WINK, WINK, NUDGE JUDGE: PERSUADING U.S. COURTS TO TAKE ACCOUNTANTS SERIOUSLY IN FEDERAL SECURITIES CASES WITH HELP FROM THE U.K. COMPANIES ACT

KURT S. SCHULZKE*

I certainly don't want to debate about GAAP.

—Enron Task Force Prosecutor Kathryn Ruemmler[1]

We live in a litigious society so people would prefer to have prescriptive guidance, so they can say they followed the rules.

—Anonymous public company CFO[2]

INTRODUCTION

The 2008 collapse of Lehman Brothers reopened wounds many thought were healed by the Sarbanes-Oxley Act ("SOX") in 2002. The *Lehman* litigation finally ended in late 2013 with audit firm Ernst & Young paying $99 million to investors[3] who claimed the firm misled them *with* generally accepted accounting principles ("GAAP").[4] Other defendants, including banks, officers, and directors, paid out more than $500 million.[5]

* Associate Professor of Accounting & Business Law and Director of Law, Ethics & Regulation, Corporate Governance Center, Coles College of Business, Kennesaw State University. Of Counsel, Slappey & Sadd, LLC, Atlanta, Georgia. J.D., Georgia State University College of Law, *cum laude*.

1 Transcript of Sentencing at 18:14-15, U.S. v. Causey (S.D. Tex. 2006) (H-04-025-SS) [hereinafter Causey Transcript].

2 Ilia D. Dichev, John Graham, Campbell R. Harvey & Shiva Rajgopal, *Earnings Quality: Evidence from the Field* 31 (SSRN Working Papers Series, Abstract No. 2103384. 2013), *available at* http://ssrn.com/abstract=2103384.

3 *See* Michael Rapoport, *Ernst & Young Agrees to Pay $99 Million in Lehman Settlement*, WALL ST. J., Oct. 18, 2013, *available at* http://www.wsj.com/articles/SB10001424052702304384104579143811517891526.

4 *See infra* notes 118-129 and accompanying text (discussing the *Lehman* case).

5 *Id.*

The bright line standards of GAAP and SOX were obviously not enough to protect *Lehman* plaintiffs or defendants. Why not? The 2006 fraud trial of Enron CEO Jeffrey Skilling offers clues. When asked at trial whether U.S. accounting principles (GAAP) permitted Enron's accountants to mislead Enron's auditors, Skilling's accounting expert Walter Rush replied: "[T]his isn't even an issue under GAAP. GAAP doesn't talk about misleading. GAAP doesn't talk about integrity. GAAP talks about accounting rules, how you measure assets and liabilities, what kind of disclosures you make."[6] At about the same time, the SEC's Chief Accountant declared that most financial statements are misleading.[7] Enron, it seems, was no anomaly.

In leading recent securities cases, federal courts have disregarded or studiously avoided GAAP and accounting experts, examining more broadly whether financial statements are "fairly presented" or "not misleading," thus dismissing costly accounting testimony as irrelevant and suddenly exposing defendants—like those in *Lehman*—to unforeseen legal exposure. Remarkably, undiluted FASB[8] GAAP remains the primary fuel for the analytical engines of America's financial markets; and therefore, misleading FASB GAAP financial statements continue to circulate, misinforming the decisions of investors and creditors and potentially setting the stage for the next *Lehman*. With the SEC again considering a switch to the IASB's[9] IFRS[10] accounting system, profound changes to the SEC's approach to financial statements deserve serious consideration.

In January 1932, American accounting luminary George O. May sought to limit the auditor's role to telling shareholders whether financial statements *fairly present* the company's financial position and results.[11] May used a leading British

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[6] Transcript of Record at 16848-16849, United States v. Skilling (S.D. Tex. 2006) (04-CR-25) [hereinafter Skilling Transcript].

[7] Don Nicolaisen, SEC Chief Accountant, 2005 PCAOB Standing Advisory Group (SAG) meeting (Oct. 5-6 2005), http://pcaobus.org/News/Webcasts/Pages/10052005_SAGMeeting.aspx ("If I were to opine on a set of financial statements with my own views, there are few that I would find to be other than misleading.").

[8] Financial Accounting Standards Board.

[9] International Accounting Standards Board.

[10] International Financial Reporting Standards.

[11] GEORGE O. MAY, THE ETHICAL PROBLEMS OF MODERN ACCOUNTANCY: LECTURES DELIVERED IN 1932 (1933), *reprinted in The Accountant and the Investor*, 16 ACCT. HISTORIANS J. 219, 222 (1989). May was Senior Partner of Price Waterhouse and Company's New York office,

case, *The King v. Lord Kylsant*,[12] to argue that while selection of accounting treatments is inherently contextual and judgmental,[13] audit opinions should "be so worded that not only will every statement made therein be literally true, but every inference which could legitimately be drawn from the language will be warranted by the facts."[14] Paradoxically, current SEC and professional standards encourage the opposite.

Federal securities law requires that public company[15] financial statements and disclosures be "not misleading"[16] and presumes that financial statements not compliant with generally accepted accounting principles (GAAP) *are* misleading.[17] CEOs and CFOs of public companies must personally certify that the company's (a) financial statements are *fairly presented*, (b) SEC reports, which often include financial statements, are *not misleading*, and (c) disclosure controls and internal

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Chairman of the American Institute of Accountant's [hereinafter AIA] Special Committee on Cooperation with Stock Exchanges, and accounting advisor to the New York Stock Exchange [hereinafter NYSE]. STEPHEN A. ZEFF, FORGING ACCOUNTING PRINCIPLES IN 5 COUNTRIES 122, n. 29 (1971) [hereinafter ZEFF 1971]. This is the first recorded mention of *fairly present* in relation to financial reporting in the United States. The phrase "present fairly" has been credited to NYSE President Richard Whitney. *See* Stephen A. Zeff, *The primacy of "present fairly" in the auditor's report*, 6 ACCT. PERSPECTIVES 1, 2-5 (2007) [hereinafter Zeff 2007]. However, the record indicates that May anticipated Whitney by one year. The term "results" means "earnings" or "income." Hereinafter, the term "auditor" means an external auditor of financial statements typically prepared by internal accountants denominated hereinafter (mostly) as "preparers." However, depending on context, the term "accountant" may apply to auditors, preparers or both.

[12] L.R. [1932] 1 K.B. 442

[13] MAY, *supra* note 12, at 228.

[14] *Id.* at 230 (emphasis added).

[15] Depending on context, this article interchangeably uses the terms *public company*, *issuer*, and *registrant* to signify "SEC registrant." An *issuer* is any person who issues or proposes to issue any security. 15 U.S.C. § 78c(a)(8) (2014). In general, an issuer becomes an SEC *registrant*—and must therefore register with and periodically submit financial statements and other disclosures to the SEC—when its total assets exceed $10,000,000 and it has a non-exempt class of equity securities held by 2,000 persons, or 500 persons who are not "accredited" investors. 15 U.S.C. § 78l(g)(1)(A)-(B) (2014). *Foreign private issuers* [hereinafter FPI], as distinguished from domestic issuers, with fewer than 300 security holders resident in the United States are exempt from registration. 17 C.F.R. § 240.12g3-2(a) (2014).

[16] *See, e.g.*, 17 C.F.R. § 240.12b-20 (2014).

[17] 17 C.F.R. § 210.4-01(a)(1) (2014).

controls over financial reporting are effective.[18] These requirements, though impossible to summarize in a coherent Venn diagram, nevertheless seem to promise reliable—though not necessarily useful or relevant—financial information. But even this limited promise is misleading.

SEC regulations and policy guidance do not define "misleading" or "generally accepted accounting principles" nor do they presume that GAAP-compliant financial statements are *not* misleading.[19] SEC regulations do not require auditors to opine on financial statement fair presentation or compliance with GAAP. On the other hand while PCAOB and AICPA[20] standards superficially agree that auditors must opine on both, they diverge over what, if anything, fair presentation means beyond mere GAAP compliance. The FASB itself is largely silent on fair presentation but sternly warns preparers to comply with its GAAP no matter what.

Partly because of these conflicting signals, accountants tend to superficially equate fair presentation with bare conformity to FASB-promulgated GAAP (FASB GAAP),[21] largely disregarding fair presentation and the "not misleading" mandates. As a result, today's standard audit opinions answer a mostly irrelevant question—whether the financial statements conform to FASB

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[18] *See infra* Part III.A. (discussing required certifications under Sarbanes-Oxley Act §§ 302 and 906).

[19] *See generally, e.g.*, SEC, DIVISION OF CORPORATION FINANCE, FINANCIAL REPORTING MANUAL (2013), *available at* http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml (using the term "misleading" thirteen times without defining it, except with respect to specific transactions or events). However, a 2003 SEC policy statement purports to declare FASB GAAP "generally accepted." SEC, POLICY STATEMENT: REAFFIRMING THE STATUS OF THE FASB AS A DESIGNATED PRIVATE-SECTOR STANDARD SETTER, FINANCIAL REPORTING RELEASE NO. 70 (Apr. 25, 2003), *available at* http://www.sec.gov/rules/policy/33-8221.htm#P25_3300 [hereinafter FR-70].

[20] The Public Company Accounting Oversight Board [hereinafter PCAOB] prescribes public company auditing standards; private company standards are published by the American Institute of Certified Public Accountants [hereinafter AICPA].

[21] *See* Ronald M. Mano, Matthew L. Mouritsen & James G. Swearingen, *Accounting profession, heal thyself: A matter of survival*, 73 CPA J., Aug. 2003, at 6, 8 (citing notorious cases supporting the proposition that accountants too often equate "fairly presented" with "in accordance with GAAP). This article distinguishes between broadly defined GAAP (the universe of accounting principles that enjoys some level of general acceptance) and FASB GAAP (rules promulgated by the FASB at https://asc.fasb.org/). *See also* ACCOUNTING STANDARDS CODIFICATION subtopic 105-10-05 (Fin. Accounting Standards Bd. 2013) [hereinafter FASB CODIFICATION], *available at* https://asc.fasb.org/ (purporting to designate the FASB CODIFICATION as the only "authoritative" source of U.S. GAAP, beginning in 2009).

GAAP—while giving lip service to fairness and saying nothing about predictive usefulness.

Judges, prosecutors, and plaintiffs take the opposite view. Their preference for fair presentation over technical GAAP compliance is under-appreciated by corporate directors, officers, auditors, and their attorneys and accounting experts, who often seem genuinely surprised by judicial distaste for and dismissal of GAAP. Some view highly prescriptive GAAP as safe and predictable.[22] Yet, it may actually increase risk on all sides. Brighter lines create an illusion of certainty in the minds of readers, discourage accountants from exercising professional judgment, and suggest to courts that accounting experts are either irrelevant or unhelpful in answering case-critical questions. Who needs an expert to read bright lines?

The remainder of the article is structured as follows. Part I examines leading securities cases that demonstrate the tendency of federal courts to ignore accounting experts and to misinterpret accounting literature. Part II chronicles the ongoing debate over fair presentation and outlines current AICPA, PCAOB, and FASB interpretations, adducing evidence that FASB GAAP systematically misleads readers. Part III summarizes relevant U.S. and U.K. statutes and regulations. Part IV draws conclusions, while Part V closes with related recommendations suggested by the U.K. Companies Act 2006, the IASB, and the FASB's own Concepts Statement No. 8, which may help to restore the courtroom relevance of accounting experts. While this article addresses only the weight accorded to their testimony, reserving to future discussion its admissibility under the Federal Rules of Evidence,[23] it may also be helpful in evaluating admissibility in particular cases.

I. CASE LAW

In Part I, a famous British case sets the stage for consideration of subsequent U.S. case law which is presented in chronological order. The overall theme of these opinions is a disregard for accounting standards in favor of broader fair presentation. Additionally, a line of cases beginning with *Basic, Inc. v.*

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[22] *See* Dichev et al., *supra* note 2, at 30-31 (citing evidence that fear of litigation drives public company CFOs toward accounting rules so prescriptive that they sometimes "don't reflect the economic substance of the transaction.").

[23] Qualified expert testimony is admissible if "the expert's . . . specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue." FED. R. EVID. 702(a).

Levinson[24] is included to elucidate the judicial interpretation of materiality, a concept essential to all securities cases.

A. The King v. Lord Kylsant

In 1928, Lord Kylsant, a director of Royal Mail Steam Packet Co. (Royal Mail), published a prospectus promoting Royal Mail debentures.[25] The prospectus avowed that while Royal Mail had "suffered from the depression in the shipping industry [like other firms], the audited accounts . . . show that during the past ten years the average annual balance available . . . after providing for depreciation and interest on existing debenture stocks, has been sufficient to pay the interest on the present issue more than five times over,"[26] and that dividends were paid in every year from 1911 to 1927 except 1914.[27]

However, the prospectus omitted key contrary indicators. While World War I made the 1918-to-1920 interval highly profitable, thereafter, Royal Mail had consistently incurred substantial losses and paid dividends in years 1921-1927 only out of non-recurring war-time sources of cash such as tax refunds, "war contingency reserves," and a deferred repairs account.[28] At trial, Kylsant was

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[24] *Levinson,* 485 U.S. 224 (1988).

[25] King, L.R. [1932] 1 K.B. 442. . *Kylsant*'s inferential reasoning doctrine broadly informs U.S. securities case law but is cited as authority in the United States only by the pre-SEC Eighth Circuit. *See* Foshay v. U.S., 68 F.2d 205, 210 (8th Cir. 1933), *cert. denied*, 291 U.S. 674 (1934) (applying the federal mail fraud statute where defendants misled investors to believe the company was earning regular profits by touting monthly "dividends" actually paid out of invested capital). *E.g.*, A debenture is a bond secured only by the issuer's reputation. THOMPSON REUTERS, *Debenture*, INVESTOPEDIA, http://www.investopedia.com/terms/d/debenture.asp (last visited Apr.7, 2015). *Foshay* is cited by subsequent cases involving the sale of securities. *See, e.g.*, Deaver v. U.S., 155 F.2d 740, 744 (D.C. Cir. 1946); U.S. v. Proctor & Gamble Co., 47 F. Supp. 676, 678 (D. Mass. 1942). *See also* Greenhill v. U.S., 298 F.2d 405, 411 (5th Cir. 1962) (holding that honest belief in a venture's ultimate success does not justify false representations in the sale of its securities) (citing *Foshay*, 68 F.2d 205; Danser v. U.S., 281 F.2d 492, 496-97 (1st Cir. 1960) (upholding conviction for violating Securities Act § 17(a) where, around Jul. 23, 1954, the defendant circulated a prospectus dated Mar. 31, 1954 that omitted material intervening losses known to the defendant); Proffer v. U.S., 288 F.2d 182 (5th Cir. 1961); U.S. v. Crosby, 294 F.2d 928 (2d Cir. 1961) Linn v. United States, 234 F. 543, 552 (7th Cir. 1916) (where defendant materially misled prospective investors to believe that he controlled a mine, his honest belief in the ultimate success of the mining venture was not a mail fraud defense)).

