999, a former auditor of Microsoft Corporation alleged that Microsoft Corporation improperly used "cookie jar reserves." Rajiv Chandrasekaran, *Microsoft Says SEC is Probing Its Practices*, WASH. POST, July 1, 1999, at E3. Microsoft announced on June 30, 1999, that the SEC began an investigation of Microsoft Corporation's accounting practices with respect to reserves. *Id.* The SEC was still investigating Microsoft's use of reserves as of the 10Q filed on Dec. 31, 2001. MICROSOFT CORPORATION, FORM 10Q FOR MICROSOFT CORPORATION FOR THE QUARTERLY PERIOD ENDED DEC. 31, 2001 (2002) available at <http://www.sec.gov/news/speech/speecharchive/1998/spch231.htm> (last visited Aug. 29, 2002) (referring to Part 1, Financial Information, "Notes to Financial Statement"). Microsoft has historically established reserves exceeding twenty percent of sales revenue of software products to cover the costs of technical support and customer support. Chandrasekaran, *supra*. During the time when the reserves were established, Microsoft developed a strong reputation as a company that has consistently met or exceeded the earnings consensus of analysts. *Id.*

44. SCHILIT, *supra* note 15, at 34. An issuer improperly recognizes revenue if the issuer ships goods before a sales contract or agreement has been reached with a customer, or even after a customer has canceled an order. Turner Financial Remarks, *supra* note 39, at 2. Manufacturer-issuers may have a sense of urgency to ship out as many products as possible toward the end of the year, or even at the end of each quarter, to meet a sales quota. *Id.*

An issuer may prematurely record revenue when the completion of a sales transaction is contingent upon the occurrence of an uncertain event. SCHILIT, *supra* note 15, at 34. For example, if the buyer is likely to return goods or not pay for the goods, the shipment of goods should not be recognized as revenue. *Id.* at 39. See FASB Statement No. 48 that defines when revenue recognition is proper in the context of a buyer's right to return a product.

The revenue cannot be recognized where the customer's payment depends upon obtaining financing or resale to a third party if the issuer's receipt of payment is dubious at best. SCHILIT, *supra* note 15, at 42.

An issuer may prematurely record revenue when future services are incomplete or owed to the purchaser as a condition for the purchaser's payment. Turner Financial Remarks, *supra* note 39. The issuer may have an obligation to provide installation services or other ancillary services prior to the purchaser's duty to pay arises. SCHILIT, *supra* note 15, at 43; Turner Financial Remarks, *supra* note 39. If the issuer receives an advance payment for the performance of future services, the issuer may properly allocate the prepaid funds to unearned revenue, which represents a liability until the services are performed, at which time the prepaid funds are recognized as earned revenue. SCHILIT, *supra* note 15, at 44-46.

45. SCHILIT, *supra* note 15, at 34-36.

been headed up as follows: 'Year ended June 30, 1994.'"<sup>46</sup>

Materiality abuse refers to any accounting technique that improperly or lawfully distorts actual financial results by a quantitative percentage that is said to be too minuscule to matter.<sup>47</sup> For example, accountants may intentionally record errors that are within a certain margin to pick up a few cents of quarterly earnings.<sup>48</sup> If some accountants and corporations fail to fix known financial errors or intentionally create such errors and label them immaterial, those accountants are at risk for SEC enforcement activity that may seek to maximize the scope of materiality.<sup>49</sup>

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46. Walter P. Schuetze, Chief Accountant, Division of Enforcement, U.S. Securities and Exchange Commission, Remarks at the 1998 Twenty-Sixth Annual AICPA National Conference on SEC Developments (Dec. 8, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch241.htm> (last visited Nov. 27, 2002) [hereinafter Schuetze SEC Remarks].

47. Levitt, *supra* note 16. The SEC states that the proper standard for materiality should be based primarily on qualitative factors, or both quantitative and qualitative factors, but not quantitative factors alone. Securities and Exchange Commission, Staff Accounting Bulletin No. 99, 17 C.F.R. 211 (2002) (amended Aug. 12, 1999). Accordingly, a quantitatively small misstatement may become material if warranted by a particular qualitative circumstance, including whether the misstatement masks a change in an earnings trend, hides a failure to meet analysts' consensus expectations, or transforms a loss into income. *Id.* Even if an intentional misstatement is immaterial, a corporation may violate section 13(b)2 of the Exchange Act for failing to keep accurate books, records and accounts in reasonable detail that fairly reflect transactions and dispositions of assets of the corporation. *Id.* According to the SEC, compliance with the books and records provision is not judged under materiality, but under a higher standard based on the level of detail and degree of assurance that would satisfy a prudent man in the conduct of his own affairs. *Id.*

The courts have defined materiality consistently with the SEC's foregoing interpretation. The Supreme Court has broadly defined disclosure as material if there is a substantial likelihood that a reasonable investor would consider the disclosure important to his investment decision. *T.S.C. Industries, Inc., v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Further, the Supreme Court has also defined material as referring to information that, if published, would affect the total mix of information available about an issuer's financial condition. *Id.*

The judiciary generally embraces more of a qualitative standard of materiality than accountants do. In practice, accountants tend to define materiality as less than five percent of net income, net loss, or assets. MEYER, *supra* note 29, at 64. Certain FASB statements state that the accounting requirements do not need to be applied literally if the failure to follow the requirements would not be material, but according to the SEC the "FASB has long emphasized that materiality cannot be reduced to a numerical formula." Staff Accounting Bulletin, *supra*. If supported by an FASB statement with an immateriality escape hatch, accountants may ignore the technically correct treatment of a particular accounting entry for an immaterial error. MEYER, *supra* note 29 at 63.

48. Levitt, *supra* note 16.

49. *Id.* In a settlement of SEC enforcement actions against Arthur

Can corporations manage earnings without making use of the earnings management techniques that the SEC staff has identified as candidates for possible enforcement activity? Yes, the nature of GAAP has flexibility that may be exploited in numerous ways.<sup>50</sup> When the SEC and the FASB lock and bolt one door, corporate executives may open up another to manage earnings, either lawfully or improperly. Corporations may see an open door to skew earnings by adding pension plan gains to income and ignoring stock option costs.<sup>51</sup> Changes in inventory and restructuring charges represent unlocked doors that invite earnings management.<sup>52</sup> Recently, Enron used partnerships called

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Anderson and its partners for Andersen's auditing of Waste Management's financial reports, the partners of Andersen were unable to justify as immaterial the inflated income in the 1993 and 1995 financial reports under section 10(b) and Rule 10b-5 of the Exchange Act. Press Release, Securities and Exchange Commission, *Arthur Andersen LLP Agrees to Settlement Resulting in First Antifraud Injunction in More than 20 Years and Largest-Ever Civil Penalty (\$7 Million) In SEC Enforcement Action Against a Big Five Accounting Firm* (June 19, 2001), available at <http://www.sec.gov/news/headlines/andersenfraud.htm> (last visited Nov. 27, 2002) [hereinafter Andersen Release]. In 1993, correction of current and prior-period misstatements would have reduced income by twelve percent before special items. *Id.* at 4. In 1995, a Practice Director at Andersen incorrectly reasoned that (1) netting of prior-expenses against a recent gain and (2) nondisclosure of the misstatements of the prior-expenses were not material to Waste Management's 1995 financial statements when taken as a whole. *Id.* at 5. The SEC found that the netting and misstatements were material to the 1995 audit report, although the netting only represented approximately ten percent of pre-tax income before special charges. *Id.* In both 1993 and 1995, one or more partners incorrectly determined that the above misstatements in income were immaterial and that Andersen could issue an unqualified report on the financial statements. *Id.*

50. SCHILIT, *supra* note 15, at 6.

51. Elizabeth McDonald & Daniel Kruger, *More Ploys*, FORBES, Mar. 4, 2002, at 106.

52. SCHILIT, *supra* note 15. For example, manufacturing companies can manage earnings by switching from a last-in, first-out (LIFO) inventory method to a first-in, first-out (FIFO) inventory method during inflationary periods. *Id.* at 23-24. If the unit price of a manufactured good increases over time, the issuer switches to the first-in, first-out inventory method to realize the price differential between the current manufacturing cost and the past manufacturing cost of the good, until all of the old, lower-priced goods are shipped. *Id.*

Restructuring charges are loosely defined under GAAP and offer further opportunities for lawful earnings management. Conden, *supra* note 14. Restructuring charges refer to one-time losses for non-continuing activities. SCHILIT, *supra* note 15, at 74. Non-continuing activities include discontinued operations, extraordinary gains or losses, and changes in accounting principles. *Id.* at 74. Operating income should not be commingled with nonrecurring charges or gains. *Id.* at 70. Issuers may violate GAAP by hiding operating losses under non-continuing losses or gains. *Id.* at 75. Conversely, issuers may violate GAAP by adding nonrecurring income from the sales of assets to operating income. *Id.* at 73.

“special purpose entities” to conceal its true debt load from creditors and investors.<sup>53</sup>

#### SEC ENFORCEMENT ACTIVITY

Thus, as evidenced above, corporations have available numerous methods to manage their financial appearance in a way that is technically legal, but not completely forthright. The legitimacy of financial accounting and reporting are currently enforced by the SEC,<sup>54</sup> which brings administrative proceedings and civil enforcement actions.<sup>55</sup> Recent SEC enforcement proceedings illustrate such lapses in financial reporting as:

- (1) liability for misleading disclosure on “cookie jar reserves,”<sup>56</sup>

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53. Burton Malkiel, *WatchDogs and Lapdogs*, WALL ST. J., Jan. 16, 2002, at A16. The SEC must complete a study and prepare a report on the amount of off-balance sheet transactions of issuers, the extent to which special purpose entities facilitate off balance sheet transactions, and whether GAAP or SEC rules require adequate and transparent disclosure of the off-balance sheet transactions. Securities Exchange Act of 1934 § 13, 15 U.S.C. 78m (1934), amended by the Sarbanes-Oxley Act of 2002 § 401(c) (2002).

54. Presently, the SEC annually pursues administrative proceedings or federal cases against 0.3 percent to 0.6 percent of reporting companies on matters involving accounting, financial statements, Management’s Discussion and Analysis (MD&A) disclosure, auditing issues, and disclosure. Schuetze SEC Remarks, *supra* note 46.

55. The SEC has authority to bring an administrative proceeding and/or a civil action in federal court for violations of the federal securities laws. For example, the SEC may bring cease-and-desist administrative proceedings as authorized under § 21C of the 1934 Act and § 8A of the 1933 Act. Securities Exchange Act of 1934 § 21C, 15 U.S.C. § 78u-3 (2000) and Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1 (2000).

56. *See, e.g.*, Cendant Corporation, Exchange Act Release No. 42933, 2000 SEC LEXIS 1237 (June 14, 2000) [hereinafter “Cendant Release”]. In the past, government regulators were concerned about the failures of banks to allocate sufficient reserves to influence current income. SCHILIT, *supra* note 15, at 94. In 1998, the SEC filed an action against W.R. Grace in federal court in Miami, alleging that W.R. Grace improperly bolstered earnings with general-purpose reserves. Ann Davis, *SEC Case Claims Profit ‘Management’ by Grace*, WALL ST. J., Apr. 7, 1999, at C1. The SEC was primarily concerned with the National Medical Care Inc. unit of W.R. Grace. *Id.* During the early 1990’s, Brian J. Smith, Grace’s C.E.O., allegedly ordered the National Medical Care Unit to report earnings only to a cap and to place all earnings exceeding the cap into a reserve account. *Id.* In 1992, W.R. Grace allegedly allocated at least 50 million dollars to reserves. *Id.* W.R. Grace & Co., Exchange Act Release No. 41578, 1999 SEC LEXIS 1299 (June 30, 1999), available at <http://www.sec.gov/litigation/admin/34-41578.htm> (last visited Nov. 27, 2002) [hereinafter “Grace Release”]. When earnings slowed in the first quarter of 1994, W. R. Grace allegedly took 5.4 million dollars from the reserves to bolster earnings. Davis, *supra* note 56, at C1 and C20. According to the SEC, the executives of W.R. Grace were paid bonuses on figures that were inconsistent with W.R. Grace’s reported earnings. The executives of W. R.



- (2) the prevalence of revenue recognition problems;<sup>57</sup>
- (3) liability for fraudulent financial statements;<sup>58</sup>

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Grace were paid bonuses on the actual level of earnings of the National Medical Care Unit, but a lower level of earnings was incorrectly reported in the financial reports because of the reserves. *Id.* The SEC found that W.R. Grace failed to keep accurate books and records that accurately reflected transactions in violation of section 12(b)(2)(A) of the Exchange Act because W.R. Grace maintained general reserves without a probable and reasonably estimable future liability, counter to the GAAP requirement. Grace Release, *supra*.

57. A substantial majority of the SEC enforcement of earnings management SEC enforcement cases involve improper revenue recognition. Lynn Turner, Chief Accountant, SEC, Remarks at the Colorado State Society of Certified Public Accountants, 1998 SEC Conference (Dec. 3, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch243.htm> (last visited Nov. 27, 2002) [hereinafter "Turner Colorado Remarks"]. Sensormatic is one example of an SEC administrative proceeding illustrating improper revenue recognition among other things. Sensormatic Electronics Corporation, Exchange Act Release No. 39791, 53 S.E.C. 488, 489, 492-93 (Mar. 25, 1998) [hereinafter Sensormatic Release]. The improper revenue recognition involved allegedly turning back a computer clock for recording shipments to wrongfully extend the duration of each quarter during a two-year period. *Id.* at 493. Further, the respondents recognized revenue improperly at the time of shipment, rather than at the time of receipt by the customer for certain free on board (F.O.B.) shipments. *Id.* at 494. According to the SEC, Sensormatic "improperly recognized revenue in order to manipulate its quarterly revenue and earnings to reach its budgeted earnings goals and thereby meet analyst's quarterly earnings projections." Green Release, *supra* note 22, at 3. In the Green administrative hearing, the SEC noted that "[Sensormatic's] financial statements were not in conformity with generally accepted accounting principles ('GAAP') and misstated Sensormatic's earnings". *Id.* at 4. (emphasis added). Sensormatic's periodic reports on its Form 10K and Form 10Q overstated income by a staggering 38.3% for the third quarter of 1995, meeting the definition of material by any standards. *Id.* at 7.