[26] *Kylsant (Lord)* np.

[27] *Id.*

[28] *Id.*

found guilty of circulating a prospectus he knew was materially false with the intent to induce investment in Royal Mail debentures.[29]

The Criminal Court of Appeal agreed, finding that the prospectus could be expected to lead readers to infer that the company was financially sound and that a "prudent investor could safely invest."[30] The court held that even though the prospectus was "letter by letter, word by word, an accurate document, so far as it goes," Kylsant was indeed guilty of larceny for fraudulently inducing bond subscriptions.[31] In other words, Kylsant's otherwise factually accurate prospectus misled readers to infer that Royal Mail's financial future was bright while undisclosed negative information suggested it might not be so.

Kylsant was not an accountant but he played a similar role as an information intermediary. In the United States, George May used *Kylsant* to argue that accountants must ensure that "no statement is put forward which is a half-truth or which . . . will probably give rise" to ill-founded inferences.[32] May also argued that while they are not fairly accountable for unwarranted inferences drawn by ignorant or careless investors, accountants should be held responsible for inferences that flow naturally from the literal truths of their words.[33]

B. U.S. v. Simon

The statutory phrase "not misleading" first appeared in Sections 17(a) and 19(a) of the Securities Act.[34] Thereafter, it was included in the FTC's implementing regulations.[35] In case law, the phrase "not misleading" was first

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[29] *Id.*

[30] *Id.*

[31] Kylsant was indicted for violating Larceny Act, 1861 24 & 25 Vict. c. 96, § 84, which criminalized the publication of any written "statement or account which he shall know to be false in any material particular, with intent . . . to induce any person . . . to intrust or advance any property to [a] company . . . shall be guilty of a misdemeanor. . . ." *Id.*

[32] MAY, *supra* note 12, at 231-232.

[33] *Id.* at 232.

[34] Securities Act §§ 17(a) and 19(a) (1933). 15 U.S.C. §§ 77(q), 77(b) (1916).

[35] FED. TRADE COMM., RULES AND REGULATIONS UNDER THE SECURITIES ACT OF 1933, Art. 15 (Jul. 6, 1933).

mentioned in 1936 in *U.S. v. Alluan*.[36] The most influential decision, however, was *U.S. v. Simon* which was handed down in 1969.[37]

In *Simon*, the Second Circuit Court of Appeals upheld convictions of a partner, junior partner, and senior associate of audit firm Lybrand, Ross Bros. & Montgomery.[38] The defendants were convicted for "certifying" financial statements that omitted mention of a $3.9 million related party receivable and the collateral securing its repayment.[39] At trial, the defendants' eight expert accounting witnesses—characterized by the appellate court as "an impressive array of leaders of the profession"—testified that the defendants' financial statements were not inconsistent with GAAP except for one relatively minor error.[40] On these facts, the trial court denied the defense request for a jury instruction that

> a defendant could be found guilty only if, according to generally accepted accounting principles, the financial statements as a whole did not fairly present the financial condition of [the firm] and then only if his departure from accepted standards was due to willful disregard . . . with knowledge of the falsity of the statements and an intent to deceive.[41]

Instead, the court instructed the jury that:

> the "critical test" was whether the financial statements as a whole "*fairly presented* the financial position and *accurately reported* the operations [of the firm]." If they did not, the basic issue became whether defendants acted in good faith. Proof of compliance with generally accepted standards was "evidence which may be very persuasive but not necessarily conclusive that [they] acted in good faith, and that the facts as certified were not materially false or misleading. . . ."[42]

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13 F.Supp. 289, 291 (N.D. Tex. 1936).

37 U.S. v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied* 397 U.S. 1006 (1970).

38 *Id.* at 800-01.

39 *Id.* .

40 *Id.* at 805.

41 *Id.* at 805.

42 *Id.* at 805-06 (emphasis added).

In other words, the jury's inquiry must start with *fair presentation* (for financial position or balance sheet) or *accuracy* (for operations or income statement),[43] including materiality, and then proceed to *culpability* against which GAAP compliance *may* be a persuasive defense.[44]The Second Circuit agreed that the jury was not

> required to accept the accountants' evaluation whether a given fact was material to overall fair presentation, at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment and their conclusion that nothing in the financial statements themselves negated the conclusion that an honest judgment had been made.[45]

The core *Simon* doctrine, that fair presentation or accuracy trumps GAAP compliance in proving securities fraud, has since spread to other circuits.[46]

C. Materiality

Materiality merits its own sidebar discussion. Materiality is an essential element of securities fraud because only material information is required to achieve fair presentation. Yet, despite materiality's legal importance, neither statute nor regulation defines it. Attempting to fill this gap, in *Basic, Inc. v. Levinson*,[47] the U.S. Supreme Court held that "materiality depends on the significance the reasonable investor would place on the withheld or

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[43] Why the court distinguished fair presentation from accuracy is unclear.

[44] Scienter is the "mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). Recklessness may also constitute scienter. *See* Dain Rauscher, Inc., 254 F.3d at 856. *But see* Mattrix v. Sircusano, 131 S. Ct. 1309, 1323 (2011) (citing Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3) (2007) (noting that the Supreme Court has not yet decided whether recklessness amounts to scienter)). Criminal conviction requires scienter; civil liability generally requires only negligence.

[45] *Simon*, 425 F.2d at 806.

[46] *See, e.g.*, SEC v. Todd, 642 F.3d 1207, 1217 (9th Cir. 2011); In re K-tel Int'l Inc. Sec. Litig., 300 F.3d 881, 906 (8th Cir. 2002); U.S. v. Sarno, 73 F.3d 1470, 1482 n.6 (9th Cir. 1995); McLean v. Alexander, 420 F. Supp. 1057, 1085 (D. Del. 1976), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979).

[47] Basic, Inc. v. Levinson, 485 U.S. 224, 224 (1988).

misrepresented information."[48] Furthermore, the Court held that an omitted fact is material if there is a "substantial likelihood" that its disclosure "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available" with respect to the security in question,[49] and that "[a]ny approach that designates a single fact or occurrence as always determinative of materiality, must necessarily be over inclusive or under inclusive."[50]

In 2011, the Court reaffirmed *Basic*'s total mix test and clarified that material causality may be inferred from other evidence with or without "statistical significance."[51] Along similar lines, SEC staff have opined that information may be material quantitatively, qualitatively, or both.[52]

The quantitative materiality of forward-looking or contingent information should be assessed using an expected value framework balancing the probability of the event and its anticipated magnitude in relation to the activity of the company as a whole.[53] Materiality should not "attribute to investors a child-like

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[48] *Id.* at 240.

[49] *Id.* at 231-32 (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

[50] *Basic Inc.*, 485 U.S. at 236 n.14 (citing H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., REP. OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 327 (Comm. Print 1977) (noting that "absolute certainty in the application of the materiality concept . . . is illusory and unrealistic")). *Compare* Council Directive 2013/34/EU, art. 2, 2013 O.J. (L 182) 19, 28 (defining "material" as "the status of information where its omission or misstatement could reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking").

[51] Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1318-23 (2011) (applying the *Basic* "total mix" test in holding that pharmaceutical adverse event reports showing no statistically significant increased risk of harm from Zinc-based nasal spray were nevertheless material under Section 10(b) and Rule 10b-5, which create an affirmative duty to disclose only that material information necessary to avoid misleading).

[52] SAB No. 99, *available at* http://www.sec.gov/interps/account/sab99.htm. Quantitative misstatements of less than 5%-of-basis are often viewed as material.[52] *Id.* (citing as potentially significant qualitative factors whether the misstatement (a) masks a change in earnings or other trends; (b) affects the registrant's compliance with regulatory requirements; (c) affects the registrant's compliance with loan covenants or other contractual requirements; or (d) involves concealment of an unlawful transaction).

[53] *Basic, Inc.*, 485 U.S. at 238 (quoting SEC v. Tex. Gulf Sulphur Co., 401 F. 2d 833, 849 (2d Cir. 1968)). Expected value is the "the mean of a probability distribution" obtained by weighting each possible outcome by its probability, where the sum of the probabilities of individual outcomes equals one. *See* JOHN K. KRUSCHKE, DOING BAYESIAN DATA ANALYSIS 37 (2011).

simplicity [or] an inability to grasp the probabilistic significance of negotiations" but should "filter out . . . information that a reasonable investor would not consider significant."[54] Thus, the scope of legally material information has been held to exclude puffery and general expressions of optimism.[55]However, intentionally misleading press releases have been found sufficiently material to violate Exchange Act Section 10(b) and Rule 10b-5.[56]

D. U.S. v. Skilling & Lay

The collapse of Enron Corporation launched scores of civil and criminal actions;[57] a comprehensive survey of which would fill a shelf of law review articles.[58] Two earn mention here: the widely publicized criminal jury trial of Jeffrey Skilling and Ken Lay and the plea bargain and sentencing hearing of Richard Causey.[59] Media and government blamed Enron's demise on fraudulent accounting. [60] Similarly, the government's indictment of Causey, Skilling, and Lay

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[54] *Basic, Inc.*, 485 U.S. at 234 (quoting *TSC Industries*, 426 U.S. at 448-49).

[55] *See, e.g.*, In re Ford Motor Co. Sec. Litig., 381 F.3d 563, 570 (6th Cir. 2004); Rosenzweig v. Azurix Corp., 332 F.3d 854, 865 (5th Cir. 2003);; Searls v. Glasser, 64 F.3d 1061, 1066 (7th Cir. 1995); In re Sec. Litig. BMC Software, Inc., 183 F.Supp.2d 860, 888 (S.D. Tex. 2001).

[56] *See, e.g.*, SEC v. Platforms Wireless Int'l Corp., 617 F.3d 1072, 1081-82 (9th Cir. 2010) (aff'g Rule 10b-5-based summary judgment against a defendant that issued a press release describing technical details and performance characteristics of a wireless communications system while actually possessing only a description of the system but no prototype or money to build one); Ponder Indus., Inc., 65 S.E.C. Docket 45, 1997 WL 409773 (July 22, 1997). ((where respondent believed his company would receive revenue but knew receipt was subject to contingencies, the SEC found that he had violated Section 10(b) and Rule 10b-5 in part by omitting mention of the contingencies).

[57] *See* Tom Fowler, *Ex-Enron CEO Skilling's Sentence Cut to 14 Years*, WALL ST. J., Jun. 21, 2013, http://online.wsj.com/article/SB10001424127887323393804578559603861442848.html (citing criminal charges against "nearly three dozen executives and employees of Enron" and its business partners).

[58] On September 16, 2013, the Lexis-Nexis law review database returned 276 articles containing "Enron" in the title.

[59] Causey was Enron's Chief Accounting Officer; Skilling and Lay had each been CEO. Skilling's case concluded in June 2013 with his resentencing downward to 14 years from 24. *See* Fowler, *supra* note 60.

[60] *See, e.g.*, Alex Berenson, *Enron's Collapse: The Accountants; Watching the Firms That Watch the Books*, N.Y. TIMES, Dec. 5, 2001, at C1 (asserting that "the sudden failure of Enron . . . has generated a new wave of criticism that corporate accounting is out of control"); *Enron: The Real Scandal*, THE ECONOMIST, Jan. 17, 2002, *available at* http://www.economist.com/node/940091 (asserting that

repeatedly accused them of "manipulating" or "circumventing" accounting standards[61] in Forms 10-K and 10-Q and related management representation letters sent to auditors.[62]

Yet, despite the pretrial accounting hype, at trial the government began and ended its opening argument denying any accounting connection: "This is a simple case. It is not about accounting. It is about lies and choices."[63] This opening could hardly be more misleading.[64] It was definitely not a simple case and was mostly about accounting; the government itself used the root word

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Enron's collapse signals systemic defects in U.S. accounting standards); Mary Flood, *Enron's Former Top Accountant Arrested*, HOUSTON CHRON., Jan. 22, 2004, http://www.chron.com/business/enron/article/Enron-s-former-top-accountant-arrested-1556608.php (quoting an ETF prosecutor as saying that Enron was "propped up by accounting schemes"). *But see* Tom Fowler, *Some Say Enron Deserves a Brighter Legacy*, HOUSTON CHRON. (Dec. 3, 2011), http://www.chron.com/news/article/Some-say-Enron-deserves-brighter-legacy-2341651.php (quoting observers who argue that Enron's conduct was not as bad as portrayed). Enron's accounting has also been controversial in academic and professional circles. *Cf.* C. Richard Baker & Rick Hayes, *The Enron Fallout: Was Enron an Accounting Failure?*, 31 MANAGERIAL FIN. 5, 9-23 (2005) (discussing various Enron accounting techniques, characterizing some as permissible and others not under GAAP); Neville Grusd, *The Enron affair from a lender's view*, CPA J., Dec. 2002, at 8 (stating that Enron's "use of off-balance-sheet partnerships to hide losses . . . [was] permitted by current rules"); Anthony Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 69-77 (describing GAAP on SPEs as "questionable" and "haphazard" but characterizing Enron's application thereof as "clear error," "notorious" and "infamous").

[61] Superseding Indictment at 10-13, 16, 18-19, 24, 31, 33, 52, U.S. v. Skilling Cr. No. H-04-25 (S.D. Tex. Jul. 7, 2004) [hereinafter Skilling Indictment] . The version of events presented to the *Skilling* jury may have been misleading because of alleged material misstatements and omissions of ETF prosecutors. *See, e.g.*, UNGAGGED.net, Attorney Ethics Complaint (Jul. 24, 2012), *available at* http://ungagged.net/concealingevidence.php (alleging that ETF prosecutor Ruemmler withheld exculpatory SEC investigative interview notes contradicting the government's version of Enron's so-called Nigerian Barges Deal).

[62] Skilling Indictment at 46-47, 49-53.

[63] Skilling Transcript at 347, 394.

[64] *See* John C. Hueston, *Behind the Scenes of the Enron Trial: Creating the Decisive Moments*, 44 AM. CRIM. L. REV. 197, 197-98 (2007) (admitting that the ETF's case was centered on "allegations of earnings manipulation and disputes over . . . the application of often arcane accounting rules"); Skilling Transcript at 376 (in opening argument, Prosecutor Hueston telling the jury they would "hear a lot about Raptors" which were "very complicated financial structures" that "look like spider webs" through which "the accountants and the lawyers crawled" but which the jury could ignore because "It's a case about lies, folks. . . .").

"account" thirty times in opening[65] and seventy-nine times in closing.[66] Furthermore, while the government did not call its own accounting expert, it thoroughly cross-examined the two defense experts and used five current or former Enron or Andersen accountants as fact witnesses on accounting issues.[67]

Defense experts Jerry Arnold and Walter Rush both testified that Enron's accounting was GAAP compliant overall.[68] Both, however, also ran into trouble on issues of critical importance to the jury's verdict and on the relevance of accountants in securities fraud cases generally. Early in Rush's direct examination, the court undercut his testimony in responding to a prosecution objection, as follows:

> DEFENSE COUNSEL: And just as a general matter, a company such as Exxon [sic], with its size, can you give the jury a sense, when we're talking about what would be immaterial, what kinds of dollar amounts would we typically be talking about?
>
> PROSECUTOR: Objection on 403. I just want to make clear we're talking about accounting materiality?
>
> THE COURT: Yes. I've already explained to the jury, and . . . I'll reiterate later, in a week or two, the legal definition of "materiality". . . . It's different from accounting materiality that Mr. Rush is getting ready to explain.[69]

In other words, as to materiality—arguably one of two words (the other being *misleading*) upon which the entire case turned—the $600-per-hour defense

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[65] Skilling Transcript at 347-96 (repeating "accountant", "accountants", and "accounting" thirty times).

[66] Skilling Transcript at 17687-834.

[67] *Enron Trial: Profiles Of Prosecution Witnesses*, WALL ST. J., May 8, 2006, http://online.wsj.com/article/SB113898435336064528.html (summarizing testimony of Wesley Colwell, Wanda Curry, Sherron Watkins, John R. Sult and Thomas Bauer). Causey was technically available for either prosecution or defense, but neither side called him to testify. *Id.*

[68] Skilling Transcript at 16441-526, 16716-17823 (reporting the direct testimony of Arnold and Rush).

[69] *Id.* at 16736-37. According to the trial transcript, the court never returned to define "accounting materiality" or to cite authority on any discrepancy between it and legal materiality.

accounting expert[70] was about to speak a foreign language that the jury must disregard as a matter of law.

The court's evisceration of Arnold was perhaps more devastating. Under cross examination, when Arnold was asked whether Enron investors would want to know that Enron had a "one billion dollar accounting error on its books," the court interjected, "That's a question for the jury to decide. He [Arnold] testified as to accounting materiality, not to the issues that will go before this jury."[71] Given the apparent irrelevance of accounting materiality, whatever the court meant by it, it is unclear why the court allowed Arnold's testimony in the first place.[72]

In *Basic*, the Supreme Court held that materiality must be evaluated from the viewpoint of a reasonable investor, not of an accounting expert.[73] However, against Skilling, the government pushed far beyond *Basic*, calling as witnesses two "common investors" for the express purpose of providing a "human perspective," playing to the jury's emotions and marginalizing their objective consideration of materiality.[74] The defense called no one in rebuttal[75] and, as explained below, failed at trial and on appeal to defend *Basic*'s reasonable investor test.

On direct, Rush testified that Enron's accounting for reserves and operating segments were GAAP compliant and free of material misstatement.[76]

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[70] *Id.* at 16724 (estimating Rush's witness fees at $570,000). Arnold was paid $600,000. *Id.* at 16708-09.

[71] *Id.* at 16677.

[72] A few months before Enron's implosion, Robert Prentice prophetically declared, "Unless accountant experts can take relevant accounting expertise and meld it with 'accepted legal theories,' their testimony will be rejected by the courts and serve no purpose." Robert A. Prentice, *The Case for Educating Legally-Aware Accountants*, 30 AM. BUS. L.J. 597, 617-18 (2001).

[73] *See supra* notes 40-49 and accompanying text (discussing materiality-related holdings in *Basic* and other cases).

[74] *See* Hueston, *supra* note 57, at 208-09 (admitting that after failing to find a single stock analyst who had been deceived by Enron's filings or disclosures, the ETF resorted to "common investors" to provide a "human perspective" who, while offering "less compelling evidence of materiality," would "level the field in the battle for jury empathy"); *Enron Trial: Profiles Of Prosecution Witnesses*, *supra* note 70 (summarizing testimony of former Enron employees John Sides and Johnny Nelson who lost retirement funds invested in Enron stock).

[75] *See Enron Trial: Profiles Of Defense Witnesses*, WALL ST. J., May 16, 2006, http://online.wsj.com/article/SB114416411098516589.html.

[76] Skilling Transcript at 16724-16823.

Rush also implied that materiality is purely *quantitative*,[77] failing to mention that materiality may be established either *quantitatively* or *qualitatively*, according to both the AICPA[78] and SEC staff.[79] This task was left to prosecutor Sean Berkowitz who finagled Rush into the following clown-car colloquy:

> Q: And, sir, the question, I think, is a simple one. Maybe I'm wrong. If [Enron accountant] Mr. Colwell misled Arthur Andersen, you're saying that that would be okay under GAAP?
>
> A: No. I didn't say that. GAAP doesn't even -- this isn't even an issue under GAAP. GAAP doesn't talk about misleading. GAAP doesn't talk about integrity. GAAP talks about accounting rules, how you measure assets and liabilities, what kind of disclosures you make.[80]

Thus, after the court neutralized both defense experts on *materiality*, on *culpability*, one of the two effectively indicted the U.S. accounting profession as heedless of integrity and the allegedly misleading nature of Enron's financial statements.[81] No prosecutor could hope for more.

Two days later, on May 5, 2006, the defense proposed a *Simon*-based jury instruction that GAAP compliance is "highly persuasive, but not necessarily conclusive evidence that Enron's financial disclosures and defendants' public statements were not materially false or misleading and that defendants . . . acted in good faith."[82]

The government's case was based largely on revenue from so-called "secret oral side deals" allegedly struck by Skilling and Enron CFO Andy Fastow by which Enron allegedly guaranteed that Fastow's partnerships would lose no

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[77] *Id.* at 16735, 16736-37, 16758, 16759.

[78] *See* SAS No. 47 at ¶¶ 6-7 (1983), *available at* http://umiss.lib.olemiss.edu:82/record=b1038073.

[79] *See Staff Accounting Bulletin* (SAB) No. 99, *available at*, http://www.sec.gov/interps/account/sab99.htm .

[80] Skilling Transcript at 16848-49.

[81] Accountants in IFRS-adopting countries, including the European Union, should theoretically escape similar condemnation because of "not misleading" and "true and fair view" exceptions discussed in text accompanying notes 174-75 and 220-21.

[82] Jeffrey Skilling's Supplemental Proposed Jury Instructions at 3, U.S. v. Skilling, No. H-04-25, 2006 WL 1316581 (S.D. Tex. May 5, 2006) .

money on specific transactions.[83] The government claimed that the oral side deals rendered Enron's recognition of revenue from the transactions misleading.[84] Arguing that the side deals were legally invalid and unenforceable, the defense requested that the jury be instructed how to determine their legal validity and how, if at all, they should be recorded in Enron's financial books.[85]

The court rejected the defense's proposed GAAP and oral side deals instructions, substituting in their place the following:

> A violation of [accounting requirements] . . . should not be considered by you as a violation of the criminal law.
>
> Whether the defendants followed or deviated from [them] is one circumstance you are entitled to consider and weigh in determining whether the defendants had the required specific intent . . . .[86]
>
> . . . .
>
> . . . Reliance on the advice of an accountant or attorney may constitute good faith. To decide whether such reliance was in good faith, you may consider whether the defendant relied on a competent accountant or attorney concerning the material facts allegedly omitted or misrepresented. . . .[87]

These instructions did not reference GAAP and effectively barred the jury from relying on accounting or accountants for anything but scienter. On scienter, remarkably, the jury was free to decide that following "accounting requirements" could be evidence of criminal intent while violating them could not. In relation to *not misleading*, the court defined misleading *omissions* as failures to disclose "material information . . . necessary to make an allegedly false statement accurate or

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[83] U.S. v. Skilling, 554 F.3d 529, 538-41 (5th Cir. 2009), *aff'd in part, vacated in part, on other grounds*, 561 U.S. 358 (2010) (discussing alleged "secret side deals" in relation to Cuiaba, Nigerian Barge, Raptor, and "Global Galactic" transactions).

[84] *Id.* at 538-41.

[85] *See* Brief of Defendant-Appellant Jeffrey K. Skilling at 99, U.S. v. Skilling, 554 F.3d 529 (5th Cir. 2007) (No. 06-20885) [hereinafter Skilling Brief].

[86] Skilling Transcript at 17650-51.

[87] *Id.* at 17653.

complete" but offered no definition of misleading *statements* or fair presentation.[88] Finally, on materiality, the court rejected a detailed defense proposal[89] and departed from *Basic*[90] as follows:

> [F]or you to find a fact or omission material, the Government must prove . . . that the fact misstated or the fact omitted was of such importance that it could reasonably be expected to . . . induce a person to invest or . . . not to invest in Enron stock.
>
> Assessment of materiality requires you to view the facts misstated or the fact omitted in the context of all the circumstances, including the total mix of information made available.
>
> The securities fraud statute . . . does not cover minor or meaningless or unimportant misstatements or omissions.[91]

Under *Basic*, an omitted fact is material if there is a *substantial likelihood* that its disclosure *would have been* (not "could reasonably be expected to be") viewed by the *reasonable investor* (not merely "a person") as having *significantly altered* the "total mix" of information available (not merely "could reasonably induce investment").[92] Some allegations undergirding the government's case against Skilling, which the defense characterized as non-specific puffery, have been held immaterial as a matter of law in other cases.[93] Yet, the Skilling court failed to illuminate these nuances for the jury, who found Skilling guilty of securities fraud and making false statements to auditors and found Lay guilty on all counts.[94]

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[88] *Id.* at 17666:14-18 ("Government must prove . . . that each alleged omission of material fact was misleading because a Defendant failed to disclose material information that was necessary to make an allegedly false statement accurate or complete, and therefore, not misleading").

[89] *See* Skilling Brief at 99; *Skilling*, 554 F.3d 529, 552, 554-55 (5th Cir. 2007) (detailing the actual instruction and the portion of the proposed supplemental instruction enumerating forward-looking statements, facts already known to the market, and non-specific puffery as "inherently not material").

[90] Basic, Inc. v. Levinson, 485 U.S. 231-32 (1988).

[91] *Skilling* 554 F.3d at 552.

[92] *Basic, Inc.* 485 U.S. at 231-32.

[93] *See* Skilling Brief at 95-104 (alleging reversible error in the trial court's failure to properly instruct the jury on the legal immateriality of puffery).

[94] *Skilling*, 554 F.3d at 542. Lay died on July 5, 2006; therefore, his indictment was vacated and dismissed. U. S. v. Lay, 456 F. Supp. 2d 869, 870 (S.D. Tex. 2006).

On appeal, Skilling portrayed as reversible error the trial court's refusal to "instruct the jury on accepted principles of materiality" especially as to puffery [95] and the legal validity and accounting treatment of the alleged secret oral side deals,[96] but did not challenge the rejection of his proposed supplemental instruction on GAAP. In affirming Skilling's convictions, the Fifth Circuit found that the allegedly immaterial puffery was more than puffery and provided sufficient evidence for conviction,[97] that the trial court's materiality instructions were close enough,[98] and that Skilling had waived his objection to the lack of instruction on oral side deals by submitting the proposed instruction on May 10, 2006, long after the court-imposed March 31, 2006 submission deadline.[99]

Like most defendants in accounting-related cases, Lay and Skilling faced bad facts, complex and contradictory accounting standards, and inadequate law. But they also grappled with prosecutors intent on avoiding accounting standards. For example, at Causey's post-trial sentencing hearing, Causey argued that his sentence should be reduced because he had helped convict Lay and Skilling by collaborating with ETF prosecutors to withhold potentially exculpatory accounting evidence:

> Had we gone to trial, we would have fought the GAAP issue on the land, on the sea, in the air, I think we would still be in court, still trying the case. I think everybody, particularly the government, was advantaged by that . . . it seemed like I was on the receiving end of hundreds of calls from both sides as to whether or not Rick Causey was going to be a witness for the defense or [the government].

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[95] 554 F.3d at 551-55.

[96] *Id.* at 556; *see also* Skilling Brief at 111-12 (the proposed jury instruction stated, inter alia, "Written guarantees do affect the accounting treatment of sales transactions. *Oral guarantees, whether legally enforceable or not, can but do not always affect the accounting treatment of sales transactions. Letters of comfort and verbal assurances not amounting to a guarantee or agreement do not affect the accounting treatment of sales transactions.*").

[97] *Skilling*, 554 F.3d at 554 (finding that "the statements were not immaterial as a matter of law").

[98] *Id.* (finding that the court's actual instructions "captured most of the substance of Skilling's proposed supplement and adequately explained 'materiality' to the jury").

[99] *Id.* at 556. The proposed GAAP instruction was submitted on May 5, 2006 and would likely have suffered the same fate on appeal. The timing suggests that counsel may have initially been unaware of the accounting consequences of the alleged side deals. *Id.*

> . . . I believe the defense . . . would have liked evidence before the jury that in the main, the accounting at Enron was consistent with GAAP based upon what was known at the time by the chief accounting officer. They didn't call him . . . the net effect was that the cooperation relationship that he had with the government kept the accounting case out of the Lay/Skilling trial, which I think was of inestimable value to the government . . . .[100]

Prosecutor Ruemmler countered that "having a cooperating witness who is reluctant to acknowledge their own responsibility is not really of much use to the government at all."[101] Most significant to this discussion was Ruemmler's admission of her deliberate strategy to avoid presenting serious accounting evidence to Skilling's jury.

E. U.S. v. Ebbers

From late 2000 to early 2002, Bernard J. Ebbers, CEO of WorldCom, Inc.,[102] orchestrated a series of accounting manipulations to prop up WorldCom's stock price, trying to preserve collateral for his personal debts.[103] The manipulations, which added billions of dollars to WorldCom's publicly reported net income, included padding projected revenues from so-called "under-usage" penalties, recording as assets internet line leasing costs that WorldCom had customarily expensed, failing to deduct marketing commissions from revenues, and reversing cookie-jar reserves for income taxes.[104]

As WorldCom's financial hole deepened, Ebbers resigned and the SEC began investigating. In June 2002, the company publicly disclosed the worst of its accounting shenanigans[105] in response to which which Ebbers' was later

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[100] Causey Transcript, *supra* note 1, at 11-13.

[101] Causey Transcript, *supra* note 1, at 22:6-8. If the government wants truth, it should insist that witnesses who believe themselves blameless say so. *Id.*

[102] U.S. v. Ebbers, 458 F.3d 110, 112 (2d Cir. 2006), *cert. denied*, 549 U.S. 1274 (2007).

[103] *Id.* at 113-14.

[104] *Id.* at 114-16.

[105] *Id.* at 117.

criminally charged.[106] However, despite a wealth of factual detail evincing accounting irregularities, the indictment alleged no GAAP violation.[107]

At trial in 2005, a jury convicted Ebbers of securities fraud and willful false filings under 15 U.S.C. §§ 78j(b), 78m(a), and 78ff.[108] Ebbers appealed, arguing in part that the government should be required to prove that the disputed accounting violated GAAP because "where a fraud charge is based on improper accounting, the impropriety must involve a violation of GAAP, because financial statements that comply with GAAP necessarily meet SEC disclosure requirements."[109]

The Second Circuit disagreed, affirming Ebbers' convictions, citing Simon for the proposition that "even where improper accounting is alleged, the statute requires proof only of intentionally misleading statements that are material,"[110] defining "intentionally misleading statement" as one "designed to affect the price of a security,"[111] and holding that the government was not obligated "to prevail in a battle of expert witnesses" over technical GAAP compliance.[112] Construing the term "misleading," the court pointed to WorldCom's undisclosed changes in revenue and cost accounting policies which falsely led investors to infer that Worldcom's current reported revenues and costs had been calculated just as before.[113] In this sense, whether the financial statements were misleading was not a function of the accounting principles followed but of the failure to disclose period-to-period *changes* in those principles.