During 1994 through July 10, 1995, Sensormatic allegedly manipulated its revenue to meet analysts' expectations within one cent. Sensormatic Release, *supra* note 57. The President and C.E.O. of Sensormatic, Ronald G. Assaf, signed annual reports that he knew were misleading in violation of section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13, and 13b2-1. *Id.* at 9. Assaf had to pay a civil fine of \$ 50,000. *Id.* Other executives at Sensormatic were held liable for fraud under Rule 10b-5 of the 1934 Act and section 17(a) of the '33 Act, for falsifying accounting records under Exchange Act of 1934 Rules 13b2-1, 13b2-2 and 13b-5, and for making misrepresentations to auditors under Exchange Act of 1934 Rule 13b2-2. *Id.*

58. See, e.g., Cendant Release, *supra* note 56. Livent concerns both financial performance manipulation and outright fraud. Livent, Inc., Exchange Act Release No. 40937, 53 S.E.C. 1220 (Jan. 13, 1999) [hereinafter Livent Release]. The financial performance manipulation in Livent represents blatant, deceitful violations of accounting standards, rather than cleverly crafted attempts to fall technically within the letter of the law. Even though certain theatrical performances were in reality losing money, Livent projected an image of a relatively successful operation to analysts. *Id.* at 1226. The fraud was so pervasive that after the fraud was revealed, Livent's stock price lost most of its value. *Id.* at 1223.

(4) wide-spread application of the accounting provisions, section 13(b)(2)(A) and section 13(b)(2)(B), of the Exchange Act for curtailing earnings management abuses,<sup>59</sup>

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From 1994 until 1998, Livent's Chairman and C.E.O. (Drabinsky) and a director (Gottlieb), allegedly manipulated Livent's books to understate expenses and to overstate earnings. *Id.* at 1226. Pre-production costs, including advertising costs of theatrical performances, were incorrectly characterized as fixed assets concerning the construction of theaters so that the pre-production costs could be written-off over a greater time span to inflate earnings. *Id.* While pre-production costs can be properly amortized over a maximum period of five years, fixed assets can be depreciated properly over a maximum of forty years or their applicable useful life. *Id.* Livent allegedly inflated earnings by using an improperly protracted depreciation period, instead of a shorter amortization-period in derogation from GAAP. *Id.*

Livent allegedly removed expenses from its general ledger and reentered them as if they properly belonged in the next fiscal quarter to bolster earnings for the present fiscal quarter. *Id.* Livent supposedly transferred costs among different shows to increase the amortization period for certain costs. *Id.* at 1227. Livent maintained two sets of books, the quintessential indicator of fraud, to track the deletions and movement of expenses from one quarter to the next. *Id.* Further, Livent maintained two sets of books to track the shifts in costs among different theatrical performances to improperly exploit the amortization periods. *Id.* According to the SEC during 1996, Livent understated expenses by over 18 million dollars using the foregoing manipulative techniques. *Id.* at 1227.

Livent improperly recognized revenue from an agreement that did not represent a complete sale of real property rights to Dundee Realty Corporation. *Id.* at 1234. According to the SEC, the revenue could not be recognized properly under GAAP because Livent entered into a separate secret agreement from the sale of real property with Dundee Realty Corporation that allowed the sale to be renegotiated. *Id.* at 1235. Livent concealed the existence of the separate agreement from Livent's auditors to include the sales price as recognizable revenue in 1997. *Id.*

59. *See, e.g.,* Candant Release, *supra* note 56. In addition to the widely used Rule 10b-5 that covers misstatements on Forms 10-K and 10-Q of the 1934 Act reports, sections 13(b)(2)(A) and 13(b)(2)(B) are pertinent where an issuer's books are inaccurate or where an issuer lacks adequate internal accounting controls. Green Release, *supra* note 22. Armed with sections 13(b)(2)(A) and 13(b)(2)(B), the SEC pursued an administrative hearing against Thomas H. Pike, who served as Director of Management Information Services, and, at one point, Director of U.S. Operations for Sensormatic. Thomas H. Pike, Exchange Act Release No. 39793, 1998 SEC LEXIS 500 (Mar. 25, 1998) [hereinafter Pike Release]. Pike was a certified public accountant, licensed in Florida, but his primary responsibility as Director of the Management Information Services included managing Sensormatic's computer and information systems. *Id.* From February of 1994 until April of 1995, Pike served as Sensormatic's Director of U.S. operations, which included responsibility over the general accounting operations and records for financial statements. *Id.* At the end of one or more quarters, Pike allegedly received internal Sensormatic memoranda estimating the amount of revenue needed to meet its quarterly revenue goal. *Id.* Thus, Pike allegedly had access to information that would enable him and his employees to extend a fiscal quarter by a planned amount to meet the sales goal and meet analyst projections. Pike allegedly instructed his employees to turn back a computer

(5) lapses of judgment of inside accountants and senior management;<sup>60</sup> and

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clock to falsify shipping dates that should have been outside of a fiscal quarter. *Id.*

The SEC found that Pike violated Rules 13a-1 and 13a-13 and sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934. *Id.* The SEC was careful in its selection of language with respect to the interpretation of the foregoing rules so as to indicate negligence is sufficient for culpability. Scienter is not required for a violation of section 13(b)(2). *SEC v. World-Wide Coin Investments*, 567 F.Supp. 724, 749 (N.D. Ga. 1983) (cited with approval in *Advanced Medical Release*, *supra* note 31.) In the SEC's interpretation of Rules 13a-1 and 13a-13, the SEC noted that Pike "knew or *should have known* that the company recorded and reported revenue on the out-of-period shipments based on the backdated shipping documents." Pike Release, *supra* note 59 (emphasis added). Similarly, the SEC found that Pike violated sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act because "Pike knew, or *should have known*, that his role in resetting the computer clock would result in the falsification of Sensormatic's books and records, and the subversion of existing internal controls." *Id.* (emphasis added).

The SEC's interpretation of negligence is entirely consistent with the plain meaning of section 13(b) of the Securities Exchange Act. In particular, section 13(b)(7) explains that "reasonable detail" under section 13(b)(2)(A) and "reasonable assurances" under section 13(b)(2)(B) refer to "such a level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." Securities Exchange Act of 1933 § 13(b)(2)(7), 15 U.S.C. § 78m (2000). The foregoing language is particularly reminiscent of the due diligence or heightened negligence standard under section 11(c) of the 1933 Act. Securities Act of 1933 § 11(c), 15 U.S.C. § 77k (2000). Nevertheless, negligence gives way to intent for criminal liability to apply under section 13(b)(2), as set forth in 13(b)(5). Securities Exchange Act of 1934 §§ 13(b)(2), 13(b)(5), 15 U.S.C. § 78m (2000).

60. Paul Hiznay, Exchange Act Release No. 42934, at § V (June 14, 2000), available at <http://www.sec.gov/litigation/admin/34-42934.htm> (last visited Nov. 27, 2002) (discussing the actions taken by management in order to ensure that company profits met Wall Street predictions); Robert G. Kutsenda, Exchange Act Release No. 44448, at § III (June 19, 2001), available at <http://www.sec.gov/litigation/admin/34-44448.htm> (last visited Nov. 27, 2002) (examining Arthur Andersen's reporting of financial statements of Waste Management). See, e.g., Mary Sattler Polverari, Exchange Act Release No. 42936, at § V (June 14, 2000), available at <http://www.sec.gov/litigation/admin/34-42936.htm> (last visited Nov. 27, 2002) (examining the actions of financial reporters and their involvement in accounting schemes designed to make company profits meet the results predicted by Wall Street analysts). The W.R. Grace administrative proceedings involved poor judgment of the Grace senior management and internal accountants. W. R. Grace & Co., Litigation Release No. 16008, 1998 SEC LEXIS 2765 at \*3 (Dec. 22, 1998); Grace Release, *supra* note 56, at § IV. Once the National Medical Care, Inc., a subsidiary of Grace, transferred funds from the stockpiled reserves to increase Grace's earnings per share, the former Grace senior management and the accountants, Smith, Sukenik and Armstrong, allegedly mischaracterized the source of the increase in Grace's earning per share. *Id.* at § III.A.3. In particular, the management and accountants described the transfer as emanating from "a change in accounting estimate." *Id.* at § III.A.4.c. Thus, the SEC found that the accountants and former Grace senior management

(6) lack of independence or at least stalwart objectivity of outside auditors.<sup>61</sup>

This article will primarily consider the role of the public auditors and in-house accountants in the SEC enforcement activities, in its proposal of changes to be made.

#### AUDITOR OBJECTIVITY IN W. R. GRACE

The published circumstances surrounding W. R. Grace<sup>62</sup> provide insight into the real-world problems associated with auditing financial statements. Price Waterhouse, the responsible auditor, initially informed W.R. Grace that its use of reserves was improper, but later allegedly backed down, relying on an accounting technicality, sometimes referred to as quantitative materiality, to support management's view at W.R. Grace.<sup>63</sup> To check for quantitative materiality, auditors first calculate management's desired accounting entries and, secondly, calculate or estimate the technically correct accounting entries. If the differential between the correct and management's less precise accounting entries is immaterial, the auditors might approve the financial statement containing potentially less accurate entries advocated by management.<sup>64</sup> The Price Waterhouse auditors change-of-heart endorsement of management's incorrect entries epitomizes a lack of stalwart objectivity that tarnishes the auditing profession. Ironically, Chairman Levitt announced that the accounting technicality used by W.R. Grace, "non-material" adjustments, was among the top priorities for enforcement in his much-publicized speech.<sup>65</sup>

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violated sections 10(b), 13(a), and 13(b)(2) of the Exchange Act and corresponding Rules 10b-5, 12b-20, 13a-1, and 13a-13. *Id.* at § IV.

61. William F. Moody, Exchange Act Release No. 36700, 1996 SEC LEXIS 14 \*16 (Jan. 11, 1996) [hereinafter Moody Release] (finding that Moody caused ACC to misstate financial information); Davis, *supra* note 56, at C1 (discussing creative management of financial information of the corporation). See, e.g., Andersen Release, *supra* note 49 (finding Andersen's reports for Waste Management to be false and misleading).

62. Davis, *supra* note 56, at C1.

63. *Id.*

64. To justify their conduct, the auditors may also seek to characterize the incorrect entry as an error rather than an irregularity as defined in Statement on Auditing Standard No. 82, "Consideration of Fraud and Financial Statement Audit." See Eugene F. Gaughan, Exchange Act Release No. 41580, 1999 SEC LEXIS 1292 \*12 (June 30, 1999) [hereinafter "Gaughan Release"] (examining whether financial statements failed to comply with auditing standards).

65. Levitt, *supra* note 16. A non-material adjustment refers to the practice where accountants slant financial statements toward consistent earnings to an extent that the slanted financial information is not quantitatively material, roughly being between five to ten percent change in earnings. Pat Flannery, *Symington Hyped Assets to Accountants, Judge Told*, ARIZONA REPUBLIC,

## SENSORMATIC PROCEEDING

Sensormatic illustrates an alleged breakdown of Sensormatic's internal accounting procedures orchestrated under the direction of high-level inside accountants, presumably under extreme pressure to achieve certain financial results.<sup>66</sup> Under such circumstances, the SEC can invoke Rule 102(e), as well as Rules 13b2-1 and 13b2-2 of the Exchange Act. Rule 102(e) permits the SEC to temporarily suspend or permanently bar accountants from practicing before the SEC.<sup>67</sup> The SEC may invoke Rule 102(e) if an accountant:

- (1) lacks the qualifications to represent a client before the SEC;
- (2) lacks a sufficient character or integrity;
- (3) engages in improper or unethical professional conduct as defined by the American Institute of Certified Public Accountants ("AICPA"), or
- (4) willfully violates or aids and abets a violation of the securities laws or rules.<sup>68</sup>

Green was a certified public accountant and Sensormatic's

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June 24, 1997, at A1; Melody Petersen, *Cleaning Up in the Dark; Companies Disclose Little About Costs of Toxic Sites*, N.Y. TIMES, May 14, 1998, at D1. However, the SEC and federal courts have always defined such materiality loosely to encompass qualitative as well as quantitative aspects of materiality. The true materiality standard considers any amount material if the information would be reasonably likely to be considered important by an investor in making a voting, sales, or purchase decision concerning a security. See generally *T.S.C. Industries*, 426 U.S. at 445 (explaining that materiality is interpreted as the weight that a fact would place on a reasonable investor's judgment concerning the company). If National Medical Care was regarded as a separate segment for purposes of the MD & A, the shift in earnings of the National Medical Care Unit was arguably material. Gaughan Release, *supra* note 64, at 6-7.