F. U.S. v. Rigas

Adelphia Communications Company (Adelphia) was founded by John Rigas in the early 1950s, went public in 1986, and had grown into one of largest

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106 *Id.* at 117, 125.

107 *Id.*

108 *Id.* at 117.

109 *Id.* at 125.

110 *Id.* (citing U.S. v. Simon, 425 F.2d 796, 805-06 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970)).

111 *Id.* Because "design" is manifestly a function of scienter and "material" is not a function of "design," the court most likely meant the word "designed" to interpret "intentionally," not "material". *Id.*

112 *Id.* at 126-27.

113 *Id.* at 126.

cable TV systems in the United States by 2001.[114] Between March 1998 and September 2001, Adelphia's publicly disclosed bank borrowings grew six-fold to $5.4 billion.[115] At the same time, on the advice of Adelphia's audit firm, Deloitte & Touche,[116] Adelphia's financial statements did not disclose an additional $2.3 billion owed, under a so-called "co-borrowing" arrangement, by other companies owned by the Rigas family for which Adelphia was contingently liable[117] but did not expect to pay.[118]

In August 2001, on the basis of only the publicly disclosed debt, Moody's Investors Service labeled Adelphia one of the country's most highly leveraged cable TV companies.[119] On March 27, 2002, in response to the unraveling of Enron and ensuing changes to SEC policies, Adelphia first disclosed the $2.3 billion in a press release announcing its 2001 annual financial results.[120] That day, Adelphia's stock closed down about 25 percent, at $20.39 per share, and was delisted in May 2002 at $1.16.[121]

At the inception of the ensuing investigation, John Rigas and sons, Timothy and Michael, were indicted for securities fraud and conspiracy to

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114 U.S. v. Rigas, 490 F.3d 208, 212 (2d Cir. 2007), *cert. denied*, 128 S. Ct. 1471 (2008).

115 *Id.*

116 *Id.* At trial, no evidence was adduced to suggest that John Rigas was involved in decisions about Adelphia's disclosure of the contingent liabilities and no witness testified to any misstatement on any subject by John Rigas. *See* Joint Brief for Defendants-Appellants at 102 [hereinafter Rigas Joint Brief], United States v. Rigas, 490 F.3d 208 (2d Cir. 2006) (No. 05-cr-3577), 2006 WL 1721265.

117 *Rigas*, 490 F.3d at 212 n.2. According to relevant FASB GAAP (then and now), contingent liabilities, like guarantees of others' indebtedness, must not be recorded ("recognized" or "accrued") as liabilities on the balance sheet unless, at the balance sheet date, they are probable to occur and the amount can be reasonably estimated. FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5 ¶ 8 [hereinafter SFAS No. 5] (2010). Footnote "disclosure" of unrecognized but "reasonably possible" contingencies is required, while disclosure of merely remote contingencies is optional, *Id.* at ¶ 10, except for guarantees of the indebtedness of others, which must be disclosed. *Id.* at ¶ 12.

118 *Rigas*, 490 F.3d at 212 n.2 (reproducing the footnote in the March 27, 2002 press release that disclosed the $2.3 billion contingent liability and stated that Adelphia "does not expect . . . to repay the amounts borrowed").

119 *Rigas*, 490 F.3d at 213.

120 *Id.* at 212 n.2.

121 *Id.* at 212.

commit securities fraud.[122] Paragraph 67 of the indictment alleged an apparent evidentiary cornerstone of the government's case: "Pursuant to GAAP, Adelphia was required . . . to disclose the full amount of its joint and several liabilities under the Co-Borrowing Facilities in the notes accompanying its financial statements."[123]

Despite the indictment's express invocation of GAAP, at trial, the government deliberately avoided it, offering no expert testimony or other evidence of actual GAAP requirements.[124] Instead, the prosecution sought to prove that Adelphia's failure to disclose the contingent liabilities prior to March 27, 2002 was materially misleading in the *Basic* sense: that these contingencies would be significant in the mind of a reasonable investor.[125] In essence, the government's case replaced whatever GAAP might say with *Simon's* mandate: Don't mind GAAP. Just don't mislead.

The defense offered no GAAP evidence, perhaps assuming it unnecessary because the prosecution proved no GAAP violation. This strategy deprived the jury of evidence, if any, of the defendants' good faith reliance on GAAP.[126] In July 2004, the jury found John and Timothy Rigas guilty of securities fraud and conspiracy.[127]

On appeal, the defendants argued that the government should have been required to introduce SFAS No. 5 into evidence and to call an accounting expert to explain it[128] because, unlike in *Simon*, the *Rigas* prosecutors alleged "accounting malfeasance" controlled by a specific accounting rule.[129] The Second Circuit upheld the convictions, citing *Simon* and *Ebbers* to the effect that violation of accounting standards was not an element of the charged securities fraud[130] and

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[122] Indictment at 29 [hereinafter Indictment], U.S. v. Rigas, 490 F.3d 208 (S.D.N.Y. 2002) (No. 02-cr-1236), 2002 WL 32153610.

[123] Indictment at 29.

[124] *See* Rigas Joint Brief at 49.

[125] Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

[126] *Rigas*, 490 F.3d at 220 (holding that while GAAP may be relevant to a defendant's good faith effort to comply with GAAP or reliance upon an accountant's advice thereon may negate scienter, nevertheless, the statte alone establishes the elements of fraud).

[127] *Id.* at 211.

[128] *Id.* at 219-20.

[129] *Id.* at 220.

[130] *Id.*

that, even if the defendants had complied with GAAP, a jury could find that they had intentionally misled investors.[131] *Rigas* thus reaffirmed and even expanded *Simon's* doctrine of GAAP irrelevance to include financial statement fraud governed by specific accounting standards.[132]

G. In Re Lehman Bros. Securities

Just as in criminal cases, courts have disregarded FASB GAAP in notable civil ones. *In re Lehman Bros. Securities & ERISA Litigation* illustrates both the judiciary's accounting expertise deficit and the folly of requiring mechanical, fairness-free adherence to prescriptive GAAP. The plaintiffs alleged that Lehman's financial statements were misleading in that they violated SFAS No. 140—which governed accounting for assets used as collateral in so-called "Repo 105" transactions—because, in the absence of a "true sale at law" opinion from a U.S. law firm, Lehman treated quarter-end Repo 105 transactions as sales rather than as borrowings thereby causing the "repetitive, temporary, and undisclosed reduction" of Lehman's "net leverage" indebtedness metric.[133] In the plaintiffs' view, a true-sale opinion from U.K. law firm Linklaters was insufficient to support sale treatment.[134] The court disagreed, finding no SFAS No. 140 violation but that a jury might find that the statements violated the Second Circuit's self-concocted FASB GAAP "requirement that the [financial] statements as a whole accurately reflect the financial status of the company."[135]

One of the most striking aspects of the *Lehman* case was Lehman's transoceanic manipulation of a bright-line, post-Enron, SOX-era accounting standard. SOX was supposed to prevent future Enrons. Yet, for Lehman, the bright lines of SFAS No. 140 and concomitant prohibitions against fair presentation overrides facilitated deception. The court responded by unilaterally rewriting GAAP in the image of *Simon* and the FASB quickly drew new bright

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131 *Id.* at 221.

132 The court also inexplicably quoted what it called the "relevant part" of SFAS No. 5, *Rigas*, 490 F.3d at 220 n.14, but omitted paragraph 8 thereof which explains how contingent liabilities should be recorded or disclosed depending on their likelihood. *Id.*

133 In re Lehman Bros. Sec. & ERISA Litig., 799 F. Supp. 2d 258, 276-79 (S.D.N.Y. 2011).

134 *Id.* at 278.

135 *In re Lehman Bros.*, 799 F. Supp. 2d at 279 n. 127 (misconstruing an AICPA private-company auditing standard as a 2008 accounting standard for public companies).

lines, amending SFAS 140 in a tacit admission that the old bright lines were misleading.[136]

In another 2011 opinion, *SEC v. Todd*, the Ninth Circuit reaffirmed its continuing adherence to *Simon* in reinstating a civil fraud verdict[137] against Gateway Incorporated's CFO for recklessly misrepresenting Gateway's year 2000 revenues. The trial court had overturned the verdict as a matter of law in part because the SEC's accounting expert, Professor Arnold (of *Skilling* fame), cited no GAAP proscribing the defendant's recognition of revenue in the circumstances.[138] The Ninth Circuit held that whether or not the disputed revenue technically complied with GAAP, the evidence supported the jury's conclusion that its recognition was materially misleading.[139] The SEC has similarly sidestepped GAAP in more than one hundred administrative cases since 1995.[140]

H. Case law synthesis

U.S. case law treats financial statements as an information portal through which preparers and auditors present selected factual assertions from which readers may choose in forming logical inferences about the company's past performance and future prospects. Reports filed under Section 13 must be true and correct,[141] must not be false or misleading,[142] and negligence is sufficient to

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136 *See* STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 166: ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS AN AMENDMENT OF FASB STATEMENT NO. 140 (Fin. Accounting Standards Bd. 2009); Justin Chircop, Paraskevi Vicky Kiosse & Ken Peasnell, *Should Repurchase Transactions be Accounted for as Sales or Loans?*, 26 ACCOUNTING HORIZONS 657, 663-66 (2012) (describing Lehman's Repo 105 accounting and responsive changes to FASB GAAP).

137 SEC v. Todd, 642 F.3d 1207 (9th Cir. 2011).

138 *Id.* at 1216.

139 *Id.* at 1217 (citing *U.S. v. Sarno*, 73 F.3d 1470, 1482 n.6 (9th Cir. 1995) ("Adherence to GAAP would obviously qualify as weighty exculpatory evidence; it does not, however, necessarily shield one from [ ] liability.") (citing *U.S. v. Weiner*, 578 F.2d 757, 785-86 (9th Cir. 1978); *Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994))).

140 *See, e.g.*, In Re Sony Corporation and Sumio Sano, SEC Release No. 34-40305 (Aug. 5, 1998), http://www.sec.gov/litigation/admin/3440305.txt (fining Sony $1 million for falsely reporting its Pictures and Music Entertainment subsidiaries as one entertainment segment in GAAP-compliant financial statements); In Re The Coca-Cola Company, Securities Act Rel. 8569 at 8-9 (Apr. 18, 2005), http://www.sec.gov/litigation/admin/33-8569.pdf (sanctioning Coca-Cola for failing to inform readers that its GAAP-compliant income statement masked unsustainable Japanese syrup sales). For further information on side stepping of the GAAP, *see* Spreadsheet of Admin. Cases, (on file with the Author) (2015).

141 U.S. v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991).

prove civil violation of Section 13(a).[143] When the mix of facts presented in and omitted from financial statements can reasonably be expected to lead investors toward materially false inferences, the statements have been found misleading and therefore in violation of securities statutes or regulations.[144]

GAAP compliance is not an element of civil or criminal claims or charges[145] and is not a guarantee that financial statements are not misleading.[146] Financial statements that have not been proven to violate GAAP have nevertheless been found materially misleading.[147] Yet, dicta suggest that proof of compliance with GAAP may be "very persuasive" evidence that audited financial statements are not materially misleading or, if they are misleading, that the preparers or auditors nevertheless published them in good faith.[148] The legal application of GAAP and auditing standards is hampered by the fact that Courts, prosecutors and defense counsel often misconstrue or avoid them, as illustrated by *Ebbers*, *Skilling*, *and Lehman*.[149] The fact and materiality of misleading statements

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[142] *See* SEC v. Falstaff Brewing Corp., 629 F.2d 62, 67 (D.C. Cir. 1980).

[143] *See* SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1167 (D.C. Cir. 1978).

[144] *See, e.g.*, U.S. v. Ebbers, 458 F.3d 110, 126 (2d Cir. 2006), *cert. denied*, 549 U.S. 1274 (2007) (pointing to failure to disclose changes in accounting policies as falsely leading investors to infer no such changes); U.S. v. Rigas, 490 F.3d 208, 221 (2d Cir. 2006) (upholding a jury verdict that failure to disclose contingent guarantee of a related party's debt was materially misleading); SEC v. Todd, 642 F.3d 1207, 1213, 1217 (9th Cir. 2011) (upholding a jury verdict that revenue recorded on lease-back transactions structured to have zero cash-flow impact was misleading); U.S. v. Simon, 425 F.2d 796, 800-01 (2d Cir. 1969), *cert. denied* 397 U.S. 1006 (1970) (holding that omission of information about collateral underlying a receivable could mislead investors to over-value the receivable).

[145] *See, e.g.*, *Rigas*, 490 F.3d at 220.

[146] *See, e.g.*, *id.* at 221.

[147] *See, e.g.*, *supra* Part I (discussing *Simon*, 425 F.2d 796; U.S. v. Skilling, 554 F.3d 529 (5th Cir. 2009), *aff'd in part, vacated in part, on other grounds*, 2010 U.S. LEXIS 5259 (2010); *Ebbers*, 458 F.3d 110; *Rigas*, 490 F.3d. 208; *Todd*, 642 F.3d at 1217; In Re Sony Corporation and Sumio Sano, SEC Release No. 34-40305 (Aug. 5, 1998), http://www.sec.gov/litigation/admin/3440305.txt; In Re The Coca-Cola Company, Securities Act Rel. 8569 at 8-9 (Apr. 18, 2005), http://www.sec.gov/litigation/admin/33-8569.pdf).

[148] *See Simon*, 425 F.2d at 805.

[149] *See Ebbers*, 458 F.3d at 126. Similarly, a recent study found that federal judges complied in less than 14 percent of studied cases with a statutory requirement to certify that attorneys comply with Rule 11(b) of the Federal Rules of Civil Procedure in all securities cases. M. Todd Henderson & William H. J. Hubbard, *Do Judges Follow the Law? An Empirical Test of Congressional Control Over*

and omissions are treated as questions of fact amenable to expert testimony under FRE 702. While Supreme Court precedent constrains materiality to information *objectively* significant to a reasonable investor,[150] some lower courts have *subjectively* redefined it as significant to *an* investor.[151]

II. FAIR PRESENTATION CHRONICLE AND STANDARDS

A. Debating Fair Presentation

1. Fair Presentation Chronicle

The debate over the role and meaning of financial statement fair presentation, key historical inflection points of which are highlighted here,[152] has been ongoing since at least January 1933, when NYSE President Richard Whitney asked listed companies to obtain outside audit opinions on whether their 1932 balance sheets and income statements *fairly presented* their financial position and results; whether the accounts were *fairly determined* through "consistent application of the system of accounting regularly employed by the company"; and whether the company's "system" conformed to "accepted accounting practices" and five broad principles which, endorsed by the American Institute of Accountants

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Judicial Behavior (2 U. of Chi. Coase-Sandor Inst. for Law & Econ. Res. Paper No. 671, 2014), *available at* SSRN: http://ssrn.com/abstract=2377351.

[150] *See* Halliburton Co. v. Erica P. John Fund, Inc., No. 13–317, 2014 U.S. Lexis 4305, at ***42 (Jun. 23, 2014) (citing Amgen v. Conn. Ret. & Trust Funds, 2013 U.S. Lexis 1862, at ***22 (2013)) (holding that materiality is an objective question in securities cases); Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1318, 1323 (2011) (citing Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) (defining materiality through the eyes of a reasonable investor)).

[151] *See, e.g.*, *supra* text accompanying notes 62-72, 82-92 (discussing materiality as applied in U.S. v. Skilling, 554 F.3d 529 (5th Cir. 2009)).

[152] Details are chronicled elsewhere. *See, e.g*, Zeff 2007, *supra* note 8; Stephen A. Zeff, *Arthur Andersen & Co. and the two-part opinion in the auditor's report: 1946-1962*, 8 CONTEMPORARY ACCT. RESEARCH 448 (1992) [hereinafter Zeff 1992]; Zeff 1971, *supra* note 8.

(AIA),[153] had "won fairly general acceptance" and thus deserved universal application.[154]

In May 1933, Congress very quickly passed the Securities Act of 1933 (Securities Act)[155] ostensibly to "provide full and fair disclosure of the character of [covered] securities."[156] Commenting on the paucity of congressional debate over the Securities Act, one observer wrote, "There was virtually no dissent . . . [House Speaker Sam] Rayburn remarked he did not know whether the bill passed so readily because it was damned good or so damn incomprehensible."[157] Hindsight suggests the latter.

Section 19 authorized the FTC to prescribe related accounting methods.[158] FTC regulations required registration statements to include a balance sheet and income statements distinguishing between recurring and non-recurring income.[159] Statements were to be certified by an "independent public or certified accountant"[160] to the effect that the statements therein were *true* and *not*

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153 Letter from Richard Whitney, President, NYSE, Jan. 31, 1933, *in* AUDITS OF CORPORATE ACCOUNTS, CORRESPONDENCE BETWEEN THE SPECIAL COMMITTEE ON CO-OPERATION WITH STOCK EXCHANGES OF THE AIA AND THE COMMITTEE ON STOCK LIST OF THE NEW YORK STOCK EXCHANGE 13 (emphasis added), *available at* http://www.sechistorical.org/collection/papers/1930/1934_0121_AuditsCorporateT.pdf. [hereinafter CORRESPONDENCE].

154 Letter from AIA Special Committee to NYSE Committee on Stock List, Sep. 22, 1932, *in* CORRESPONDENCE at 7-9.

155 Securities Act of 1933, H.R. 5480, 73d Cong. (1933), *available at* http://www.sechistorical.org/collection/papers/1930/1933_05_27_Securities_Act.pdf. [hereinafter "Securities Act"].

156 Securities Act, *supra* note 148, at preamble.

157 Letter from Benjamin V. Cohen to James Landis, May 5, 1933, *available at Papers*, SECURITIES AND EXCHANGE COMMISSION HISTORICAL SOCIETY, http://www.sechistorical.org/collection/papers/1930/1933_05_05_Cohen_to_Landis_t.pdf.

158 Securities Act § 19(a) (1933). The power to set or "recognize" accounting standards in registration statements now resides with the SEC. Securities Act § 19(a) (2012), http://www.sec.gov/about/laws/sa33.pdf.

159 Securities Act, *supra* note 148, at § 7 and Schedule A, ¶¶ 25-26.

160 *Id.*

misleading.[161] In January 1934, J.M.B. Hoxsey, Executive Assistant to the NYSE Committee on Stock List, wrote as to a proposed audit opinion template, "[T]he Exchange . . . is not concerned with minor questions of form or with petty details, but with the substantial accuracy and fairness of accounts."[162]

The Exchange Act of 1934 (Exchange Act) followed.[163] Arguing against proposed Section 18(b), which would empower the SEC to dictate accounting standards,[164] George May wrote: "*There is no dispensing with judgment in the preparation of accounts* . . . In so far as principles of accounting are necessary . . . corporations should be allowed to exercise judgment provided that they recognize certain fundamental principles . . . definitely laid down and consistently followed."[165] The AIA added that "[u]niform financial statements simply will not solve the problem. They might look alike, but . . . would not mean the same things. Investors would be deceived, rather than protected, by such requirements."[166]

Nevertheless, accountants busily set about standardizing accounting principles and audit reports while conflating compliance and fair presentation. In 1942, the SEC warned accountants that GAAP should not "blind us to the basic question, whether the financial statements performed the function of enlightenment, which is their only reason for existence."[167] One audit firm,

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[161] FTC, Rules and Regulations Under the Securities Act of 1933, Art. 14-16 (Jul. 6, 1933) (emphasis added), *available at* http://www.sechistorical.org/collection/papers/1930/1933_0706_FTC_RulesRegs.pdf.

[162] Letter from J.M.B. Hoxsey to Edwin F. Chinlund, Chairman, Controllers Institute of America, Jan. 18, 1934, *in* CORRESPONDENCE at 30.

[163] Securities Exchange Act of 1934 ("Exchange Act") § 4, H.R. 9323, 73d Cong. (1934), *available at* http://www.sechistorical.org/collection/papers/1930/1934_06_06_Securities_Exchan.pdf.

[164] The accounting profession inexplicably did not object on the record to the grant of similar power to the FTC by Securities Act § 19.

[165] Memorandum from George O. May to the U.S. Senate Committee on Banking and Currency 4-5 (Mar. 10, 1934) (on file with author). May also argued that "broadly speaking, *the shorter the* [reporting] *period the greater relatively becomes the possible margin of error* . . . ." *Id.* at 5-7.

[166] Press Release, AIA (Mar. 11, 1934), *available at* http://www.sechistorical.org/collection/papers/1930/1934_0311_ImpositionUniformT.pdf.

[167] *In re* Assoc. Gas & Elec. Co., 11 SEC 1058, August 4, 1942 *quoted in* Address by John C. Burton, "Fair Presentation: Another View," Baruch College of the City University of New York at n.9 and accompanying text (Feb. 18, 1975), *available at* http://www.baruch.cuny.edu/library/alumni/online_exhibits/digital/saxe/saxe_1974/burton_75.htm. *See also* Samuel H. Gruenbaum and Marc I. Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Commmon Law*, 13 LOY. L.A. L. REV. 247, 263 (1980) ("Enlightenment

Arthur Andersen, took this warning to heart. By 1946, all Andersen audit certificates opined separately on fair presentation and conformity with GAAP.[168]

In 1957, Andersen partners formally voted for separate fair presentation opinions,[169] thereby triggering the 1950s equivalent of a blog war. AICPA Director of Research Carman G. Blough struck first. Referring scandalously to "a firm" (Andersen) who believed financial statements could conform with GAAP yet not present fairly,[170] he decried this "most unfortunate" heresy and warned inscrutably that henceforth no one could challenge an auditor's "fairness or his integrity, only his judgment."[171] Andersen partner Maurice E. Peloubet countered that equating "present fairly" with GAAP conformity was an abdication of professional responsibility.[172] Yet, by late 1962, Andersen had capitulated,[173] primarily to win the audit of Houston-based Superior Oil Co.[174] Forty years later, a similar capitulation to another Houston oil client would destroy the firm.

Andersen's retreat did not end the controversy, as the problem returned with vigor in the 1970s. In November 1972, the AICPA published Statement on Auditing Standards (SAS) No. 1 declaring that fairly presented financial statements must conform to GAAP *and* be materially not misleading.[175] In July 1973, the FASB was formed and authorized by the AICPA to promulgate

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means more than mathematical or literal accuracy. Taken as a whole, financial statements must fairly present the financial status of a company.").

168 Zeff 1992, *supra* note 145, at 449.

169 *Id.* at 453-55.

170 Carman G. Blough, *Implications of "present fairly" in the auditor's report*, J. ACCT., Mar. 1958 at 76.

171 *Id.*

172 Maurice E. Peloubet & Carman G. Blough, *More about "present fairly" in the auditor's report*, J. ACCT., May 1958 at 73-74.

173 Zeff 1992, *supra* note 145, at 462.

174 Superior Oil "expensed" drilling costs, whereas Andersen favored "capitalizing" or recording them as assets. *Id.* at 464.

175 STATEMENT ON AUDITING STANDARDS (1975) [hereinafter SAS] NO. 1, § 511.01. The "not misleading" phrase suggests that SAS No. 1 may have been partly a reaction to the Second Circuit's decision in United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970). *See* Zeff 2007, *supra* note 8, at 5 (stating that in 1972 the AICPA's Committee on Auditing Procedure, "probably influenced" by *Simon*, recommended deletion of "fairly" from the audit report).

accounting principles.[176] In December, the SEC issued a non-rule policy, Accounting Series Release (ASR) No. 150, announcing—without notice or comment—that the SEC would henceforth treat FASB-promulgated GAAP as authoritative and other GAAP as not so.[177] A mere eighteen months later, SEC Chief Accountant John C. Burton opined that "[F]airness means more than following a set of specific rules, standards, and guidelines. Accounting cannot be viewed as a mechanistic process and remain either professional or communicative" and that fair presentation "cannot be defined by simple references to [GAAP] . . . . [T]he objectives of financial statements . . . have an important bearing on the meaning of 'present fairly.'"[178]

In 1975, the AICPA characterized GAAP as "relatively objective" because "auditors usually agree on their existence" but allowed that identification of GAAP "requires judgment."[179] In 1976, Arthur Andersen petitioned the SEC to revoke ASR No. 150 and then sued unsuccessfully to enjoin its enforcement.[180]

Roughly twenty-five years later, with FASB GAAP bright lines running in all directions, cascading revelations of edgy accounting, sketchy corporate governance, and foolish business decisions drove Enron's stock price below $1 per share on November 28, 2001.[181] The Enron collapse, along with similar catastrophes at Worldcom and Adelphia, prompted Congress to pass the Sarbanes-Oxley Act (SOX)[182] on July 25, 2002.[183]

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176 *See* Ronald E. Large, Note, *SEC Accounting Series Release No. 150: A Critical Analysis*, 54 IND. L.J. 317 at n.3, *available at* http://www.repository.law.indiana.edu/ilj/vol54/iss2/7.

177 SEC Accounting Series Release No. 150 2 (Dec. 20, 1973), *available at* http://www.sechistorical.org/collection/papers/1970/1973_1220_SECAccounting.pdf (quoting SEC Accounting Series Release No. 4 (1938) to the effect that "accounting practices for which there [is] no substantial authoritative support [are] presumed to be misleading").

178 Burton, *supra* note 160.

179 SAS No. 5, ¶ 5 (1975) ("[T]here may be unusual circumstances in which the selection and application of specific accounting principles from among alternative principles may make the financial statements taken as a whole misleading."). SAS No. 5 ¶ 9.

180 *See* Large, *supra* note 169, at 317-19.

181 *See generally* BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM (2003).

182 107 CONG. REC. E1412 (Jul. 29, 2002) (speech of Rep. DeGette) (citing Enron, Worldcom, and Adelphia cases as the motivating force behind passage of H.R. 3763).

183 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat 745 (codified in portions of 11, 15, 18, 28, and 29 U.S.C.) [hereinafter SOX], *available at* http://www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf. The enrolled H.R. 3763 was signed in the House of

The primary contributions of SOX to the fair presentation debate were more bright lines. Section 101 formed and misnamed the PCAOB;[184] Section 108 ordered the SEC to designate a setter of GAAP; and Sections 302, 304 and 906, further discussed in Part III, introduced civil and criminal financial statement certification regimes for CEOs and CFOs but not for auditors.

In April 2003, with no notice or comment, the SEC published FR-70 reaffirming the FASB as "a designated private-sector" setter of GAAP and declaring FASB standards "generally accepted" for purposes of SOX Section 108.[185]

In 2005, the FASB moved to supplant GAAP with FASB GAAP, proposing to end the AICPA's GAAP custodianship[186] and asserting that since "[T]he selection of [FASB GAAP] results in relevant and reliable financial information," no enterprise may claim that its non-FASB-GAAP financial statements are GAAP compliant.[187]

The FASB's claim to a GAAP and fair presentation monopoly provoked an international firestorm. The Federation of European Accounting Experts (FEE) wrote:

> The proposed [FASB] statement does not address the relation between "hierarchy" and the "fair presentation" whereas [the] "fair presentation" principle can be seen as the overarching

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Representatives on July 25, 2002. 107 CONG. REC. H5787 (daily ed. Jul. 25, 2002) (report of Mr. Trandahl, Clerk of the House).

184 Because the PCAOB has authority over public company *auditing* standards, not *accounting* standards, the "A" in PCAOB should logically represent "auditing." The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, executed July 21, 2010, added nothing to the fair presentation debate, *available at* https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf.

185 FR-70, *supra* note 15. FR-70 is explicitly not an agency rule and has not been published in the Federal Register or Code of Federal Regulations. *Id. See also* Wanda A. Wallace, *Commentary: With or without due process?*, ACCT. TODAY, Nov. 26, 2007, n.p., *available at* http://www.accountingtoday.com/ato_issues/2007_21/25983-1.html (objecting to the SEC's apparent violations of due process in issuing FR-70 and multiple SABs because of their deleterious impact on the quality of resulting financial information).

186 The Hierarchy of Generally Accepted Accounting Principles ¶ A10 (FASB 2005), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175821377716&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

187 *Id.*

> principle. Given the legal requirements for preparers and auditors to certify . . . whether the financial statements fairly present . . . we believe that the FASB should . . . provide requirements and guidance for the use of the term "fair presentation" in conjunction with US GAAP.[188]

David M. Walker, Comptroller General of the United States, agreed:

> . . . [W]e strongly believe that [GAAP] should . . . include a requirement for the enterprise to consider fair presentation . . . and provide guidance for making judgments about it. If literal compliance with the individual accounting and financial reporting standards would lead to misleading financial statements . . . the enterprise should depart from [them] . . . to achieve fair presentation.[189]

The New York State Society of CPAs and its German equivalent lodged similar objections.[190] No matter, the FASB and PCAOB forged ahead, effectively sidelining professional judgment in public companies' choice of accounting principles.[191]

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[188] Letter from F**é**d**é**ration des Experts Comptables Europ**é**ens to FASB (Jul. 14, 2005), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175817846735&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs (noting that the FASB's move "leaves the impression that the application of US GAAP is a mechanical exercise").

[189] Letter from David M. Walker, Comptroller General of the United States, to FASB 1 (Jun. 27, 2005), http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175817846897&blobheader=application%2Fpdf.