66. Sensormatic Release, *supra* note 57.

67. 17 C.F.R. § 201.102(e) (1999) (including amendment to Rule 102(e) of the Commissioner's Rules of Practice, File No. 57-16-98 (Oct. 19, 1999)). The SEC's authority under Rule 102(e) has been upheld to preserve the integrity of its processes. *Touche Ross & Co. v. SEC*, 609 F.2d 570, 579 (2d Cir. 1979); MARC I. STEINBERG, CORPORATE AND SECURITIES MALPRACTICE 171 (Practising Law Institute 1992).

68. STEINBERG, *supra* note 67, at 171. Under the supervision of the SEC, the new Public Company Accounting Oversight Board (PCAOB), rather than the AICPA, is responsible for establishing or adopting ethical rules, auditing rules, quality control rules, independence rules and other standards that apply to "the preparation of audit reports for issuers." Sarbanes-Oxley Act of 2002 § 101(c)(2) (2002). However, the PCAOB may adopt ethical and other rules from the AICPA or "standards proposed by one or more professional groups of accountants" that are "designated or recognized by the Board, by rule, for such purpose." Sarbanes-Oxley Act of 2002 §§ 103(a)(1)-(a)(3)(A) (2002).

Controller of U.S. operations during the foregoing financial performance manipulation.<sup>69</sup> If a controller knows about improper revenue recognition in violation of GAAP and fails to inform the audit committee of the issuer's board of directors or the auditor about it, the controller may be held liable under Rules 13b2-1 and 13b2-2, among other Rules of the Exchange Act.<sup>70</sup> Green's alleged liability under Exchange Act Rules 13b2-1 and 13b2-2 was regarded as a willful violation because Green supposedly knew that the computer clock was turned back to fraudulently change shipping dates and deliberately withheld documents and information from the independent auditors.<sup>71</sup> In fact, Green allegedly hid documents with information requested by the auditors in her desk during the fiscal year 1995 audit.<sup>72</sup> Further, Green was subjected to Rule 102(e) proceedings for allegedly willfully violating Rules 13b2-1 and 13b2-2, regardless of any purported ethical misconduct under the AICPA Professional Code of Conduct.<sup>73</sup>

During 1994, Albert Yesner, a certified public accountant, was Controller of Sensormatic.<sup>74</sup> According to the SEC's initial understanding, Yesner allegedly told an employee that his choices were to withhold documents from the auditors or quit.<sup>75</sup> Yesner later testified that he believed that the documents were going to be turned over to the outside auditor (Ernst and Young) by the responsible parties at Sensormatic.<sup>76</sup> If an in-house officer or accountant actively conceals accounting irregularities from auditors, the accountant may be disciplined under Rule 102(e) and found liable for aiding and abetting in violation of sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934.<sup>77</sup> If an accounting officer becomes aware of an accounting irregularity, such as improper recognition of revenue, the accounting officer should report the irregularity to the audit committee of the issuer's board of directors.<sup>78</sup> Further, the accounting officer should inform the independent auditors of any material accounting irregularities during the annual audit.<sup>79</sup> However, in a subsequent administrative hearing the SEC dismissed Yesner's violation of Rule 102(e) because Yesner lacked

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69. Green Release, *supra* note 22, at 3.

70. Yesner Release, *supra* note 22, at 3.

71. Green Release, *supra* note 22, at 14.

72. Pike Release, *supra* note 59, at 9-10.

73. *Id.* at 10.

74. Yesner Release, *supra* note 22, at 1.

75. *Id.* at 2-3.

76. Albert Glenn Yesner, Initial Decision Release No. 184 (May 22, 2001) [hereinafter Yesner Initial Release].

77. Green Release, *supra* note 22, at 4, 14.

78. *Id.*

79. *Id.* at 4.

the requisite *scienter* or recklessness in inferring that the auditors had received all requested documents.<sup>80</sup> “Yesner believed the matter was resolved when E & Y (Ernst and Young) signed off on the audit without mention in its report or to the audit committee that requested documents were not received or that management had been uncooperative.”<sup>81</sup>

#### LIVENT PROCEEDING

Livent demonstrates something more egregious than the lack of internal controls or the overly aggressive use of accounting standards.<sup>82</sup> The senior management at Livent allegedly took on the active role of approving accounting manipulations and fine-tuning fraudulent financial records and statements.<sup>83</sup> The Senior Vice President of Finance, Ekstein, supposedly ordered that records of both the manipulations and the true accounting figures be kept.<sup>84</sup> Ekstein also allegedly implemented what are best described as computer-assisted-fraud (CAF) computer programs at Livent.<sup>85</sup> These programs allowed the accounting staff to make changes in the accounting records with the changes appearing as if they were original and correct entries.<sup>86</sup> The above fraudulent accounting manipulations were concealed from Livent’s auditors.<sup>87</sup> Thus, auditor independence was not an issue because the auditors were not aware of the fraud.

Livent violated Rules 13(a) and 13(b) among other rules because Livent failed to maintain a system of adequate internal accounting controls to facilitate compliance with GAAP.<sup>88</sup> Livent violated Rule 10b-5 because the financial performance manipulation resulted in multiple misstatements made to analysts and filed in various annual reports on a Form 20-F and quarterly reports on Form 6-K, as well as a registration statement on a Form F-1.<sup>89</sup>

#### MOODY PROCEEDING

Moody involves the SEC’s enforcement activity against an executive of American Aircraft Corporation (A.A.C.) for financial performance manipulation.<sup>90</sup> Moody demonstrates the SEC’s

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80. Yesner Initial Release, *supra* note 76, at 93-94.

81. *Id.* at 96.

82. Livent Release, *supra* note 58.

83. *Id.* at 1226-28.

84. *Id.* at 1227.

85. *Id.* at 1228.

86. *Id.*

87. *Id.* at 1229.

88. *Id.* at 1240.

89. *Id.* at 1236-40.

90. Moody Release, *supra* note 61, at 1-3.

willingness to hold corporate executives accountable for failing to maintain adequate internal controls or accounting procedures.<sup>91</sup> Moody's failure to hire an accountant squarely falls under Rule 13(b)(2)(B) that requires an issuer to maintain a system of adequate internal controls which are sufficient to permit preparation of financial statements in accordance with GAAP.<sup>92</sup>

Moody includes a GAAP violation that resulted in a material overstatement of assets and a material understatement of losses in the quarterly Form 10Q's and the annual financial statements on Form 10K from 1988 to 1991.<sup>93</sup> In particular, A.A.C. materially understated its net losses by over one million dollars for one fiscal year because A.A.C. capitalized research and development costs as production tooling, instead of expensing the research and development costs.<sup>94</sup>

In the Moody proceeding, the SEC chastised Moody for failing to hire a capable accountant to prepare A.A.C.'s financial statements, even though A.A.C. ultimately did have the financial statements approved by an auditor.<sup>95</sup> Nevertheless, it was alleged that Moody intentionally misrepresented to the auditor that A.A.C. had progressed beyond the research and development phase of the helicopter project in management representation letters.<sup>96</sup>

C.E.O. Moody allegedly disagreed with the auditor's accounting treatment of tooling costs and prototype costs.<sup>97</sup> The auditor correctly told Moody that tooling costs and prototype costs should be expensed as incurred.<sup>98</sup> However, Moody argued that the tooling costs should be capitalized because the tooling could be used if a helicopter was ever manufactured in the future.<sup>99</sup> Moody "persuaded A.A.C.'s auditor to agree that A.A.C. could report the R & D costs as assets even after A.A.C.'s auditor told Moody that

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91. *Id.* at 12-14.

92. *Id.* at 15-16.

93. *Id.* at 12.

94. *Id.* at 5-6.

95. *Id.* at 14.

96. *Id.* The Moody proceeding was held before the new prohibition on an officer's improper influence on the conduct of audits. Sarbanes-Oxley Act of 2002 § 303(a) (2002). The SEC's proposed rules for implementing section 303(a) discount the presence of the words "fraudulently influence" and seek broad liability under a negligence standard for officer's and for "any other person acting under the direction thereof", "if that person knew or was unreasonable in not knowing that such action could, if successful, result in rendering such financial statements materially misleading." Proposed Rule: Improper Influence on Conduct of Audits, Release No. 34-46685, File No. S7-39-02 (Oct. 18, 2002) (quoting proposed rule § 240.13b-2-2), available at <http://www.sec.gov/rules/proposed/34-46685.htm> (last visited Jan. 6, 2003).

97. Moody Release, *supra* note 61, at 8, 13.

98. *Id.* at 13.

99. *Id.* at 6-7.



such costs should be expensed.”<sup>100</sup> Similarly, “A.A.C.’s auditor, acceding to Moody’s belief, instructed A.A.C.’s bookkeeper to adjust A.A.C.’s accounting records and financial statements to capitalize the prototype’s cost as inventory for fiscal years 1990 and 1991.”<sup>101</sup>

Thus, the auditor lacked the stalwart objectivity to stand his ground against C.E.O. Moody, who argued for incorrect changes in the accounting presentation of the financial statements to achieve better financial results.<sup>102</sup> The auditor approved A.A.C.’s financial statement that improperly capitalized and depreciated the related tooling and prototype expenses, which resulted in an overstatement of income.<sup>103</sup> The tooling expenses and prototype expenses should have been expensed during the quarters in which they were incurred.<sup>104</sup> As illustrated in the W.R. Grace and Moody proceedings, the alleged lack of independence of auditors may reflect more of an absence of stalwart objectivity of auditors, rather than any intentional wrongdoing on the auditors’ part.

#### INVESTIGATION OF ENRON

According to a recent WALL STREET JOURNAL article, Arthur Andersen failed to flag Enron’s financial problems in audits and failed to adequately address Enron’s use of partnerships that kept debt off of Enron’s balance sheet to inflate earnings.<sup>105</sup> In congressional testimony, Andersen Chief Executive Officer (now former C.E.O.), Joseph Berardino, testified, “in one case, Andersen had made an error in judgment in accepting Enron’s accounting for one of its off-balance-sheet financing vehicles.”<sup>106</sup> Andersen’s acceptance of Enron’s questionable accounting treatment demonstrates a public auditor’s inability to stand its ground against the management of its audit client.<sup>107</sup> The auditing team acquiesced to Enron’s concealing of losses from certain partnerships, contrary to the professional advice of a technical expert within Andersen’s professional standards group.<sup>108</sup> “An

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100. *Id.* at 14.

101. *Id.* at 8.

102. *Id.* at 14.

103. *Id.* at 7-8.

104. *Id.* at 6.

105. Ken Brown, et al., *Paper Trail: Andersen Fires Partner It Says Led Shredding of Enron Documents*, WALL ST. J., Jan. 16, 2002, at A1.

106. *Id.*

107. Further, Andersen failed to stand up to its audit client, Enron, as evidenced by Andersen’s discipline of its own employee assigned to the Enron project. Schmidt, *supra* note 9, at E01. An auditor at Arthur Andersen was removed from the Enron project when he disagreed with Enron’s accounting treatment and Enron later complained about him. *Id.*

108. Susan Schmidt, *Tensions Flare at Trial of Andersen, Enron Auditors Said to Have Ignored Advice*, WASH. POST., May, 10, 2002, at E1.

internal Arthur Andersen document shows that as early as November 2000, the accounting firm had concluded that Enron's Internet services unit, which the company considered crucial to its growth, had such poor controls that there was a 'high risk' that financial results in the unit would be misrepresented."<sup>109</sup> During January 2002, Arthur Andersen admitted that "employees in its Houston office destroyed thousands of Enron documents shortly after learning that the SEC was investigating Enron . . . Andersen fired the lead partner on the Enron audits, David B. Duncan saying that he orchestrated the shredding."<sup>110</sup> One commentator questioned the independence of public auditor Andersen with respect to Enron's audit because of the substantial audit and consulting fees paid by Enron.<sup>111</sup> In 2000, Enron paid Arthur Andersen twenty-five million dollars in audit fees and twenty-seven million dollars for nonaudit work.<sup>112</sup> Thus, the public auditor faces a conflict of interest, or at least a serious challenge to its independence, in receiving audit fees from the very client that it must evaluate.<sup>113</sup>

#### WASTE MANAGEMENT

From 1992 through 1996, Arthur Andersen issued unqualified opinions on the financial statements of Waste Management that overstated income by more than one billion dollars.<sup>114</sup> At the time Waste Management restated the financial statements, it was the largest restatement in U.S. corporate history.<sup>115</sup> According to the

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109. Glater & Brick, *supra* note 2, at A1.

110. *Id.*

111. Cassell Bryan-Low & Jeff D. Opdyke, *How to Predict the Next Fiasco in Accounting and Bail Early*, WALL ST. J., Jan. 24, 2002, at C1.

112. *Id.* One hundred eighty days after the newly established Public Company Accounting Oversight Board (PCAOB), (a new self-regulatory organization under the SEC) begins operations, a registered public accounting firm cannot contemporaneously provide specified non-audit services (e.g., consulting services) with an audit of any issuer. Securities Exchange Act of 1934 § 10(A), 15 U.S.C. 78j-1 (1934), *amended by* the Sarbanes-Oxley Act of 2002 §§ 201(a) and (g)(2002). Section 201(g) broadly defines the prohibited non-audit services such that a public auditor is generally prohibited from contemporaneous performance of auditing and consulting work for the same audit client, except for tax preparation services, which are pre-approved by the audit committee of the audit client. *Id.* However, public auditors may apply to the PCAOB for an exemption from the prohibition on simultaneous provision of consulting and auditing services for the same client. *Id.*

113. Holman W. Jenkins Jr., *Welfare Reform for Accountants*, WALL ST. J., Jan. 16, 2002, at A17. The Sarbanes-Oxley Act of 2002 obtusely addresses the conflict of interest by requiring the audit committee to be independent and responsible for the appointment and oversight of public auditors, rather than management as in the past. Securities Exchange Act of 1934 § 10(A), 15 U.S.C. 78f (1934), *amended by* the Sarbanes-Oxley Act of 2002 § 301 (2002).