[190] Letter from NYSSCPA to FASB 5 (Jun. 23, 2005), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175817847702&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs (asserting that "fair presentation" should extend to "circumstances in which . . . GAAP renders the financial statements misleading"); Letter from Institut der Wirtschaftsprüfer to FASB 3-6 (Jun. 21, 2005), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175817847419&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=722818&blobheadervalue1=filename%3D33162.pdf&blobcol=urldata&blobtable=MungoBlobs (arguing that the FASB proposal disregards legal realities and international consensus that strict GAAP adherence can violate fair presentation).

[191] STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 162: THE HIERARCHY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ¶¶ 3-5 (Fin. Accounting Standards Bd. 2008), *available at* http://www.fasb.org/pdf/fas162.pdf (divesting the AICPA of authority over GAAP

2. Critiques of FASB-GAAP

Criticism of FASB GAAP has been widespread and sustained. A 1996 article argued that conformity with FASB GAAP "is almost a guarantee" that the financial statements are not fairly presented.[192] Others have labeled FASB GAAP and the FASB's effort to curtail use of AICPA Rule 203 politically motivated.[193] The critiques extend to even the most recent standards. For example, one public company CFO warned that an incoming FASB revenue standard will weaken the cash-flow predictive properties of revenue, increase fraud risk, and require "non-GAAP measures . . . [to] assess the economic performance" of the company.[194] One legal commentator argued that "both GAAP and GAAS have serious flaws . . ." and "have facilitated and even encouraged the recent accounting scandals."[195] Another warned lawyers to stay out of negotiations between clients

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hierarchy and prescribing sources of GAAP). *See also generally* STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 168 (Fin. Accounting Standards Bd. 2009) (categorizing the FASB CODIFICATION contents as "authoritative" GAAP and everything else as "non-authoritative"). [hereinafter SFAS No. 168].

[192] Ronald M. Mano, Mark Anderson, Vicki Nycum & Kevin McBeth, *Fairly Presented, in Accordance With GAAP: What Does It Really Mean?*, MGMT. ACCT., Jul. 1996, at 44, 44.

[193] *See* Paul B.W. Miller & Paul R. Bahnson, *Dumping Rule 203 exceptions: FASB's troubling move*, ACCT. TODAY, Jul. 11-24, 2005, at 12-13; Paul B.W. Miller & Paul R. Bahnson, *Rule 203 exceptions could prevent future Enrons*, ACCT. TODAY, Jul. 25-Aug. 7, 2005, at 14, 16-17; Paul B.W. Miller & Paul R. Bahnson, *PEAP: Proof that FASB has faulty premise on 203*, ACCT. TODAY, Aug. 8-21, 2005, at 14, 16-17; Paul B.W. Miller & Paul R. Bahnson, *WYWAP: When GAAP meets Alice's restaurant*, ACCT. TODAY, Aug. 22-Sep. 4, 2005, at 12, 15 & 20; Paul B.W. Miller & Paul R. Bahnson, *POOP: Not what the world needs, but what it gets*, ACCT. TODAY, Sep. 5-25, 2005, at 14, & 22; Paul B.W. Miller & Paul R. Bahnson, *Newsflash: Is FASB ready to close its doors?*, ACCT. TODAY, Sep. 26-Oct. 9, 2005, at 14, 16-17. *See also* EUGENE E. COMISKEY, CHARLES W. MULFORD & JOSHUA A. THOMASON, THE POTENTIAL CONSEQUENCES OF THE ELIMINATION OF LIFO AS A PART OF IFRS CONVERGENCE 6-7 (Georgia Tech Financial Analysis Lab 2008), *available at* https://smartech.gatech.edu/handle/1853/26316 (illustrating distortions of tax-motivated LIFO accounting with examples like Tesoro Corp., whose LIFO-induced inventory understatement equaled 45 percent of 2007 shareholders' equity).

[194] Letter from Doug French, VP Corporate Accounting & Financial Reporting, TELUS Corporation, Inc. to IASB 4 (Mar. 13, 2012) (Letter No. 283), *available at* http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=2011-230&page_number=3.

[195] Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1108 (2007).

and auditors over FASB GAAP numbers because of their complexity and subjectivity.[196]

Whether or not GAAP financial statements *are* by definition misleading, recent research suggests that GAAP is often *used* to mislead. A 2013 survey found that roughly 20 percent of firms "use discretion within GAAP" to misrepresent earnings by approximately 10 percent,[197] with 60 percent of the manipulation increasing and 40 percent decreasing earnings.[198] The study cited acquisition accounting, consolidation, and revenue recognition as frequent manipulation contexts[199] and quoted one CFO who had "watched numerous managements earn big incentives" by booking larger-than-necessary acquisition-related reserves later used to juice earnings in subsequent periods.[200] The same survey found most CFOs believe earnings quality would improve if regulators would issue fewer rules[201] and allow "reporting choices" to "evolve from practice."[202] On the other hand, several cited fears of litigation to justify the current regime, while another—

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196 William O. Fisher, *Lawyers Keep Out: Why Attorneys Should Not Participate in Negotiating Critical Financial Numbers Reported by Public Company Clients*, 2010 BYU L. REV. 1501 (2010).

197 Dichev et al., *supra* note 2, at 3-4, 35-36. The survey asked, "From your impressions of companies in general, in any given year, what percentage of companies use discretion within GAAP to report earnings which misrepresent the economic performance of the business?__%.[sic]" *Id.* at 35, 68. *See also* CENTER FOR AUDIT QUALITY, MAIN STREET INVESTOR SURVEY DATA, Q10 at 6 (2012) (reporting that from 2007 to 2012 the percentage of investors who claim "quite a bit" or "a great deal" of confidence in audited financial information fell from 38 to 28, while the share of those claiming "very little" or no confidence grew from 16 to 25).

198 Dichev et al., *supra* note 2, at 44.

199 *Id.* at 44-45.

200 *Id.* at 44 ("[They [the reserves] are set up at the time of the acquisition . . . but they're an estimate at that point in time. When the future happens then you take charges against that . . . it's going to be (imprecise) but whenever I have seen this it was always less than what got set up, so it got released into favorable earnings . . . [and] did impact the earnings and sometimes for . . . two-three years because they were big acquisitions.")

201 *Id.* at 29.

202 *Id.* at 29-31 ("Almost every interviewed CFO regretted the decline of the earlier bottom-up system of developing GAAP . . . ," including one who said, "The rules are so prescriptive that they override and supersede your judgment, and you end up with things that don't really reflect the economic substance of the transaction, but you have to account for it in the way that's described by the rules."). *See also* S.P. Kothari, Karthik Ramanna, Douglas J. Skinner, *Implications for GAAP from an analysis of positive research in accounting*, 50 J. ACCT. & ECON. 246, 272 (2010) ("If capture theory [of accounting standards regulation] is correct, the policy implication is to stop producing *de jure* GAAP and return to a *de facto* GAAP that arises from accounting practices with long-run survival value.").

apparently unaware of Jeff Skilling's and John Rigas' ill-advised reliance on compliance—observed, "We live in a litigious society so people would prefer to have prescriptive guidance, so they can *say* they followed the rules."[203]

A trio of recent studies concluded that for predicting future operating cash flows, current FASB GAAP earnings are inferior to current operating cash flows,[204] implying that thousands of pages of FASB rules dedicated to measuring "earnings" provide no incremental information value.

Another study noted that increasingly detailed SEC, FASB and PCAOB rules have reduced neither the number nor severity of accounting scandals. The study opined that standards-setting is now a "pseudoscience" governed by ideology and politics,[205] and it recommended that accounting methods should be developed, in part, through decentralized field testing of innovations in different countries rather than imposed by regulatory fiat.[206]Another author decried

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[203] Dichev et al., *supra* note 2 at 31 (emphasis added). *See also* Glen L. Gray, Jerry L. Turner, Paul J. Coram, & Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 ACCT. HORIZONS 659, 670 (2011) (finding that non-professional investors "never use the financial statements," preferring The Value Line Investment Survey or the Motley Fool as "important inputs to investment decisions."). *But see* Kathleen L. Casey, Comm'r, SEC, Lessons from the Financial Crisis for Financial Reporting, Standard Setting and Rule Making (Nov. 17, 2009), *available at* http://www.sec.gov/news/speech/2009/spch111709klc.htm (asserting that the stability of financial markets depends on the transparency of financial statements).

[204] Kenneth S. Lorek & G. Lee Willinger, *Multi-Step-Ahead Quarterly Cash-Flow Prediction Models*, 25 ACCT. HORIZONS 71, 73 (2011) (finding cash-flow-based quarterly prediction models superior because of "noisy" subjective estimates embedded in FASB GAAP earnings); Baruch Lev, Siyi Li & Theodore Sougiannis, *The usefulness of accounting estimates for predicting cash flows and earnings*, 15 REV. ACCT. STUD. 779, 783 (2010) ("accounting estimates do not improve the prediction of future cash flows"); Kenneth S. Lorek & G. Lee Willinger, *New evidence pertaining to the prediction of operating cash flows*, 32 REV. QUANTITATIVE FIN. & ACCT. 1, 3, 13-14 (2009) (finding annual cash flow-based prediction models "significantly more accurate" than earnings-based models). *But see* Myungsun Kim & William Kross, *The Ability of Earnings to Predict Future Operating Cash Flows Has Been Increasing—Not Decreasing*, 43 J. ACCT. RES. 753, 754-755 (2005) (relying on algorithmic approximations of operating cash flows in finding that "the ability of earnings to forecast future (operating) cash flows" generally increased between 1973 and 2000).

[205] Sudipta Basu, *How Can Accounting Researchers Become More Innovative?*, 26 ACCT. HORIZONS 851, 858 (2012).

[206] *Id.*

GAAP's role as the only information source for decision makers[207] in part because GAAP's mathematical linearity cannot reflect non-linear market realities.[208]

3. Legal Misconceptions

Case law and legal commentary reveal fundamental misconceptions about SEC rules and accounting. A 1977 law review note cited the AICPA Accounting Principles Board (APB) as authority for the erroneous assertion that GAAP financial statements "disclose the current economic status of an enterprise."[209] The reality? In markets where asset values constantly fluctuate, historical cost-based GAAP statements published weeks or months after the fact cannot possibly reveal "current economic status."[210]

In 2006, the Second Circuit Court of Appeals—which, among all U.S. courts, should be most knowledgeable in this area—propagated the following quartet of financial reporting fallacies in affirming the convictions of former WorldCom CEO Bernie Ebbers: (a) all misleading financial statements violate GAAP, (b) GAAP admits that application of some GAAP rules may produce misleading financial statements, (c) GAAP states that all misleading financial statements fail to present fairly, and (d) GAAP requires that financial statements "accurately reflect the financial status of the company."[211]

In *Skilling*, two defense accounting experts wrongly characterized as binding law SEC Staff Accounting Bulletin (SAB) No. 99 on materiality. The

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[207] John Christensen, *Accounting Errors and Errors of Accounting*, 85 ACCT. REV. 1827, 1828, 1833-36 (2010).

[208] *Id.* at 1830-33.

[209] Note, *Generally Accepted Accounting Principles: Instruction H(f) and the Preferability Issue*, 11 VAL. U. L. REV. 229, 229 n.5 (1977).

[210] *See* Charles E. Jordan, Stanley J. Clark & Gwen R. Pate, *The Debate over Fair Value Reporting*, CPA J., Feb. 2013, at 46. Fewer assets are reported at historical cost today than in 1977 but historical cost remains the default. *Id.* (asserting that fair value accounting "will likely become the primary reporting basis" in future). *See also* Shalala v. Guernsey Mem. Hosp., 514 U.S. 87, 101 (1995) (citing ROBERT S. KAY & D. GERALD SEARFOSS, HANDBOOK OF ACCOUNTING AND AUDITING 7 (2d ed. 1989)) (finding that GAAP "do[es] not necessarily parallel economic reality" and is not a "lucid," "encyclopedic" or "single-source accounting rulebook").

[211] United States v. Ebbers, 458 F.3d 110, 126 (2006), *cert. denied*, 549 U.S. 1274 (2007). The court also stated without citation to authority, "Good faith compliance with GAAP will permit professionals who study the firm and understand GAAP to accurately assess the financial condition of the company." *Id.* at 125.

reality is that like all SABs, SAB No. 99 reveals only the non-binding opinions of SEC staff.[212]

In 2007, an attorney with considerable accounting and securities law expertise cited a prominent securities litigator who, in turn, misquoted SOX Section 103(a)(3) for the proposition that the PCAOB was created to "regulate and discipline the accounting industry" and is now the "ultimate arbiter of accounting standards."[213] In fact, Section 103(a)(3) authorizes the PCAOB to write and enforce only *auditing* (not accounting) standards and these are applicable only to audits and auditors of SEC registrants.[214] That so many well-trained minds could harbor such fundamental errors suggests that the SEC's FASB-GAAP-based financial reporting model misleads those it purports to inform.

B. Fair Presentation Standards

While federal courts play a role in judging the overall fairness of financial statements, the primary regulatory players are the SEC, PCAOB, AICPA, FASB, and IASB, whose current standards are discussed below.[215]

1. AICPA

In the United States, AICPA auditing standards apply only to audits that are performed by AICPA members and are not under PCAOB jurisdiction.216

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[212] Skilling Transcript at 16512, 16849-16850. Jerry Arnold testified, "[S]enior [SEC] accounting staff put out interpretations of how things should be done. Those are binding, and they label them SABs . . . This is Number 99. . . ." *Id.* at 16512. Walter Rush testified that SAB No. 99 "is an important rule." *Id.* at 16849. SABs are drafted without public notice, comment, or Commission vote and are, therefore, not binding. *See* Kurt S. Schulzke, Gerlinde Berger-Walliser & Pier Luigi Marchini, *Lexis Nexus Complexus: Comparative Contract Law and International Accounting Collide in the IASB–FASB Revenue Recognition Exposure Draft*, 46 Vand. J. Trans. L. 515, 524 (2013).

[213] Mark, *supra* note 188, at 1109 (citing Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 133 (2002)); *see also* Arthur Acevedo, *Responsible Profitability? Not on My Balance Sheet!*, 61 CATH. U.L. REV. 651, 690 (2012) (erroneously attributing the power of "accounting legislation" to the PCAOB). SOX Section 108, entitled "Accounting Standards," creates a rubric under which the FASB's designation as a U.S. accounting standards setter was nearly inevitable. SOX § 108.

[214] SOX § 101(a) and (c).

[215] FASB and IASB merely set norms, leaving enforcement to adopting governments. SEC, PCAOB, DOJ, AICPA and state agencies enforce these norms in the United States. Outside the United States, enforcers and enforcement vary. This article groups the PCAOB together with AICPA and FASB because of the PCAOB's quasi-non-governmental status.

According to section 200 of the AU-C, audits should deliver "an opinion by the auditor on whether the financial statements are *presented fairly*, in all material respects, in accordance with *an* applicable financial reporting framework,"[217] thus signaling acceptance of multiple frameworks.

AU-C § 320 defines *materiality* as dependent on user information needs with the (highly idealistic) caveats that users (a) have a "reasonable knowledge of business, economic activities, and accounting and a willingness to study the information in the financial statements with reasonable diligence" and (b) "make reasonable economic decisions" based on the financial statements, while (c) appreciating the uncertainty inherent in such information.[218] This nuanced definition of materiality could hardly be more different from that propounded to the *Skilling* jury. It is also missing entirely from AICPA and PCAOB standard audit reports.[219]

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[216]AICPA Code, ET Appendix A, *available at* http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_appendixes.aspx. (authorizing the PCAOB and AICPA Auditing Standards Board to issue auditing standards for audits of SEC registrants and non-SEC registrants, respectively). Financial statements are generally not required of non-registrants. However, of 4,004 small businesses recently surveyed, 496 used financial statements compiled, reviewed, and/or audited by an accountant. Kristian D. Allee & Teri Lombardi Yohn, *The Demand for Financial Statements in an Unregulated Environment: An Examination of the Production and Use of Financial Statements by Privately Held Small Businesses*, 84 ACCT. REV. 1, 8 (2009).

[217] CLARIFIED STATEMENTS ON AUDITING STANDARDS, AU-C § 200.04 (Am. Inst. of Certified Pub. Accountants 2014) (emphasis added). *See also* AU-C § 700.13 (2014) (restating the elements of § 200.04 as mandatory requirements); AU-C § 700.35 (2014) (requiring "unmodified" audit opinions to expressly state that the financial statements are presented fairly.) A "financial reporting framework" guides the "measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements," like FASB GAAP, IFRS, or other "special purpose" frameworks. AU-C § 200.14. A *fair presentation framework* is one that recognizes extra-framework disclosures or outright departures as sometimes necessary to achieve fair presentation. *Id.* The AICPA recently promulgated "clarified" auditing standards designated "AU-C." AICPA, *Clarified Statements on Auditing Standards*, *available at* http://www.aicpa.org/Research/Standards/AuditAttest/Pages/clarifiedSAS.aspx. This Article identifies PCAOB and AICPA auditing standards as "PCAOB AU," "AICPA AU," "AU," or "AU-C," as context requires. PCAOB auditing standards are available at http://pcaobus.org/Standards/Auditing/Pages/default.aspx.

[218] AU-C § 320

[219] *See* AICPA, *Illustration 1 —An Auditor's Report on Consolidated Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America*, AU-C § 700.A58, *available at* http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-C-

The phrase "fair presentation" appears more than fifty times in AU-C § 200 and AU-C § 700 combined, yet its meaning is left mostly to the reader's imagination. For example, AU-C § 700 states that auditors "should also" consider "the overall presentation, structure, and content of the financial statements," and—with a circular flourish—whether the statements and notes "represent the underlying transactions and events in a manner that achieves fair presentation."[220]

AICPA Rule 203, while not expressly citing fair presentation, authorizes auditors to approve departures from FASB GAAP if the auditor "can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading."[221] In 2012, Interpretation 203.02 added that "when the literal application of GAAP would have the effect of rendering financial statements misleading . . . the *proper accounting treatment* is that which will render the financial statements not misleading."[222] Presumably, "proper accounting" is distinct from "generally accepted," "generally regarded," and "fairly presented."

AICPA Rule 203 and Interpretation 203.02 show that the AICPA believes GAAP is sometimes incapable of producing financial statements that are not misleading. An SEC Chief Accountant, a Comptroller General of the United States, numerous accounting scholars, scores of public company CFOs, and the FEE agree.[223] Some private company auditors, who are not subject to PCAOB strictures, sometimes rely on Rule 203 to depart from FASB GAAP where compliance would otherwise produce misleading financial statements.[224]

Discrediting the limitations of Rule 203.02, Rule 203.05 expressly authorizes "financial reporting frameworks other than GAAP" including jurisdictional variations of IFRS, accounting frameworks prescribed by contract,

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00700.pdf; PCAOB, *Reports on Audited Financial Statements*, PCAOB AU § 508.08(a)-(j) (1996), *available at* http://pcaobus.org/Standards/Auditing/Pages/AU508.aspx.

220 AU-C § 700.17.

221 AICPA Rule § 203.01 (2012).

222 AICPA Rule § 203.02 (2012). (emphasis added).

223 *See* Miller & Bahnson, *supra* note 186; ZEFF 2007; FEE, *supra* note 181; Walker, *supra* note 182; Dichev et al., *supra* note 2.

224 Interview with the managing partner of a large accounting firm based in the southeastern United States that audits only non-public companies (November 2014).

or "any other comprehensive basis of accounting."[225] GAAP either *is* or *is not* the only "not misleading" accounting framework. AICPA Rule 203.05 says not, that even non-GAAP accounting can be "not misleading," and that accountants are obligated to find and use principles—in or out of GAAP—that do not mislead. This, in essence, is *Simon*.

2. PCAOB

The PCAOB requires public company auditors to opine on whether the financial statements prepared by management[226] "present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles."[227] On paper, the PCAOB defines "present fairly" to mean that

> (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements [and] notes, are informative of matters that may affect their use, understanding, and interpretation . . .; (d) the information presented . . . is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed . . .; and (e) the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.[228]

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[225] AICPA Rule § 203.06 (2012).

[226] PCAOB AU § 508.08(c) (2013). Recently proposed revisions to the standard audit report do not address the fair presentation issues raised in this Article. *See* PCAOB, RELEASE NO. 2013-005, THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION (2013), *available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx*. .

[227] PCAOB AU § 411.01 (2013). *But see* PCAOB AU § 508.08(h) (2013). These two provisions seem to conflict over the meaning of generally accepted accounting principles. Section 508.08(h) requires U.S. GAAP; section 411.01 allows any GAAP with "country of origin" disclosure.

[228] PCAOB AU § 411.04. The PCAOB's definition was taken verbatim from former AICPA AU § 411 which was withdrawn in 2008. *See* PCAOB, Release No. 2008-001, EVALUATING CONSISTENCY OF FINANCIAL STATEMENTS, *available at* http://pcaobus.org/Rules/Rulemaking/Docket023/PCAOB_Release_No._2008-001_--_Evaluating_Consistency.pdf.

Thus, consistent with section 320 of the AICPA's Clarified Statements on Auditing Standards, the PCAOB—while head-faking in the direction of "use" or "user needs"—requires auditors to evaluate fair presentation without direct reference to financial statement objectives.

Here, it bears emphasis that whether a financial statement is misleading is a function of user needs and expectations. For example, equity investors and lenders have different risk-reward profiles and need different information to make investing and lending decisions. Similarly, equity investors themselves differ in their appetites for risk.

Creating a single set of financial statements that meets the needs of all of these user groups may be possible and, if so, would require an understanding of the inferences that members of each group might reasonably draw from information that could be included in or excluded from the financial statements coupled with seasoned professional judgment. Yet, despite the endorsement of professional judgment implicit in "general acceptance," "appropriate in the circumstances," and "range of acceptable limits," the PCAOB insists that auditors find fair presentation exclusively within the GAAP framework without which "the auditor would have no uniform standard for judging the presentation of financial position."[229]

3. FASB

FASB Statements of Financial Accounting Concepts articulate principles that ostensibly guide the FASB in developing the FASB GAAP now found in the Codification.[230] However, the Codification itself contains no explicit fair presentation requirement and offers no overall purpose or objective of financial statements. None of the Codification's six cursory mentions of fair presentation addresses financial statements in general. Rather, each is industry or transaction-specific. The phrase "present fairly" appears three times, each implying that financial statements should present fairly without ever clearly saying so or assigning responsibility. The term "misleading" appears eleven times—including three times preceded by "not"— but never in connection with the financial statements as a whole.

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[229] PCAOB AU § 411.03.

[230] FASB § 105-10-05 (2014). .

In contrast to the Codification's murkiness regarding fair presentation, FASB Concepts Statement No. 8 (Concepts No. 8)[231] and its identical IASB twin, the IASB Conceptual Framework (Framework),[232] offer a measure of clarity. While not outright defining fair presentation, they prescribe financial statements that are useful in making decisions about providing resources to the reporting entity[233] where "useful" means helpful in assessing "the amount, timing, and uncertainty of . . . future net cash inflows."[234] Others have reduced this mouthful to the acronym "AAATUC".[235] Useful information must also be *relevant* and must *faithfully represent*[236] economic substance over legal form,[237] a combination that Concepts No. 8 roughly equates to fair presentation.[238] Relevance, which includes materiality,[239] implies predictive or confirmatory value.[240]

Accountants might be expected to apply Concepts No. 8 to actual financial statements. However, they typically do not for at least two reasons. First, no direct measure of AAATUC currently exists.[241] Second, the FASB, PCAOB, and SEC prohibit the use of concepts statements by practicing accountants. For example, in Concepts No. 8, the FASB admits that FASB GAAP may violate

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231 FASB, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 8 [hereinafter Concepts No. 8] (Sept. 2010), *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176157498129&acceptedDisclaimer=true.

232 *See Id.* at ¶¶ QC3, QC35-39. Concepts No. 8 was jointly developed by FASB and IASB in part to "serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provision of unbiased financial and related information". *Id.*

233 *Id.* at ¶ OB2.

234 *Id.* at ¶ OB3. As elegant as Concepts No. 8 sounds, it sets a rather low performance bar: compared to zero information, any additional information could be described as "useful."

235 Paul B.W. Miller & Paul R. Bahnson, *Continuing the Normative Dialog: Illuminating the Asset/Liability Theory*, 24 ACCT. HORIZONS 419, 431 (2010).

236 Concepts No. 8 ¶ QC5.

237 *Id.* at ¶¶ QC12, BC3.26.

238 *Id.* at ¶ BC3.44.

239 *Id.* at ¶ QC11.

240 *Id.* at ¶ QC7. "[I]nformation need not be a prediction or forecast to have predictive value [but may be] employed by users in making their own predictions." *Id.* at ¶ QC8.

241 *See* Miller & Bahnson, *supra* note 228, at 431 (noting that while AAATUC cannot be directly measured, fair market values may be used to estimate it because they are "empirically observable and represent a consensus valuation" by independent parties).

principles contained in concepts statements but warns practitioners not to use such inconsistencies to justify overriding FASB GAAP to achieve fair presentation.[242] Federal courts, unaware or dismissive of the concepts statements embargo, have frequently cited them as binding GAAP authority.[243]

4. IASB

The IASB alternative to FASB GAAP, IFRS, is currently being considered by the SEC for public U.S. companies.[244] More than 450 non-U.S. companies already file IFRS statements with the SEC.[245] In contrast to FASB GAAP, IFRS expressly requires fair presentation,[246] which IFRS defines as "the faithful representation of the effects of transactions, other events and conditions in accordance with" the Framework.[247]

While IFRS compliance is presumed to achieve fair presentation,[248] IAS 1 paragraph 19 *requires* IFRS departures in the "extremely rare circumstances" in which compliance "would be so misleading [as to] conflict with the objective of financial statements" prescribed by the Framework.[249] Thus, IFRS contrasts with

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[242] Concepts No. 8 n.p. (a "Concepts Statement does not establish U.S. GAAP . . . [and] is not intended to invoke application of [AICPA] Rule 203").

[243] A Sep. 5, 2013 search of the LexisNexis All Federal Courts database for "Statements of Financial Accounting Concepts" produced 66 separate entries. *See, e.g.*, 228 F.3d 154, 162 (2d Cir. 2000) (citing FASB, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 2, ¶ 125 (1980)); S.E.C. v. Todd, 642 F.3d 1207, 1216 (9th Cir. 2011) (referring to defendants' citation to FASB, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6 as FASB authority on revenue recognition); Welch v. Chao, 536 F.3d 269, 278 (4th Cir. 2008) (citing Statement of the SEC, Amicus Curiae, in Support of Neither Side at 3 (quoting FASB, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 5, ENTERPRISES 15-16, ¶ 22 (Dec. 1984)); Higginbotham v. Baxter International, Inc., 495 F.3d 753, 758 n.+ (7th Cir. 2007) (citing FASB, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6).

[244] *See* Michael Rapoport, *New SEC Chief Accountant Weighing Switch to Global Accounting Rules*, WALL ST. J. , Nov. 6, 2014, *available at* http://online.wsj.com/articles/new-sec-chief-accountant-weighing-switch-to-global-accounting-rules-1415305697.

[245] Paul Beswick, SEC Chief Accountant, Remarks at the 32nd Annual SEC and Financial Reporting Institute Conference (May 30, 2013).

[246] IAS 1 ¶ 15 (IASB 2012).

[247] *Id.*

[248] *Id.*

[249] IAS 1 ¶ 19 (2012)

FASB GAAP, first, in that IFRS compliance is expressly tied to financial statement objectives while FASB GAAP compliance is not, and second, in that PCAOB and FASB standards flatly prohibit fair presentation departures from FASB GAAP, whereas IAS 1 requires departures from IFRS when necessary to avoid misleading readers. While the Framework's objectives have been criticized as so broad as to render paragraph 19 toothless, [250] the equivalent "true and fair view" override has long been a statutory standard of financial reporting in the United Kingdom, as discussed in Part III.

III. FAIR PRESENTATION STATUTES AND REGULATIONS

In the United States, the fair presentation of financial statements is supported, if at all, by a complex, often internally inconsistent fabric of statutes and regulations. The central threads are summarized in Part III, together with the statutory scheme in the United Kingdom.

A. Statutes

Section 11 of the Securities Act imposes civil liability for material misstatements and omissions in registration statements,[251] which are required prior to the public offering of securities. Thereafter, section 13 of the Exchange Act prescribes periodic reporting requirements.[252] Sections 30A[253] and 13(b)(2) of the Exchange Act, the so-called "accounting provisions" of the Foreign Corrupt Practices Act (FCPA),[254] require public companies to (a) keep books that accurately and fairly reflect transactions,[255] and (b) maintain internal accounting controls to ensure that the financial statements comply with GAAP and other

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[250] *See* Christopher Nobes, *The importance of being fair: An analysis of IFRS regulation and practice- a Comment,* 39 ACCT. & BUS. RES. 415, 420 (2009). Nobes' view finds some support in the rarity of reported public company IAS ¶ 19 overrides, now totaling two cases. *Id.* at 421-423 (discussing National Express Group PLC's 2005, 2006 & 2007 financial statements and *Société Générale* SA's 2007 financials).

[251] 15 U.S.C. § 77k (2014). Section 12(a)(2) imposes similar liability for untrue statements or omissions of material facts in prospectuses or oral communications. 15 U.S.C. § 77l(2) (2014).

[252] 15 U.S.C. § 78(m) (2014).

[253] 15 U.S.C. § 78dd-1 (2014).

[254] 15 U.S.C. § 78m(b)(2)(A)-(B) (2014).