114. Andersen Release, *supra* note 49.

115. *Id.*

SEC Director of Enforcement, "Arthur Andersen and its partners failed to stand up to company management and thereby betrayed their ultimate allegiance to Waste Management's shareholders and the investing public."<sup>116</sup> For example, in 1993 Andersen proposed "action steps" to correct improper accounting practices, but did not prospectively enforce Waste Management's compliance with the action steps.<sup>117</sup> Further, Andersen improperly allowed Waste Management to "bury" certain charges by netting the charges against an unrelated, non-recurring gain.<sup>118</sup> "Andersen told Waste Management that its use of netting was an 'area of SEC exposure,' but nonetheless allowed it to occur."<sup>119</sup> "We [the SEC] will not shy away from pursuing accountants and accounting firms when they fail to live up to their responsibilities to ensure the integrity of the financial reporting process."<sup>120</sup> Recently, the SEC brought a new civil suit against former officers of Waste Management.<sup>121</sup>

#### CAUSES OF FINANCIAL PERFORMANCE MANIPULATION

According to an informal survey of 160 Chief Financial Officers, a majority of C.F.O.'s had to respond to executives' requests to misrepresent financial results.<sup>122</sup> Former Commissioner Norman Johnson cited the pressure to meet analysts' expectations as the leading cause of earnings management.<sup>123</sup> In a more elaborate study, the Committee on Sponsoring Organizations of the Treadway Commission noted that eighty-three percent of the fraud investigations by the SEC, during a ten-year span, involved alleged fraudulent activities of a C.F.O., a C.E.O., or both.<sup>124</sup> If C.F.O.'s and their auditors miss the consensus estimates of earnings by even one cent per share, the market capitalization of

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116. *Id.* (quoting Richard H. Walker, the SEC's Director of Enforcement).

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *The Question Remains*, *supra* note 4, at H02. The SEC filed a civil suit against former officers of Waste Management, Inc. on Mar. 26, 2002. *Id.*

122. Keith H. Hammon, *An Outbreak of Optimism*, BUSINESS WEEK, July 13, 1998, at 108.

123. Norman Johnson, United States Securities and Exchange Commissioner, Remarks at the 26th Annual Securities Regulation Institute Conference, *Current Regulatory and Enforcement Developments Affecting the Accounting Profession* (Jan. 20, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch248.htm> (last visited Nov. 27, 2002) [hereinafter "Johnson Securities Remarks"].

124. Committee of Sponsoring Organizations of the Treadway Commission (C.O.S.O.), *FRAUDULENT FINANCIAL REPORTING 1987-1997 - AN ANALYSIS OF U.S. PUBLIC COMPANIES*, New York (Mar. 26, 1999), available at [http://www.coso.org/Publications/executive\\_summary\\_fraudulent\\_financial\\_reporting.htm](http://www.coso.org/Publications/executive_summary_fraudulent_financial_reporting.htm) (last visited Nov. 27, 2002).

the company may decline precipitously in response.<sup>125</sup>

The incentive to manage earnings often results from executive compensation that is typically based on stock options.<sup>126</sup> The executive's stock options only have value if the stock price increases by some minimum amount. For example, Craig Barret, Chief Executive Officer of Intel, lawfully made over \$110 million by exercising options during 1998 because of increases in Intel's stock price.<sup>127</sup>

Besides executive compensation, other incentives exist for meeting analysts' earning forecasts. Successful high technology companies may depend upon acquisitions of other businesses to acquire new technology and new products to compete in or to dominate their market. The acquisitions may be financed by an issuer's stock, which is sometimes inflated in value upon consideration of historic price-to-earnings ratios. Accordingly, the higher the issuer's stock price, the more acquisitions the issuer can make. If the inflated value of the acquirer's stock is the result of fraudulent management of earnings, and the acquired company's stock is fairly priced, the acquirer receives an earnings management "discount" on the acquisition. Because of this market milieu, target companies with conservative, fair presentations of financial statements may be threatened by the speciously attractive deals offered by some acquirers with aggressive, turbid presentations of their financial statements. Even absent an ill-advised acquisition, if a corporation's competitors operate in the gray area between legitimate financial reporting and fraudulent financial reporting, the corporation faces pressure to plunder in the gray area as well.<sup>128</sup>

#### AUDITOR INDEPENDENCE

With respect to the accounting firms, the SEC should address the underlying business fundamentals that may result in less-than-optimal independence of the public auditor. The *Arthur Young*<sup>129</sup> case provides an insightful view of what an ideal public auditor should be by contrasting the role of a public auditor with the role of an attorney. A public auditor should be a "disinterested

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125. Turner Financial Remarks, *supra* note 39.

126. Johnson Securities Remarks, *supra* note 123. The chief executive officer and the chief financial officer may forfeit or disgorge any bonus, incentive, or equity-based compensation for the twelve-month period prior to the filing of a materially non-compliant financial report (e.g., materially misleading report), where a restatement of the financial report is required and misconduct is present. Sarbanes-Oxley Act of 2002 § 304(a) (2002).

127. Dean Takahashi, *Intel CEO Gets \$114.3 Million Exercising Options as Bonus Falls*, WALL ST. J., Apr. 7, 1999, at B7.

128. Levitt Financial Remarks, *supra* note 40.

129. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

analyst charged with public obligations”, whereas an attorney should be a “representative whose duty it is to present the client’s case in the most favorable possible light.”<sup>130</sup> Accordingly, a public auditor should act as a “public watchdog” with “complete fidelity to the public trust” in depicting the corporation’s financial status in a manner that is independent from the corporation’s interest.<sup>131</sup> The auditor owes a superior duty of allegiance to the public, including the creditors and shareholders of the corporation, rather than corporate management.<sup>132</sup> In sum, the Court’s definition of an ideal public auditor sounds more like the description of a public servant than an employee of a private-sector accounting firm with paramount financial goals.

Further, Section 57, Article VI under the AICPA Code of Professional Conduct sets forth public interest aspects of a CPA that are consistent with the *Arthur Young* case. To best serve the public interest and fulfill the ethical obligations of the AICPA and the Public Company Accounting Oversight Board (PCAOB),<sup>133</sup> the public auditor needs a closer and cooperative relationship with the SEC in which information is mandatorily exchanged under defined circumstances.

Rather than using the SEC’s resources merely to hold outside auditors accountable for the transgressions inspired by a handful of executives, the SEC and Congress should endeavor to make public auditors more effective agents of the public interest and barriers against financial performance manipulation. While most executives are honest,<sup>134</sup> a paucity of executives can be the source

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130. *Id.* at 817-18. The Sarbanes-Oxley Act curtailed the permissible scope of consulting services of auditors to promote auditor independence and because “the accounting firm should not act as an advocate of the audit client . . . .” REPORT OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS TO ACCOMPANY S. 2673, PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT OF 2002, S. REP. NO. 107-205, 107TH CONG., 2D. SESS. (July 3, 2002).

131. *Arthur Young & Co*, 465 U.S. at 818.

132. *Id.* at 817-18.

133. “Congress has yanked the AICPA’s auditing oversight duties away from it and given them a new federal board.” Elizabeth MacDonald, *The Man With Nine Lives*, FORBES, Nov. 25, 2002, at 60. Under the new Sarbanes-Oxley Act, the new Public Accounting Oversight Board, rather than the AICPA, is responsible for establishing or adopting ethical rules, auditing rules, quality control rules, independence rules, and other standards that apply to “the preparation of audit reports for issuers.” Sarbanes-Oxley Act of 2002 § 101(c)(2)(2002). However, the Public Accounting Oversight Board may adopt ethical and other rules from the AICPA or “standards proposed by one or more professional groups of accountants” that are “designated or recognized by the Board, by rule, for such purpose.” Sarbanes-Oxley Act of 2002 §§ 103(a)(1)-(a)(3)(A) (2002).

134. According to Dick Grasso, Chairman and CEO of the New York Stock Exchange, “the thousands of CEO’s whom I’ve met in the last 35 years are as outraged at the conduct of a few.” *Nightly Business Report: Interview, Dick*

of illicit financial performance manipulation because their positions of power coalesce with their motivation stemming from financial pressures and stock option compensation. Accordingly, how can the SEC form a suitable barrier between the public auditor and the unscrupulous or overly aggressive executive to keep the executive from intentionally or unintentionally corrupting the public auditor?

Executives arguably exert some degree of influence over certain public auditors because of the auditor's desire to retain the corporate client. No public auditor wants to lose the audited client.<sup>135</sup> If the public auditor is obligated to resign from an auditing engagement because of ethical rules, the public auditor is faced with the likely challenge of replacing the lost business. In the context of an accounting firm, which handles both auditing and consulting business to the extent permitted under applicable securities regulations, a disgruntled audited client may withdraw its consulting business if the accounting firm resigns as the public auditor or if other friction is present in the auditing relationship.<sup>136</sup> "Critics are especially worked up about consulting fees auditing firms earn from the same companies whose books they audit. But the auditors themselves are hired, fired and paid by the very companies they're supposed to be scrutinizing, which ought to strike anybody as the bigger inherent conflict."<sup>137</sup> Under the new regulatory regime of the Sarbanes-Oxley Act, the audit committee of the audited business will have responsibility for hiring, compensating, overseeing, and firing the public auditor, rather than senior management.<sup>138</sup> However, the audit committee and its

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*Grasso, Chairman and CEO of the New York Stock Exchange* (PBS television broadcast, Aug. 1, 2002) (*transcript of Nightly Business Report*) available at <http://www.nbr.com/specials/nyseroundtable/transcript.htm> (last visited Jan. 6, 2003).

135. "When auditors have reservations about a large and successful company's books, they don't blab to the press or shout an announcement from the rooftops, blowing a hole in a stock owned by thousands of investors. No one would ever hire them again." Jenkins, *supra* note 113, at A17.

136. A registered public accounting firm cannot perform both non-audit and audit services for the same client, unless an exception or an exemption applies. Securities Exchange Act of 1934 § 10(A), 15 U.S.C. 78j-1 (1934), *amended by* the Sarbanes-Oxley Act of 2002 § 201 (2002). The prohibited non-audited services are listed in section 201. *Id.* The PCAOB may grant an exemption that enables the particular public auditor to do simultaneous consulting and auditing work for the same client, if certain safeguards are present. *Id.* Further, the public accounting firms can lawfully provide auditing services and tax return preparation services for the same client. *Id.*

137. Jenkins, *supra* note 113.

138. Securities Exchange Act of 1934 § 10(A), 15 U.S.C. 78f (1934), *amended by* the Sarbanes-Oxley Act of 2002 § 301(2) (2002). The audit committee requirements of the Sarbanes-Oxley Act are somewhat consistent with the tenor of the most recent Blue Ribbon Panel recommendations for improving auditor independence. Ira Millstein & John Whitehead, Committee Co-

constituent independent directors<sup>139</sup> are paid by the audited company and owe fiduciary duties (e.g., loyalty) to the audited company, as opposed to the public.<sup>140</sup>

For the foregoing reasons, public auditors may find it difficult to maintain their independence from their corporate clients. For example, if an obstreperous, strong-willed executive insists on or advocates an aggressive accounting treatment or overreaching accounting or auditing standards, the auditor may first try to accommodate the executive's request within the parameters of the accounting or auditing rules.<sup>141</sup> However, if the auditor's accommodation does not satisfy the executive, the only proper recourse is to resign or contact the audit committee of the corporation's board of directors.<sup>142</sup> Resigning is often too drastic a

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Chairs, *Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (Feb. 8, 1999), Nasdaq Newsroom available at <http://www.nasdaqnews.com> (last visited Nov. 27, 2002).

139. See Securities Exchange Act of 1934 § 10A, 15 U.S.C. 78f (1934), amended by the Sarbanes-Oxley Act § 301(3) (2002) (discussing independence of auditors); Proposed Rule: Standards Related to Listed Company Audit Committees, Release No. 34-47137, File No. S7-02-03 (Jan. 8, 2003), available at <http://www.sec.gov/rules/proposed/34-47137.htm> (last visited Jan. 8, 2003) (compelling basic independence standards through the threat of delisting companies with non-compliant audit committees or boards). The New York Stock Exchange has recently submitted new corporate governance rules to the SEC for approval. Rule Filing from NYSE to SEC, Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors August 1, 2002, (Aug. 16, 2002), available at [http://www.nyse.com/pdfs/corp\\_gov\\_pro\\_b.pdf](http://www.nyse.com/pdfs/corp_gov_pro_b.pdf) (last visited Nov. 27, 2002). For example, the new corporate governance rules require NYSE-listed companies to have a majority of independent directors on the board and separate meetings for independent directors and inside directors (i.e., management directors). *Id.*

140. Under Delaware corporate law, the directors owe fiduciary duties to both the corporation and its shareholders. *Aronson v. Lewis*, 473 A2d. 805, 811 (Del. 1984).

141. Malkiel, *supra* note 53, at A16. "The audit partner may be loath to make too much of a fuss about some gray area of accounting if the intransigence is likely to jeopardize a profitable relationship from the accounting firm." *Id.* Accordingly, although a director or an officer may be liable for fraudulently influencing or coercing an auditor under section 303 of the Sarbanes-Oxley Act, the auditor may hesitate to vilify an executive who is merely trying to attain the best possible lawful presentation of the financial results. Sarbanes-Oxley Act of 2002 § 303 (2002).

142. In practice, even prior to section 301(2) of the Sarbanes-Oxley Act, audit committees were supposed to resolve disagreements between management and the auditor regarding financial reporting. However, in the past insular audit committees often convened only several times during the year and were not adequately exposed to the financial operations of the company to be effective watch dogs. The post-Sarbanes-Oxley audit committee may engage advisers or consultants that are necessary to carry out its duties and exercise due diligence over corporate financial matters pursuant to the Sarbanes-Oxley Act § 301(5). Securities Exchange Act of 1934 § 10A, 15 U.S.C. 78f (1934),

step, where a public auditor's livelihood depends on the audit client or a "crown jewel" client.<sup>143</sup> Contacting an audit committee may not help if the audit committee is either inexperienced in financial management<sup>144</sup> or sympathetic to the executive's view.<sup>145</sup>

Prior to the improved independence of audit committees under the Sarbanes-Oxley Act of 2002 and accompanying exchange listing rules,<sup>146</sup> the SEC proposed strengthening the audit committees of corporations to counteract the self-interest of public auditors in auditing clients.<sup>147</sup> In response to a recent SEC

*amended by the Sarbanes-Oxley Act of 2002 § 301(5) (2002).*

143. Malkiel, *supra* note 53, at A16. "Indeed, audit partners are often compensated by how much non-audit business they can capture. They may be incentivized, then to overlook some particularly aggressive accounting treatment suggested by their clients." *Id.* Public auditor, Arthur Andersen regarded Waste Management as a "crown jewel" client, and Andersen did not resign in the face of accounting problems. Andersen Release, *supra* note 49.

144. The SEC requires each issuer "to disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission." Sarbanes-Oxley Act of 2002 § 407(a)(2002).

145. "The Audit Committee needs to stick up for the outside auditor if it's necessary against management. And we've probably all had to do that one time or another. But that's important to, again, keeping the relationship the way it ought to be and keeping the reporting relationship coming to the Committee and not overly influenced by management." Securities and Exchange Commission, *Roundtable Discussion on Financial Disclosure and Auditor Oversight*, (Apr. 4, 2002) (quoting Barbara Franklin who has served on at least one dozen audit committees), available at <http://www.sec.gov/spotlight/roundtables/accountround040402.htm> (last visited Jan. 6, 2003).

146. Anitha Reddy, *Audit Committees Using New Power*, WASH. POST., Aug. 17, 2002, at E01.

Audit committees . . . have long been criticized as weak-willed watchdogs. But after a string of corporate-finance scandals, Congress passed an accounting oversight law and stock market officials gave the committees new powers and responsibilities. The most significant change is that a company's audit committee, not its executives, must hire and fire auditors, a requirement that has effected the balance of power between management and boards, some directors said. Audit committees are supposed to use that new power to ensure that auditors have no conflicts of interest, such as receiving huge consulting fees, that might tempt them to ignore efforts by companies to cook their books.

*Id.*

147. During Arthur Levitt's term as the Chairman of the SEC, the Blue Ribbon Panel developed a plan to strengthen audit committees through NYSE listing and NASDAQ listing rules as well as SEC rule-making procedure. Millstein & Whitehead, *supra* note 138. Levitt has remarked that, "qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest." Levitt, *supra* note 16.

On Feb. 8, 1999, the Blue Ribbon Panel provided a report on improving the role of audit committees. Millstein & Whitehead, *supra* note 138. Some aspects of the Blue Ribbon Panel's recommendations were advised over ten years ago by the Treadway Commission, officially known as the National Commission on Fraudulent Reporting, and prior to the Sarbanes-Oxley Act of



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2002 had not resulted in any changes to the financial reporting process. *See generally* Lynn Turner, Chief Accountant, United States Securities and Exchange Commission, Remarks at “The SEC Speaks in 1999” sponsored by the Practising Law Institute, Washington, D.C. (Feb. 27, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch255.htm> (last visited Nov. 27, 2002) [hereinafter “Turner Practising Law Remarks”].

The NYSE and the NASD sponsored the Blue Ribbon Panel, which included executives from corporations, the NYSE, NASD, and accounting firms. Millstein & Whitehead, *supra* note 138. The report addresses audit committee membership requirements and functional aspects of the audit committee.

A first group of recommendations proposes new NYSE and NASD listing rules for any listed issuer regardless of market capitalization. *Id.* The Blue Ribbon Panel recommended that the NYSE and the NASD require the audit committee of each listed corporation to adopt a written charter that describes the audit committee’s authority, procedures, and membership requirements. *Id.* The charter must contain the following: (1) a statement that the outside auditors are ultimately responsible to the board of directors and the audit committee; (2) a statement that the board of directors and the audit committee have the power to select and replace the outside auditor; and (3) a statement that the audit committee is responsible for obtaining and reviewing information to ensure adequate independence of the outside auditors. *Id.*

The written charter must be approved by the complete board of directors of the listed corporation and reviewed on an annual basis. *Id.* An auditor replacement is typically subject to the approval of the shareholders in a proxy statement for the annual shareholder’s meeting.

A second group of recommendations proposes new NYSE and NASD listing rules for a corporate issuer, if the issuer exceeds a minimum threshold market capitalization of 200 million dollars. *Id.* First, the Blue Ribbon Panel recommends that the NYSE and the NASD should adopt a definition of independent directors for serving on the audit committee. *Id.* In general, a director is considered sufficiently independent if the director has no preexisting financial or familial relationship with the corporate issuer that might interfere with the director’s professional judgment, objectivity, or otherwise constitute a conflict of interest. *Id.* Second, the Blue Ribbon Panel recommends NYSE and the NASD should adopt a requirement that the audit committee only consist of independent directors as defined. *Id.* Third, the NYSE and NASD should adopt a requirement that all audit committee members are “financially literate” and at least one member of the audit committee have accounting or financial management expertise. *Id.*

A third set of recommendations proposes new SEC disclosure rules. *Id.* The Blue Ribbon Panel recommended that the SEC require audit committees for reporting companies disclose the written charter of the audit committee in the next annual report or proxy statement during any year in which significant changes to the written charter were made. *Id.* Alternately, if no significant changes were made, the written charter must be published in the annual report or proxy statement at least once every three years. *Id.* Each proxy statement for the annual shareholders’ meeting must disclose whether or not the board has approved the written charter and whether or not the audit committee complied with the written charter applicable during the previous year. *Id.*

Further, the Blue Ribbon Panel urged the SEC to require all reporting companies to include a letter from the audit committee in the annual report to the shareholders and in the Form 10K annual report. The letter should state whether or not the audit committee, after consulting with management and

request, the New York Stock Exchange (NYSE) has recently proposed stricter independence requirements for audit committees, including the absence of a present relationship with the company and a cooling-off period of five years for certain previous relationships.<sup>148</sup> Further, the SEC has required publication of the amount paid by the audit client to the public auditor for nonauditing work and auditing work.<sup>149</sup> Although the SEC and Congress have promoted various measures to improve auditor

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the outside auditor, believes that the company's financial statements are fairly presented in substantial conformance with GAAP. *Id.*

The Blue Ribbon Panel also recommended amending the generally accepting auditing standards ("GAAS") to require auditors to discuss the auditor's judgment on the clarity and quality, as opposed to merely the acceptability, of the company's financial disclosure with the audit committee. Turner, *supra*.

148. Rule Filing, *supra* note 140. The Sarbanes Oxley Act defines independence of the board members of the audit committee more generally than the proposed listing standards of the NYSE. The Sarbanes Oxley Act requires each member of the audit committee to comply with the following two independence requirements. First, a board member cannot accept any consulting, advisory, or other fee from the issuer other than in his capacity as a board member. Sarbanes Oxley § 301(2002). Second, the board member cannot be an affiliated person of the issuer. Sarbanes Oxley § 301(2002). The proposed NYSE listing rules would require a majority of the board of directors to be independent, unless an exemption applies. Rule Filing from NYSE to SEC, Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors August 1, 2002 (Aug. 16, 2002), available at <http://www.nyse.com> (last visited on Sept. 12, 2002). The board would need to affirmatively determine that a director has no material relationship with the company that would compromise his independence. New Section 303A of the Exchange's Listed Company Manual. The NYSE rules requires a five year cooling off period before a former employee of the listed company may qualify as an independent director. *Id.* The listed companies must establish codes of business conduct and ethics for board members and should establish an orientation program for new board members. *Id.* NYSE proposed listing rules would require a nominating committee, a compensation committee, and audit committee, each comprised of independent directors. *Id.*

Director's compensation must be the sole remuneration from the listed company for audit committee members. *Id.* Further, non-management or independent directors would be required to meet without management in regular executive sessions. *Id.*

149. Bryan-Low & Opdyke, *supra* note 111, at C2. In the past, auditors needed to disclose the following categories of fees: audit fees, financial system fees, and all other fees. 17 C.F.R. 240.14a-101(Item 9(e)(1999)). The SEC has proposed changing the categories of the fees and requiring disclosure for the two most recent fiscal years, instead of the single most recent fiscal year. Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 33-8154, Exchange Act Release No. 34-46934, File No. S7-49-02 (Dec. 2, 2002), available at <http://sec.gov/rules/proposed/33-8154.htm> (last visited Jan. 6, 2002). The proposed new fee categories include audit fees, audit-related fees, tax fees, and all other fees to be consistent with the recent restrictions on the consulting practices of auditing firms. *Id.*

independence, none of the measures adequately address the perceived conflict-of-interest that arises from the corporation's payment of auditing fees to the public auditor.<sup>150</sup> The latest regulatory framework continues to rely heavily on whatever independence and oversight an audit committee can contribute to the audit function. As a timorous precautionary measure, some corporations recently have filed proxy statements with the SEC that contain various controversial disclaimers for liability flowing from the audit committee's oversight responsibilities.<sup>151</sup>

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150. Even under the Sarbanes-Oxley Act of 2002, a corporation hires and pays for the auditor through the audit committee. Securities Exchange Act of 1934 § 10A, 15 U.S.C. § 78f (2002) (as amended by Section 301(2) of the Sarbanes-Oxley Act). The SEC has amended rule 102(e) to improve auditor independence and the Independence Standards Board (ISB) has published a new independence standard to improve the responsibility of auditors to the public trust. Amendment to Rule 102(e) of the Commissioner's Rules of Practice, 63 Fed. Reg. 57,164 (Oct. 26, 1998) (to be codified at 17 C.F.R. pt. 201). Amendment to Rule 102(e) of the Commission's Rules of Practice, Release No. 33-7593, 1998 SEC LEXIS 2256 (Oct. 19, 1998). The SEC has revised Rule 102(e) to address egregious shortfalls of independence in the auditing context that amount to improper professional conduct. *Id.* The revision to rule 102(e) increases the SEC's scope of authority in the regulation of accountants that practice before the SEC. Perhaps, the SEC's revision to Rule 102(e) will help fill the void left by the absence of public enforcement activity by the AICPA. The AICPA Code of Professional Conduct continues to provide that a member who provides auditing services "should be independent in fact and appearance." AICPA CODE OF PROFESSIONAL CONDUCT, *supra* note 23, at § 55, Art. IV. The AICPA contains specific details on independence throughout section 100 of the AICPA Code of Professional Conduct. *Id.* at § 100.

The ISB published a new independence procedure in January of 1999 that requires an auditor to provide written disclosure of a relationship to an audit committee if the relationship involves a potential conflict of interest, an actual conflict of interest, or otherwise might interfere the auditor's independence. Turner Practising Law Remarks, *supra* note 147, at 5. The ISB considered recommending an annual discussion between auditors and audit committees concerning auditors' fees and independence. Turner Colorado Remarks, *supra* note 57, at 7. Besides the ISB's activities, the Public Oversight Board established an Audit Effectiveness Committee to evaluate the effectiveness of audits. *Id.*

If an auditor lacks independence when completing an audit, the financial statements must typically be audited again by another accounting firm that is truly independent. Lynn E. Turner, Chief Accountant, United States Securities and Exchange Commission, Remarks at the "Ethics Under Stress" Conference of the American Institute of CPA's 4 (Apr. 23, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch277.htm> (last visited Nov. 27, 2002) [hereinafter Turner Ethics Remarks]. In the meantime, the company may default on loan covenants that require audited financial statements to be completed within a certain time frame or may be unable to complete shelf-offerings. *Id.*

151. Daniel Sorid, Audit Committee Disclaimer under Fire, REUTERS (Dec. 25, 2002), *available at* [http://biz.yahoo.com/rb/021225/bizauditing\\_1.html](http://biz.yahoo.com/rb/021225/bizauditing_1.html) (last visited Jan. 6, 2002). "To some extent, this kind of language is the corporate

One controversial way to reduce or eliminate the undesirable influence of the corporate executive over the public auditor would be to turn the auditing function into a government-sponsored program of public auditors that are employees or independent contractors of the federal government.<sup>152</sup> However, accounting professionals and corporations might argue that a governmental auditing program might deprive a corporation of its choice of a particular public auditing firm with skill or experience that is well-suited for the corporation.

Another somewhat more palatable way to reduce the influence of the corporate executive over the public auditor would be to authorize the self-regulatory organizations (SRO's) to select or nominate auditors (subject to shareholder approval) for listed companies and to fund the public auditing process through payments to the SRO's (e.g., exchange-listing fees). Here, the self-regulatory organizations may refer to national exchanges under section 6 of the Exchange Act<sup>153</sup> and any registered securities association under section 15A of the Exchange Act.<sup>154</sup> For example, the NYSE would be responsible for selecting and paying auditors for public audits of NYSE-listed companies. Similarly, the National Association of Securities Dealers Regulation, Inc. (NASDR), would be responsible for selecting and paying auditors for National Association of Securities Dealers Automated Quotation System (NASDAQ) and American Stock Exchange-listed (AMEX) companies. Although fostering the greatest level of auditor independence is a desirable goal for the long term, the foregoing measures would require an extension of the self-regulatory responsibility of the exchanges.<sup>155</sup> The listing rules of the exchanges would need to be changed to promote more effective auditing.<sup>156</sup>

Under the new regulatory structure of the Sarbanes-Oxley Act, the exchanges do not have the responsibility of hiring,

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governance system pushing back a little bit and saying, 'et's be realistic here about what you can expect from us.'" *Id* (quoting James Gerson, Chairman of the American Institute of Certified Public Accountants, commenting on the disclaimers of the audit committees).

152. Jenkins, *supra* note 113, at A17. "The SEC should contract directly with accounting firms to audit books of companies that want to raise money in the public markets." *Id*.

153. Securities Exchange Act of 1934 § 6, 15 U.S.C. § 78f (2000).

154. Securities and Exchange Act of 1934 § 15A, 15 U.S.C. § 78(o-3)(2000).

155. "In addition to direct SEC enforcement, the self regulatory organizations – the exchanges and the NASD – can discipline [broker-dealers] for violations of their rules. Self regulatory disciplinary actions are subject to SEC review and, in turn, to review by a federal court of appeals." HAZEN, *supra* note 27, at 461.

156. *See, e.g.*, Millstein & Whitehead, *supra* note 138, at 16 (outlining the Blue Ribbon Committee's recommendations for responsibility of auditors' statements).

compensating, and firing public auditors. Instead, the independent audit committee is responsible for hiring the public auditor, compensating the auditor, supervising the auditor, and resolving any disagreement between the auditor and management on questionable accounting treatments.<sup>157</sup> If the independent audit committee does not exercise sufficient independence from management or if serving on an audit committee proves too burdensome, the SEC and the exchanges should change the listing rules to assume greater authority over the audit committee or its responsibilities. Although Congress could amend section 10A of the Securities and Exchange Act to mandate the deference of companies to an SRO's selection, compensation, hiring and firing of independent auditors,<sup>158</sup> a new SEC rule could accomplish a similar result by merely authorizing audit committees to delegate voluntarily any part of their selection, hiring, firing, and compensation of the public auditor to a suitable SRO.

Under one possible regulatory scheme, the SEC, the SRO, or both would require rotation of the assignment of an auditing firm to a corresponding business entity on a regular basis.<sup>159</sup> For example, auditing assignments may be limited to maximum terms of several years (e.g., three years), after which a mandatory rotation would occur. The Comptroller General of the U.S. will study the potential effects of the mandatory rotation of audit firms and will prepare a report for the applicable congressional committees.<sup>160</sup> If listed companies were not opposed to auditor term limits or if the SEC mandated it, the NYSE could amend the NYSE Listed Company Manual, sections 204.05 and 802.01, to require the listed company to change the accounting firm that conducts the audit at least once every several years to promote auditor independence.<sup>161</sup> The Sarbanes-Oxley Act, merely requires rotation of audit partners, as opposed to audit firms, in accordance

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157. Securities Exchange Act of 1934 § 10A, 15 U.S.C. 78f (1934), *amended* by the Sarbanes-Oxley Act § 301 (2002).

158. *Id.*

159. *See, e.g.,* Malkiel, *supra* note 53, at A16 (stating, "One possibility is to require that auditing firms be changed periodically the way audit partners within each firm are rotated. This would incentivize auditors to be particularly careful in approving accounting transactions for fear that leniency would be exposed by later auditors."). A bill recently introduced by Senator Christopher J. Dodd and Senator Jon S. Corzine would require companies to change audit firms every four years, among other things. Jackie Spinner, *Ease Up on Accounting Curbs*, WASH. POST, Mar. 21, 2002, at E01. The lead auditing partner or coordinating partner must rotate off the audit every five years. Securities and Exchange Act § 10A, 15 U.S.C. 78j-1 (1934), *amended* by the Sarbanes-Oxley Act, § 203 (2002).

160. Sarbanes-Oxley Act of 2002 § 207 (2002).

161. NEW YORK STOCK EXCHANGE, NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL, *available at* <http://www.nyse.com/listed/listeddr.html> (last visited Oct. 30, 2002).

with a five year time limit.<sup>162</sup> Following the financial collapse of Enron, former Federal Reserve Chairman, Paul A. Volcker proposed mandatory rotation of lead partners on audits on a regular basis.<sup>163</sup>

#### IMPROVING FRAUD DETECTION

Aside from the issues of achieving the optimum level of auditor independence, the SEC should facilitate expanded use of public auditors to enhance fraud detection and financial performance manipulation prevention. Prior to enacting section 10A(b) of the Exchange Act, Representative (now Senator) Wyden concluded that “[t]he problem is, under current law auditors are not required to alert regulators regarding doubts and concerns they have about a client’s representations. This violates the spirit of the auditor’s role and leads to a wide gap between the CPA’s view of [its] responsibilities and the public perception of those responsibilities.”<sup>164</sup>

Even after section 10A(b) was enacted and prior to the Sarbanes-Oxley amendments to section 10A, independent auditors have sometimes hesitated to engage in whistleblowing activity.<sup>165</sup> In the Waste Management auditing engagement, the public

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162. Sarbanes-Oxley Act of 2002 § 203 (2002). The AICPA SEC Practice Section previously required an engagement partner of a public auditor to leave temporarily an auditing engagement after seven years and not to return to the auditing engagement until the expiration of two more years. American Institute of Certified Public Accountants, Sec Practice Section requirements of Members at item e, *available at* [www.aicpa.org/members/div/secps/require.htm](http://www.aicpa.org/members/div/secps/require.htm) (last visited Aug. 20, 2002).

163. *A Blow to Accounting Reform*, BUS. WK., Apr. 1, 2002, at 96. Volcker also proposed public auditing practice should be changed by severing auditing from consulting and banning auditing firms from doing internal audits and tax consulting. Joseph Weber, *The Heavy Hand of Justice*, BUS. WK., Apr. 1, 2002, at 32.

164. MARK STEVENS, *THE BIG SIX* 52-53 (1991).

165. *See, e.g., Jenkins, supra* note 113, at A17 (reviewing recent accounting proposals for reform in order to police audit conduct). In April of 1998, the management at Cendant uncovered the financial fraud of CUC International Inc. (a predecessor of Cendant), as opposed to the independent auditors. *See, e.g., Cendant Release, supra* note 56, at fn.2 (outlining Cendant’s procedures in discovery of massive financial fraud conducted by former management). The Sarbanes-Oxley amendments to section 10A require audit committees to keep records of complaints regarding accounting, internal controls, or auditing and to support the confidential, anonymous submission of an employee’s concerns on questionable accounting or auditing matters. Securities and Exchange Act § 10A, 15 U.S.C. 78f (1934), *amended by* the Sarbanes-Oxley Act, § 301(4)(2002). In June of 2002, an internal auditor at WorldCom, Cynthia Cooper, as opposed to the public auditor Andersen, informed the audit committee about improper accounting practices that lead to uncovering \$ 9 billion in accounting misstatements. Amanda Ripley, *The Night Detective*, TIME, Jan. 6, 2003, at 45.

auditor failed to stand up to the management of Waste Management or follow their "action steps for correcting identified accounting deficiencies" associated with the financial statements for 1995 and 1996.<sup>166</sup> In the auditing of American Aircraft Corporation, the public auditor backed down to accommodate management's accounting treatment associated with depreciation.<sup>167</sup> In W.R. Grace, the auditor acquiesced to management's suggested accounting treatment and justified it based on immateriality.<sup>168</sup> In the Enron auditing engagement, the public auditor approved of management's accounting treatment of one or more questionable special purpose entities and the Internet division with inadequate internal controls.<sup>169</sup> Not only did the public auditor approve of Enron's financial statements, but the public auditor orchestrated the shredding of documents rather than engage in any required whistle-blowing activity under section 10A.<sup>170</sup>

Congress enacted section 10A of the Exchange Act in the Private Securities Litigation Reform Act of 1995 (Public Law 104-67) to enhance fraud detection in the auditing context and to potentially reduce litigation stemming from such fraud.<sup>171</sup> Later,

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166. Andersen Release, *supra* note 49.

167. Moody Release, *supra* note 61.

168. Grace Release, *supra* note 56.

169. Jenkins, *supra* note 113, at A17; Glater & Brick, *supra* note 2, at A1.

170. *Id.*

171. *Levitt Offers Views on Fraud Detection, Investment Advisers, Fund Fees, Derivatives*, 68 BNA BANKING REPORT 948 (May 19, 1997); THOMAS J. BLILEY, COMMON SENSE LEGAL REFORMS ACT OF 1995, H.R. Rep. No. 104-50(I), 70-71 (1995) (stating the additional dissenting views of Mr. Wyden). Representative Wyden (now Senator) explained various reasons for the auditor whistle-blower law, including deficient auditing prior to the failures of various banks and savings and loans. *Id.* The proposal of the auditor whistle-blowing law was partially a response to the exposure of Representative Wyden and Representative Dingell to auditing limitations reflected in the ZZZZ Best fraud scandal, where the auditor resigned, but did not report the client's fraud to the SEC. *Id.*; STEVENS, *supra* note 164, at 51-52.

In the ZZZZ Best fraud scandal, Ernst & Whinney refused to certify the financial statements for the 1987 fiscal year after discovering a \$7 million dollar contract listed in ZZZZ Best's financial statement turned out to be a sham transaction, among other things. *Id.* at 45-49. Ernst & Whinney resigned as ZZZZ Best's auditor for the fiscal year dated 1987 after ZZZZ Best's underwriter first resigned. *Id.* at 48. However, after Ernst & Whinney resigned, ZZZZ Best's 8-K filed on June 17, 1987 falsely stated that "[t]here were no disagreements between the Company and Ernst & Whinney on any matter of accounting principles, financial statement disclosure or auditing scope or procedure." *Id.* at 49-50. The public was misled by ZZZZ Best's 8-K for almost a month until Ernst and Whinney explained the true circumstances in Ernst and Whinney's follow up filing with the SEC. *Id.* at 50. If the whistle-blowing duty were in effect, upon the auditor's discovery of the potential fraud on May 19, 1987 and prior to the duty to respond to ZZZZ Best's 8-K filing, Ernst and Whinney would have reported the problem first to

Congress passed an amendment to section 10A in the Sarbanes-Oxley Act of 2002, in which auditors are required to disclose certain information (e.g., critical accounting policies) to an audit committee, rather than the SEC or an SRO. The auditor whistle-blowing duty of sections 10A(b) includes three progressive stages of auditor activity upon the public auditor's discovery of an illegal act during an audit.<sup>172</sup>

In accordance with a first stage (section 10A(b)(1)), if the auditor detects or becomes aware of information, such as an accounting irregularity, that indicates an illegal act has occurred or may have occurred, the auditor must "adequately inform" the appropriate level of management and the audit committee or the board of directors of the illegal act.<sup>173</sup> To adequately inform the foregoing parties, the auditor determines under Generally Accepted Auditing Standards (GAAS) whether the illegal act likely has occurred and whether the illegal act would have a possible effect on the issuer's financial statement, including any liability for the illegal act.<sup>174</sup> If the illegal act is "clearly inconsequential" in the possible effect to the financial statement as determined by the auditor, the auditor has no duty to inform management or the audit committee about the illegal act.<sup>175</sup> Accordingly, the first stage of the whistle-blowing rule gives the board of directors an opportunity to correct accounting irregularities or take other remedial action prior to any duty arising for the auditor to report an illegality to the SEC.

After the auditor adequately informs the audit committee or board of directors of the illegal act under the first stage, the auditor progresses to the requirements of the second stage (section 10A(b)(2)) of the auditor whistle-blowing law.<sup>176</sup> In the second stage, the auditor must reach conclusions on whether the illegal act has a material effect upon the financial statement of the issuer, whether senior management has taken timely and appropriate remedial action with respect to the illegal act, and whether the failure to take remedial action is reasonably expected to require deviation from a standard audit report or warrant resignation from an audit engagement.<sup>177</sup> An auditor will have to inform the company's board of directors of its conclusions in a report as soon as possible in certain instances. The report will be

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the board of directors and then to the SEC, if the company, ZZZZ Best, did not take appropriate action.

172. Securities and Exchange Act of 1934 § 10A, 15 U.S.C. 78j-1 (2000).

173. Securities and Exchange Act of 1934 § 10A(b)(1), 15 U.S.C. 78j-1(b)(1) (2000).

174. *Id.*

175. *Id.*

176. Securities and Exchange Act of 1934 § 10A(b)(2), 15 U.S.C. 78j-1(b)(2) (2000).

177. *Id.*



mandated if the illegal act would have a material effect on the issuer's financial statement, if the senior management has failed to take timely and appropriate remedial action with respect to the illegal act, and if the failure to take remedial action is reasonably expected to require deviation from a standard audit report or is warrant resignation from an audit engagement.<sup>178</sup>

In a third stage (section 10A(b)(3)), after receiving the auditor's report, the issuer must summarize the report or provide a copy of the report to the SEC within one business day after the receipt of the report from the public auditor.<sup>179</sup> If the issuer fails to notify the SEC of the auditor's reported conclusions within the issuer's one day deadline, the public auditor has the duty to report the conclusions on the illegal act to the SEC on the following day, regardless of whether or not the auditor resigns.<sup>180</sup> The disclosure to the SEC may be made on a confidential basis to protect the issuer against prejudicial or inaccurate public disclosure.<sup>181</sup> An auditor who reports a suspected illegality is not liable in a private action for any conclusion or any statement made in the report pursuant to the whistle-blowing provision.<sup>182</sup> However, a public auditor who willfully fails to provide the requisite information to the SEC, as opposed to the audit committee, may be subject to civil penalties in an administrative proceeding.<sup>183</sup>

The former Chairman of the SEC commented that section 10A of the Exchange Act empowers auditors with "additional leverage to influence management of a public company to correct certain illegal acts."<sup>184</sup> If an audit client has obviously committed an illegal act or fraud, section 10A arguably functions best because the public auditor may have actual knowledge of the illegal act that could lead to liability under the civil penalties provision of section 10A(d) or Rule 102(e).<sup>185</sup> The whistle-blowing rule may be difficult for the public auditor to apply to a potentially illegal act that is obscured by the murky boundaries of proper accounting treatment

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178. *Id.*

179. Securities and Exchange Act of 1934 § 10A(b)(3), 15 U.S.C. 78j-1(b)(3) (2000).

180. *Id.*

181. *Id.* The SEC typically shares confidential information of wrong-doing with other applicable domestic and foreign governmental regulators for investigatory purposes. *See, e.g.*, SEC Form 1662. The SEC would probably try to use the confidential information that the auditor provided under the whistle-blowing bill in the same manner.

182. Securities and Exchange Act of 1934 § 10A(c), 15 U.S.C. 78j-1(c)(2000).

183. Securities and Exchange Act of 1934 § 10A(d), 15 U.S.C. § 78j-1(d) (2000).

184. *Levitt Offers Views, supra* note 171.

185. Securities and Exchange Act of 1934 § 10A(d), 15 U.S.C. § 78j-1(d) (2000). Rule 102(e) provides that the SEC may suspend or permanently bar an accountant from practicing before the SEC if the accountant willfully violates any federal securities law. 17 C.F.R. 201.102(e) (2002).

under GAAP.<sup>186</sup> Here, the auditor may have a good faith belief or even a negligent belief in the propriety of an aggressive accounting technique that may fall within the purview of illicit financial performance manipulation. Absent knowing behavior on the part of the public auditor, the civil penalties provision of the whistle-blowing law does not apply. Moreover, the civil penalties provision of section 10A(d) does not even apply to the auditor's knowing failure to provide a report on an illegal act to management in the first place under sections 10A(b)(1) or 10A(b)(2).<sup>187</sup> Thus, the public auditor is most concerned about disclosing willful fraud or a concretely illegal act to the SEC, as opposed to some potential misstatement resulting from the unintentionally misleading portrayal of the audit client's financial position.

If the public auditor does not have compelling information on a fraudulent or illegal act, the public auditor may be particularly reluctant to make the momentous and grave determination that a client or a related party has likely committed an illegal act of material significance to the client's financial statement.<sup>188</sup> Even though the auditor is not personally liable for a report under section 10A(c), a mistaken determination of an illegal act could catastrophically degrade the public auditor's credibility with the board of directors and lead to considerable legal expenses for the issuer. For example, if the public auditor jumps to the wrong conclusion on finding an illegal act, the issuer may be forced to defend against an elaborate SEC investigative inquiry, after which the issuer is ultimately cleared of any wrongdoing. Thus, in the absence of verifiable fraud or patently egregious behavior that impacts the issuer's financial statements, the public auditor may hesitate to invoke the auditor's ten-megaton atomic weapon under section 10A(b) and 10A(c) that might destroy all business relationships within its mushroom cloud. The auditor would be unlikely to invoke section 10A(b) and 10A(c) and persuade the executive management with respect to routine accounting matters

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186. Malkiel writes:

"The audit partner may be loath to make too much of a fuss about some gray area of accounting if the intransigence is likely to jeopardize a profitable relationship for the accounting firm. Indeed, audit partners are often compensated by how much non-audit business they can capture. They may be incentivized, then, to overlook some particularly aggressive accounting treatment suggested by their clients."

Malkiel, *supra* note 53, at A16.

187. Securities and Exchange Act of 1934 § 10A(d), 15 U.S.C. § 78j-1(d) (2000).

188. See, e.g., Jenkins, *supra* note 113, at A17. "When auditors have reservations about a large and successful company's books, they don't blab to the press or shout an announcement from the rooftops, blowing a hole in a stock owned by thousands of investors. No one would ever hire them again." *Id.*

or gray areas of creative accounting. For instance, the auditor may express a preference for a conservative or a more proper accounting treatment, but may accommodate senior management by issuing a favorable opinion on a financial statement relying on a borderline or arguably overly aggressive accounting treatment. Although a registered public accounting firm must now disclose "all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management" and "the treatment preferred by the registered public accounting firm" to the audit committee, it is not yet clear whether this additional disclosure to the audit committee will improve the auditor's ability to select any more conservative accounting treatments than previously possible.<sup>189</sup>

#### AUDITOR FRAUD DETECTION UNDER SAS 82

The foregoing auditor whistle-blowing law is consistent with the improved fraud detection mechanisms provided under Statement of Accounting Standards (SAS) No. 82.<sup>190</sup> SAS 82 provides guidance on fraud detection during an audit.<sup>191</sup> The outside auditor must first detect the likelihood of fraudulent activity in the corporation.<sup>192</sup> The outside auditor may reference a list of nonexhaustive factors provided in SAS 82 for guidance.<sup>193</sup> The outside auditor then devises a plan with the appropriate level of scrutiny and intensity of the audit based on the evaluation of the fraudulent level.<sup>194</sup>

The list of risk factors for fraud in SAS 82 is particularly practical and useful. The Public Oversight Board (POB)<sup>195</sup> called

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189. Sarbanes-Oxley Act of 2002 § 204 (2002).

190. STATEMENT OF AUDITING STANDARDS NO. 82, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT AU § 316 (1997).

191. PAUL MUNTER & THOMAS A. RATCLIFFE, APPLYING GAAP AND GAAS § 28.11 (1999).

192. *Id.*

193. *Id.*

194. *Id.* In some cases, the auditor may resign instead of continuing with the audit if fraud is afoot from the outset. The auditor documents the evaluation of the fraud for the fraud detection plan. *Id.* The duty to devise an appropriate plan is continuous and ongoing during the audit, so if the auditor uncovers suspicious materials or red flags a later time during the audit, the level of scrutiny of the audit must be increased proportionally to comply with SAS 82. *Id.*

195. The Public Oversight Board (POB) is different than the recently created Public Company Accounting Oversight Board (PCAOB). "The Public Oversight Board is an independent private sector body created in 1977 for overseeing and reporting on the self-regulatory programs of the SEC Practice Section." Public Oversight Board, Annual Report 1996-1997 at 6. SEC Practice Section members include most accounting firms that audit publicly traded companies. *Id.* The POB consistently promoted the integrity of auditing by participating in peer review of auditing and accounting practices. *Id.*

for the cataloging of specific examples of signs of fraud to enhance detection of fraud.<sup>196</sup> Some of the more pragmatic risk factors include the following:

- (1) "There is an excessive interest in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices;"
- (2) "Nonfinancial management excessively participates in, or is preoccupied with, the selection of accounting principles or the determination of significant estimates;"
- (3) "Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters, including opinion shopping;"
- (4) "Unreasonable demands on the auditor including unreasonable time constraints regarding the completion of the audit or the issuance of the auditors report;"
- (5) "Domineering management behavior in dealing with the auditor;" and
- (6) "There are significant, unusual, or highly complex transactions close to year end that pose difficult substance over form questions."<sup>197</sup>

If fraud is detected, SAS 82 provides that the auditor must inform the audit committee, management, or the board of the directors, as is appropriate with the severity of the transgression.<sup>198</sup> SAS 82 contemplates that the transgression could be reported to the SEC or another third party, if the auditor does not violate the duty of confidentiality.<sup>199</sup> Accordingly, reporting an accounting irregularity to the SEC is permitted under SAS 82 where the corporation or a control group has violated a federal securities law, such as the internal control provision or the books and records provision. However, SAS 82 does not mandate such a disclosure to the SEC. In practice, such optional disclosure to the SEC may seldom be exercised. SAS 82 is consistent with the Public Oversight Board's conclusion that auditing performance may be improved by improving auditing standards and practices to detect management fraud.<sup>200</sup>

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196. PUBLIC OVERSIGHT BOARD, A SPECIAL REPORT BY THE PUBLIC OVERSIGHT BOARD OF THE SEC PRACTICE SECTION, AICPA 28 (Mar. 5, 1993) [hereinafter PUBLIC OVERSIGHT BOARD].

197. MUNTER & RATCLIFFE, *supra* note 191.

198. *Id.*

199. *Id.*

200. PUBLIC OVERSIGHT BOARD, *supra* note 196, at 34.

## FINANCIAL PERFORMANCE MANIPULATION PREVENTION

The auditor whistle-blowing provision of section 10A and SAS 82 are consistent with fulfilling the definition of the public auditor in the *Arthur Young* case. However, the auditor whistle-blowing provision and SAS 82 are generally directed more toward fraud detection than specifically preventing financial performance manipulation for overly aggressive accounting. To prevent financial performance manipulation, a public auditor should be obligated to report a material accounting disagreement to either the SEC or an authorized self-regulatory organization (e.g., an exchange or the PCAOB). This report should be made prior to expressing an audit opinion on an annual financial report, and should be expressed if the public auditor has been unable to resolve the problem to his or her satisfaction with the internal audit committee of the corporation.

Under the new Sarbanes-Oxley Act, an accounting firm must report to the audit committee, as opposed to a self-regulatory organization, all critical accounting policies and all alternative treatments of financial information within GAAP that have been discussed with management of the issuer.<sup>201</sup> It would be

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201. Securities Exchange Act of 1934 § 10A, 15 U.S.C. § 78-j (1934), *amended* by the Sarbanes-Oxley Act § 204 (2002). The SEC has proposed new rules for regulation S-X under the Sarbanes Oxley Act that would require the auditor to disclose critical accounting policies to the audit committee prior to the filing of the audit report with the SEC. Release 33-8154 (discussing proposed rule 17 CFR § 210.2-07, Communication with Audit Committees).

Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods. Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.

Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Release No. 33-8040, 66 F.R. 65013 (Dec. 12, 2001), *available at* <http://www.sec.gov/rules/proposed/33-8040.htm> (last visited Jan. 10, 2003).

[A] critical accounting estimate is defined as an accounting estimate recognized in the financial statements (1) that requires the registrant to make assumptions about matters that are highly uncertain at the time the accounting estimate is made and (2) for which different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the registrant's financial condition, changes in financial condition or results of operations.

Strengthening the Commission's Requirements Regarding Auditor Independence, Release 33-8154, File No. S7-49-02 (Dec. 2, 2002) *available at* <http://www.sec.gov/rules/proposed/33-8154.htm> (last visited Jan. 6, 2003).

"We recognize [ The SEC recognizes] that the complexity of financial transactions results in accounting answers that are often the subject of

reasonable for SEC or the PCAOB to require the audit committee to preserve the records of the critical accounting policies, alternative treatments, and management-auditor disagreements in the same manner as the complaints of section 301.<sup>202</sup> Pursuant to section 104 of the Sarbanes-Oxley Act or otherwise, the PCAOB might later review the retained records of the critical accounting policies, treatments, and auditor-management disagreements during the registration process or as part of the oversight rules to

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significant debate between management and the auditors. We believe that these discussions of accounting alternatives that occur between management and the auditors should be shared with the audit committee in their oversight role."

*Id.*

Therefore, we are proposing rules requiring communication, either orally or in writing, by auditors to audit committees of alternative accounting treatments of financial information within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm.

*Id.*

The "entire range of alternatives available under GAAP that were discussed by management and the auditors would be communicated along with the reasons for not selecting those alternatives. If the accounting treatment selected is not the preferred method in the auditor's opinion, we would expect that the reasons why the auditor's preferred method was not selected by management also would be discussed.

*Id.*

The Committee believes that it is important for the audit committee to be aware of key assumptions underlying a company's financial statements and of disagreements that the auditor has with management. The audit committee should be informed in a timely manner of such disagreements, so that it can independently review them and intervene if it chooses to do so in order to assure the integrity of the audit.

REPORT OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS TO ACCOMPANY S. 2673, PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT OF 2002, S. REP. NO. 107-205, 107TH CONG., 2D. SESS. (July 3, 2002).

202. Securities Exchange Act of 1934 § 10A, 15 U.S.C. § 78f (1934), *amended* by the Sarbanes-Oxley Act § 204 (2002). The Public Company Accounting Oversight Board may establish rules that require the retention of records for inspection purposes. Sarbanes-Oxley Act § 104(e) (2002). The Oversight Board must require registered public accounting firms (1) to prepare and maintain audit work papers and other papers related to audits for a period of not less than seven years and (2) to provide a concurring or second partner review and approval of the audit report. Sarbanes-Oxley Act, § 103(a)(2)(A) (2002). The SEC's proposed rules ask for comments on "should the auditor be required to provide the communication in writing" to the audit committee. Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 33-8154, Exchange Act Release No. 34-46934, File No. S7-49-02 (Dec. 2, 2002), *available at* <http://sec.gov/rules/proposed/33-8154.htm> (last visited Jan. 6, 2003).

be adopted to ensure accurate disclosure of the reported financial statements.<sup>203</sup> The proposed disagreement reporting duty would eliminate the above circuitous route of communication between the auditor and the PCAOB. This may lead to the public disclosure of inaccurate information in financial reports by the time the PCAOB has the opportunity to review the retained records.<sup>204</sup>

The proposed disagreement reporting duty would be consistent with the ethical duties of a certified public accountant under the AICPA Code of Professional Conduct.<sup>205</sup>

Interpretation 102-4 of the AICPA Code provides that in situations where there is a dispute, members need to make a judgment regarding the materiality of the misrepresentation [in a financial statement or recording of a transaction] in light of existing authority. If, in the member's judgment, material misrepresentations do exist, the member is obligated to bring it to the attention of the appropriate level of management. In the most extreme cases, members should consider disclosure to third parties or discontinuing employment.<sup>206</sup>

The disagreement reporting duty should extend beyond material misrepresentations covered by Interpretation 102-4 to questionable or creative accounting treatments that lie in the gray areas where allegations of fraud might later arise if financial performance of the corporation deteriorates.

The foregoing proposed disagreement reporting duty would apply to the public auditor, as opposed to the issuer. The new disagreement reporting duty would go beyond the present commentary<sup>207</sup> of the public auditor in rebuttal to an issuer's filing a Form 8-K, which relates to the resignation or termination of the public auditor.<sup>208</sup> The public auditor would be encouraged to

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203. Section 104 of the Sarbanes-Oxley Act of 2002 authorizes the Oversight Board to conduct inspections of public accounting firms. The Sarbanes-Oxley Act authorizes the Oversight Board to establish or adopt auditing, quality control ethics and other standards related to the preparation of audit reports. Sarbanes-Oxley Act, § 103(a)(2)(A) (2002).

204. The SEC has expressed concern that the public auditor's disclosure of critical accounting policies to the audit committee should occur prior to finalizing and filing annual reports with the SEC. Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 33-8154, Exchange Act Release No. 34-46934, File No. S7-49-02 (Dec. 2, 2002), available at <http://sec.gov/rules/proposed/33-8154.htm> (last visited Jan. 6, 2003).

205. AICPA CODE OF PROFESSIONAL CONDUCT, *supra* note 23, at Interpretation 102-4.

206. Yesner Initial Release, *supra* note 76, at n.36.

207. Regulation S-K, 17 C.F.R. 229.304(a)(3) (2002).

208. The present Form 8-K filing procedure should remain intact to cover situations where the public auditor resigns or is terminated. Under the present system, an issuer must file a Form 8-K within five days of the

communicate the substance of such a disagreement to the SEC or an authorized self-regulatory organization (e.g., the PCAOB) because the auditor would not be required to make any serious determination of an illegal act or fault of the audited client as presently required under section 10A. Similarly, few auditors would relish accusing an executive of violating section 303 of the Sarbanes-Oxley Act that requires a finding of fraudulent influence, coercion, manipulation or misleading of the auditor.<sup>209</sup> Further, by eliminating the impediment of the auditor's sacrificial resignation, the public auditor may routinely disclose such a disagreement to the SEC or the self-regulatory organization before annual financial statements are filed and publicly available. The SEC, PCAOB, or another self-regulatory agency would intervene by providing one or more disinterested accounting experts (e.g., selected AICPA members) to resolve disagreements on overly aggressive accounting, creative accounting, auditing tactics, or otherwise, that are problematic, but do not prompt the public auditor to resign or to report the client under the whistle-blowing law.

A similar, but broader, definition of "disagreement," which presently applies to the Form 8-K context, should apply to the public auditor's new reporting duty on a disagreement. Accordingly, a disagreement may pertain to "[a] matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure."<sup>210</sup> Further, a disagreement excludes any initial problem that was resolved to the auditor's satisfaction.<sup>211</sup> The engagement partner or another signatory on

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resignation or dismissal of the public accountant. SEC Form 8-K (B(1) of "General Instructions" B(1) and Item 4 of "Information to Be Included in the Report." Although the present scheme allows the accountant to present its conflicting view in 200 words or less for inclusion in the annual report, proxy statement or information statement if the accountant believes the issuers Form 8-K is incomplete or incorrect, such an auditor's statement is too little, too late to help prevent financial performance manipulation. Regulation S-K, 17 C.F.R. 229.304(b)(2) (2000). Moreover, the public cannot depend on the public auditor to resign to trigger the contingent Form 8-K reporting duty in the first place. Although a disagreement, in the auditing context, might indicate an accompanying incident of creative accounting, an auditor, a mere legal novice, may readily overlook the disagreement as not concerning a reportable illegality under the whistle-blowing rule. Thus, the proposed disagreement reporting duty appropriately complements the scope of the whistle-blowing rule to prevent financial performance manipulation.

209. Sarbaes-Oxley Act of 2002 § 303 (2002). "It 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 . . . for the purpose of rendering such financial statements materially misleading." *Id.*

210. Regulation S-K, 17 C.F.R. 229.304(b)(3) and Instruction 4 (2002).

211. *Id.* at 229.304(b)(5) and Instruction 4. Here, the definition of a "disagreement" may include the disclosure required under section 204 of the



the audit report should make the decision on whether a disagreement is actually present.<sup>212</sup>

The auditor would need to report an unresolved material disagreement if there is a substantial likelihood that a reasonable investor might consider the disclosure of the disagreement to the SEC, the PCAOB, or the self-regulatory organization important in maintaining accurate financial reporting on his investment. Thus, the public auditor may have a duty to report a material accounting disagreement regardless of whether the auditor's report ultimately represents an unqualified opinion, a qualified opinion, a disclaimer, or an adverse opinion so long as an unresolved material disagreement is present before issuing the annual audit report and filing the Form 10-K. The foregoing definition of materiality is broader than the existing Form 8-K reporting standard which merely defines a disagreement as material if a disagreement is "not resolved to the satisfaction" of the auditor and if the disagreement "*would have caused*" the public auditor "to make reference to the subject matter of the disagreement in connection with its report."<sup>213</sup>

Application of the disagreement reporting rule could have preemptively diffused the auditing dilemmas faced by the public auditors in the American Aircraft Corporation (A.A.C.) administrative proceeding, the Waste Management settlement, and W. R. Grace litigation before the misleading information was ever filed in the respective financial statements. If the proposed disagreement reporting rule were present, the public auditors of A.A.C., Waste Management, and W. R. Grace would arguably not have succumbed to the desires of strong-willed management, but rather fulfilled their mandatory duty to report such a disagreement to the SEC or its authorized self-regulatory organization without the disincentive of resignation from an auditing engagement or reporting the audit client as the perpetrator of an illegal act.

With respect to Enron, if the public auditor, Arthur Andersen, was aware of special purpose entities associated with the audited issuer that may be perceived as concealing debt of an issuer, the public auditor could readily report the problem under the disagreement reporting duty without determining that the issuers conduct was illegal or violated applicable accounting standards. Thus, the disagreement reporting rule could lead to a potential reduction in enforcement activity of the SEC and less

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Sarbanes-Oxley Act and any applicable SEC rules thereunder. Securities Exchange Act of 1934 § 10A, 15 U.S.C. 78j-1 (2002). Further, "disagreement" may incorporate the scope of "disagreement" under applicable auditing standards. Auditing Standard AU § 380.

212. Regulation S-K, 17 C.F.R. 229.304 (b)(4) and Instruction 5.

213. *Id.* at Instruction 4.

repercussions for shareholders of various publicly traded corporations.<sup>214</sup> As a policy matter, the SEC and any self-regulatory organization thereunder should use the confidentiality section 105(b) of the Sarbanes-Oxley Act to protect the confidentiality of information in a manner that elicits full disclosure of accounting problems by whistleblowers and rapid resolution of the problems through timely and accurate public disclosure to the market.<sup>215</sup>

#### ENFORCEMENT ACTIVITY

The proposed, expanded supervision of public auditors by a self-regulatory organization authorized by the SEC and the proposed disagreement reporting duty (amendment to section 10A or establishment of a corresponding PCAOB rule) represent prophylactic measures intended to increase market transparency and reduce the need for future SEC enforcement activity. However, the SEC should continue to hold C.E.O.'s and C.F.O.'s accountable by bringing actions against unscrupulous earnings management, particularly for non-listed securities. As illustrated by SEC enforcement activity, the SEC can effectively tailor surgical strikes in enforcement activities by targeting the minority of executives themselves that engage in improper earnings management, rather than the underlying companies.<sup>216</sup> A study from Committee of Sponsoring Organizations of the Treadway Commission indicates the SEC has routinely taken enforcement action for fraudulent financial reporting against executives in small corporations that were not listed on the NYSE or AMEX exchanges.<sup>217</sup>

The Supreme Court has stated that "if investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might be lost."<sup>218</sup> The SEC has pursued various cases on auditor independence during the last several years.<sup>219</sup> Several SEC enforcement actions reflect a lack of adherence to basic independence standards. For example, a public auditor cannot audit a client while negotiating employment with the client.<sup>220</sup> A public auditor cannot work as an employee of the

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214. Harvey Pitt, Former Chairman of the Securities and Exchange Commission, indicated the SEC did not want to play "gotcha", but wanted to protect investors by proactively solving disclosure problems that might damage shareholders. Hilzenrath, *supra* note 12, at A25.

215. Sarbanes-Oxley Act of 2002 § 105(b)(5)(A), 15 U.S.C. § 7201 (2002).

216. The ultimate goal should be to protect the investor or the shareholder, as opposed to targeting the corporation in enforcement activity that financially harms the shareholder.

217. FRAUDULENT FINANCIAL REPORTING, *supra* note 124.

218. *U.S. v. Young*, 465 U.S. 805, 819 n.15 (1984).

219. Schuetze SEC Remarks, *supra* note 46.

220. Norman S. Johnson, Commissioner, United States Securities and

entity the auditor is auditing.<sup>221</sup> A public auditor cannot audit his or her own bookkeeping.<sup>222</sup>

The AICPA has been criticized for keeping disciplinary proceedings against accountants out of the public view.<sup>223</sup> As a result, the SEC has made an effort to grab the headlines in enforcement activities against accountants to show that accountants are truly accountable. In a recent settlement against PriceWaterhouseCoopers L.L.P., the SEC fined the firm 2.5 million dollars because numerous accounting personnel had invested in the stock of PriceWaterhouseCooper's audit clients. The SEC's goal was to persuade PriceWaterhouseCoopers "to educate the accounting profession about the importance of the Commission's independence rules."<sup>224</sup>

### CONCLUSION

Investors may lose confidence in the U.S. equity markets if changes in financial reporting do not take place to illuminate true financial conditions.<sup>225</sup> 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.<sup>226</sup> 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. Thus, more capital might be allocated to a poorly performing business than otherwise might be. Conversely, less capital may be available for truly meritorious corporations that present their financial records fairly. The SEC, alone or with Congressional legislation, should authorize exchanges to hire and fire public auditors for listed corporations to foster proper supervision over the post-Sarbanes-Oxley audit committees. The SEC could limit the self-regulatory authorization of the exchanges by imposing term limits or

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Exchange Commission, Remarks at the Practicing Law Institute's SEC Speaks (Feb. 26, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch264.htm> (last visited Nov. 27, 2002).

221. *Id.*

222. *Id.*

223. See generally Turner, *supra* note 54.

224. Johnson, *supra* note 220. If the SEC is unable to bring sufficient improvements in financial performance on the proposed auditor disagreement reporting duty by amending section 10A of the Exchange Act, Congress should extend a private right of action for aiding and abetting liability once again to auditors to over-rule the controversial *Central Bank v. Denver* Supreme Court decision. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). Such Congressional action should be carefully considered as it might spur the type of frivolous class-action lawsuits that Reform Act of '95 was designed to keep in check.

225. See generally Levitt, *supra* note 16.

226. *Id.*

rotational requirements for the public auditors auditing of any single listed corporation.

Congress or the recently formed PCAOB<sup>227</sup> should ensure auditors fulfill their auditing obligations to the public by enacting appropriate legislation or rules for the protection of investors and the integrity of the equity markets. For example, section 10A of the Exchange Act could be amended or the upcoming PCAOB rules could be crafted to include the proposed disagreement reporting duty. The public auditor needs a routine procedure, to follow for safeguarding market integrity, that does not require the public auditor's sacrificial resignation or the public auditor's extremely grave determination of a reportable illegality when faced with a disagreement with management, the audit committee, or both over accounting or auditing issues. This proposed disagreement reporting duty provides an expedient route to the SEC or an SRO thereunder for the public auditor to comply with applicable securities regulations and ethical rules. Presently, the public auditor is required to struggle slowly over an arduous footpath through the jungle of the audit committee review, resignation, confidentiality, and section 10A "illegal acts" to fulfill the auditor's public responsibilities. The auditor disagreement reporting duty would allow the SEC or an authorized SRO to interact quickly and constructively with issuers to prevent misleading numbers from being filed in financial statements in the first place. The SEC would have an interactive opportunity to resolve matters of overly aggressive accounting from the outset without resorting to enforcement activity that might adversely impact the investments of blameless shareholders. Thus, if the foregoing improvement to the Exchange Act or applicable rules thereunder were adopted, public confidence in the equity markets would be enhanced without escalation of the SEC's enforcement resources.

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227. The Public Accounting Oversight board will have five financially literate members that are appointed by the SEC. Sarbanes-Oxley Act of 2002 § 101(a), (e)(1), (e)(4)(A), 15 U.S.C. § 7201 (2002). The Oversight Board will establish or adopt auditing, quality control, ethics and other standards related to the preparation of audit reports. Sarbanes-Oxley Act of 2002 at § 103(a)(1).