[255] 15 U.S.C. § 78m(b)(2)(A) (emphasis added).

criteria.[256] Knowing falsification of records or circumvention of controls triggers civil and criminal liability.[257]

SOX Sections 302 and 906 distinguish financial reporting *reliability* from GAAP *compliance*. SOX Section 302 requires a public company's CEO and CFO to (a) certify that each annual and quarterly report contains no material "misleading" factual misstatement or omission[258] and that the financial statements "fairly present in all material respects" the registrant's financial condition, operating results, and cash flows;[259](b) acknowledge responsibility for the registrant's disclosure controls and internal controls over financial reporting; and (c) certify that they have designed the internal controls "to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with [GAAP]."[260]

SOX Section 906 requires both CEOs and CFOs to certify that periodic reports containing financial statements comply with section 13(a) of the Exchange Act and fairly present, in material respects, the issuer's financial condition and results of operations.[261] On paper, the fines and prison time imposed for erroneous certification are severe. [262] However, to date, no reported case has applied these penalties, though the possibility of such may have induced defendants to settle. In addition, under SOX Section 304, officers of issuers that publish accounting restatements due to material noncompliance with SEC rules must disgorge incentive compensation and gains from sales of issuer stock

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256 15 U.S.C. § 78m(b)(2)(B).

257 15 U.S.C. § 78m(b)(5). *See, e.g.*, Brown v. U.S., 571 F.3d 492, 494 (5th Cir. 2009) (denying Merrill Lynch-employee defendants' motion to dismiss their indictment for conspiracy to falsify Enron's books in connection with a Nigerian barge deal).

258 15 U.S.C. § 7241(a)(2) (2014).

259 15 U.S.C. § 7241(a)(3); 17 C.F.R. §§ 240.13(a)-14(a), 240.15d-14(a) (2014); 17 C.F.R. § 229.601(b)(31)(i) (2014) (mandating the exact contents of the certifications required by 17 C.F.R. 240.13a-14(a) and 240.15d-14(a)).

260 15 U.S.C. § 7241(a)(4); 17 C.F.R. § 229.601(b)(31)(i). SOX does not define reliability.

261 18 U.S.C. § 1350(a)-(b) (2014). The SEC rule requiring SOX section 906 certifications is 17 C.F.R. § 240.13a-14(b).

262 Mere "knowing" certification of non-compliant statements yields up to 10 years in prison and $1,000,000 in fines, whereas "willful" false certification yields up to 20 years and $5,000,000. 18 U.S.C. § 1350(c).

received during the twelve months following the original publication of the erroneous financial information.[263]

Securities fraud is prohibited under both section 17 of the Securities Act and section 10(b) of the Exchange Act. Sections 17(a)(2) and 17(a)(3) of the Securities Act prohibit material untrue factual statements, misleading factual omissions, and other behavior that would operate as a fraud upon a purchaser, in connection with an offer or sale of a security.[264] Similarly, section 10(b) of the Exchange Act prohibits the use of any manipulative or deceptive device in connection with the purchase or sale of any security.[265] The scope of section 10(b) has been established in part by SEC Rule 10b-5, whose central theme is that financial statements must not be materially misleading.[266] Willful and knowingly false and misleading statements made in violation of the Exchange Act or any regulation thereunder are punishable by up to 20 years in prison and fines up to $5,000,000.[267]

B. Regulations

Securities disclosure statutes are implemented in part through reports that registrants must submit periodically to the SEC. Domestic issuers[268] must file periodic, quarterly, and annual reports[269] on Forms 8-K,[270] 10-Q,[271] and 10-K.[272] Foreign private issuers (FPIs), [273] which report annually on Form 20-F[274] and

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263 15 U.S.C. § 7243(a) (2014).

264 15 U.S.C. § 77q(a)(2)-(3) (2014).

265 15 U.S.C. § 78j(b) (2014).

266 *See* 17 C.F.R. 240-10b-5.

267 15 U.S.C. § 78ff(a) (2014).

268 15 U.S.C. § 77b(4) (2014). "Security," for purposes of federal securities law, is defined in 15 U.S.C. §§ 77b(1), 78c(10).

269 15 U.S.C. § 78m(a).

270 17 C.F.R. § 240.13a-11 (2014). Form 8-K is used to report material events or transactions arising between 10-Q and 10-K filing deadlines.

271 17 C.F.R. § 240.13a-13 (2014).

272 17 C.F.R. § 240.13a-1 (2014).

273 17 C.F.R. § 240.3b-4(c) (2014) (defining FPIs).

274 17 C.F.R. § 249.220f (2014) (requiring FPIs to file Form 20-F within six months of fiscal year end).

"currently" on Form 6-K,[275] have no quarterly obligation. SEC regulations are internally conflicted over whether and to what extent financial statements filed with these forms must comply with GAAP or be fairly presented. SEC Rule 210.4-01(a)(1) presumes that non-GAAP financial statements are misleading or inaccurate despite any mitigating footnote or other disclosures,[276] but GAAP is not clearly defined by statute or regulation. Indeed, Form 20-F financial statements may be prepared using IFRS, FASB GAAP, or any other comprehensive set of accounting principles.[277] Similarly, SEC FR-70 does not explicitly derecognize other standards as "not GAAP". Thus, while non-GAAP accounting is presumed "misleading or inaccurate," *FASB GAAP* is not presumed accurate, not misleading, or the only GAAP available.

SEC regulations do not require external auditors to opine on fair presentation or on compliance with GAAP. Rather, they must offer only an "opinion . . . in respect of the financial statements . . . and the accounting principles and practices reflected therein"[278] and their consistent application. This requirement differs markedly from the SOX certifications required of CEOs and CFOs.

Rule 10b-5[279] makes it unlawful to "employ any device, scheme, or artifice to defraud" or to "make any untrue statement of a material fact or to omit a material fact necessary . . . to make the statements made, in the light of the circumstances under which they were made, not misleading" in connection with the purchase or sale of any security. [280] While typically deployed against misleading optimism, Rule10b-5 was written because a company president falsely talked *down* his company's stock.[281] Rule 12b-20 requires reports filed with the SEC to include "further material information. . . as may be necessary to make the

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275 17 C.F.R. § 240.15d-16 (2014).

276 17 C.F.R. § 210.4-01(a)(1)(2014). No LexisNexis case annotation mentions an attempt to challenge this presumption.

277 17 C.F.R. § 210.4-01(a)(2) (2014). Regulation G, regulating non-GAAP disclosures, offers similar guidance. 17 C.F.R. § 244.101(b) (2014).

278 17 C.F.R. § 210.2-02(c)(1) (2014). SEC rules, as applied, require only the signature of the firm, not the individual auditor. 17 C.F.R. § 210.2-02(a)(2).

279 Exchange Act Release No. 3230 (May 21, 1942), 17 C.F.R. § 240.10b-5 (2014).

280 *Id.*

281 *See* Lewis D. Solomon & Dan Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform*, 43 FORDHAM L. REV. 505, 509 n.12 (1975).

required statements, in the light of the circumstances under which they are made, not misleading."[282] In these regulations, the operative phrase is "not misleading". Fair presentation is not mentioned.

C. U.K. Law

The United Kingdom offers a working example of a financial market similar to that of the United States wherein a fair presentation equivalent—known as "true and fair view" (TFV)—has been statutorily prioritized over GAAP compliance since 1947.[283] In broad terms, the relevant differences between the United Kingdom and United States are few. The countries' legal and accounting professions share common law heritage, legal procedure, and regulatory environment. Their capital markets, though of different scales,[284] are roughly equivalent in terms of the concentration of ownership in publicly traded companies[285] and market capitalization in relation to GDP.[286] Both countries periodically experience large-scale financial reporting fraud,[287] though the comparative local impact of fraud is not clear.

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[282] 17 C.F.R. § 240.12b-20 (2014). The phrase "not misleading" currently appears ninety times in Title 17 of the C.F.R. However, the scope of required information disclosures may be limited by an SEC Confidential Treatment Order (CTO). 17 C.F.R. § 240.24b-2 (2014). A March 2, 2014 search of the SEC's EDGAR database returned 1,095 Confidential Treatment Orders filed since 2008. CTOs have been criticized for depriving investors and creditors of highly material information. *See, e.g.*, Nadelle Grossman, *Out of the Shadows: Requiring Strategic Management Disclosure*, 116 W. VA. L. REV. 197 (2013) (advocating disclosure of strategic management processes to the same extent as risk management).

[283] *See* GEORGE BOMPAS QC, *INTERNATIONAL FINANCIAL REPORTING STANDARDS* ¶ 12 (2013), *available at* http://www.lapfforum.org/TTx2/press/ifrs-opinion (reciting the 1947 statutory debut of "true and fair view" as a "paramount requirement" in the Companies Act 1947, Sections 13 and 16).

[284] The 2012 U.K. and U.S. stock market capitalization was $3,019 and $18,668 billion, respectively. *See* THEGLOBALECONOMY.COM, http://www.theglobaleconomy.com/economies/ (last visited Nov. 25, 2014).

[285] *See* Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSPECTIVES 117, 118-19 (2007) (reporting the 1995 proportions of "widely held" firms among the largest twenty firms in the U.S. and U.K. as 80 and 100 percent, respectively).

[286] The 2012 U.K. and U.S. stock market capitalization as a percentage of GDP was 123 and 115 percent, respectively. *See* THEGLOBALECONOMY.COM, http://www.theglobaleconomy.com/economies (last visited Nov. 25, 2014).

[287] Leading U.S. fraud cases are discussed in Part I. In the United Kingdom, Walmart competitor Tesco is currently under investigation by the Serious Fraud Office [hereinafter SFO] for alleged revenue accounting fraud. *See* Peter Evans, *Tesco Fraud Investigation Opened*, WALL ST. J. (Oct. 29,

Despite the similarities, one regulatory difference stands out: In the United Kingdom, a single, independent entity, the Financial Reporting Council (FRC), sets and enforces U.K. standards for corporate reporting (including accounting standards), auditing, and corporate governance.[288] In the United States, these responsibilities are divided among three organizations: FASB, PCAOB, and SEC. One result of the U.K. "united command" structure is consistency—notably lacking in the United States—between accounting and auditing standards and between the two sets of standards and their enforcement.

The United Kingdom, as a European Union (EU) member, is subject to EU law. The EU Accounting Directive (Directive) requires member states to ensure that financial statements "give a true and fair view" (TFV) of the firm's financial position (shown in the balance sheet) and profit or loss (portrayed in the income statement), regardless of company size or accounting framework.[289] In exceptional cases where application of the relevant accounting framework fails to deliver a TFV, the Directive requires that companies do so by departing from the framework.[290]

The EU's IAS Regulation obligates public U.K. companies to follow IFRS in their consolidated statements.[291] Otherwise, companies are free to choose

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2014), *available at* http://online.wsj.com/articles/u-k-s-sfo-to-investigate-tesco-1414593597 (outlining the SFO's jurisdiction over the investigation and its accounting provenance). *See also* SERIOUS FRAUD OFFICE, (2015) *available at* http://www.sfo.gov.uk/ (describing the responsibilities of the SFO).

288 *About the FRC*, FRC.ORG.UK, https://www.frc.org.uk/About-the-FRC.aspx (last visited Oct. 3, 2014); Memorandum from Stephen Haddrill, for the FRC, and David Lawton, for the FCA, (April 2, 2013), *available at* https://frc.org.uk/Our-Work/Publications/FRC-Board/Memorandum-of-Understanding-between-the-Financial.pdf (describing responsibilities of FRC).

289 Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2003 on the Annual Financial Statements, Consolidated Financial Statements, and Related Reports of Certain Types of Undertakings and amending Directive 2006/43/EC O.J. (L 182) 29, art. 4 [hereinafter Directive]. *See also* MARTIN MOORE QC, *INTERNATIONAL ACCOUNTING STANDARDS AND THE TRUE AND FAIR VIEW*. ¶¶ 41-61 (2013) [hereinafter Moore 2013], *available at https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Martin-Moore-QC-Opinion-3-October-2013.pdf* (explicating the relationship between prudence and true and fair view and arguing that the latter can exist without the first).

290 Directive at 20 ¶ 9. *See also* Moore 2013 (arguing that this so-called "true and fair" override survived the replacement of "true and fair view" with "fair presentation" in the updated IAS 1).

291 Companies Act, 2006, c. 46, § 403(1) (Eng.).

between IFRS or Companies Act 2006 accounting frameworks.[292] As discussed in Part II, IAS 1 paragraph 19 requires IFRS-compliant firms to depart from IFRS in order to correct misleading financial statements.

No matter the accounting framework, TFV continues to be the U.K. financial reporting lodestar. Unlike the SEC, the FRC has consistently and unambiguously defended the TFV override as essential to quality financial reporting.[293] Nevertheless, in the wake of the IASB's recent replacement of TFV with fair presentation, the applicability of TFV to IFRS financial statements has been energetically debated, most visibly through dueling Queens Counsel (QC) opinions commissioned by the Local Authority Pension Fund Forum (LAPFF)[294] and the FRC. [295]

TFV is not defined in EU or U.K. legislation but has been equated by leading British commentators to fair presentation[296] and usefulness which, in turn, compromises relevance, reliability, comparability, and understandability.[297] A

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[292] Companies Act, 2006, c. 46, § 395 (Eng.) (creating the accounting option for individual accounts); Companies Act, 2006, c. 46, § 403(2) (creating the accounting option for group accounts).

[293] *See, e.g.*, FINANCIAL REPORTING COUNCIL [hereinafter FRC], TRUE AND FAIR (2014), *available at* https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/True-and-Fair-June-2014.pdf; FRC, TRUE AND FAIR (2011), https://www.frc.org.uk/FRC-Documents/FRC/Paper-True-and-Fair.pdf; FRC, *Importance of true and fair view in both UK GAAP and IFRS reaffirmed by the Accounting Standards Board and Auditing Practices Board* (Jul. 21, 2011), https://frc.org.uk/News-and-Events/FRC-Press/Press/2011/July/Importance-of-true-and-fair-view-in-both-UK-GAAP-a.aspx; FRC, *Relevance of 'True and Fair" concept confirmed* (May 19, 2008), https://frc.org.uk/News-and-Events/FRC-Press/Press/2008/May/Relevance-of-True-and-Fair-concept-confirmed.aspx.

[294] Bompas, *supra* note 277 (questioning whether companies can both follow IFRS and override it using TFV).

[295] Moore 2013, at ¶¶ 70-82, at 21-26 (rebutting Bompas, *supra* note 277, and reaffirming the continuing preeminence of TFV for all U.K. companies). *See also* FRC, TRUE AND FAIR, *supra* note 287 (confirming the centrality of true and fair to accounting and auditing).

[296] *See, e.g.*, Moore 2013, at ¶ 71 (reaffirming his 2008 assertion that "true and fair view" and "fair presentation" are equivalent); MARTIN MOORE QC, THE TRUE AND FAIRE REQUIREMENT REVISITED ¶¶ 28-29 (2008), *available at* https://www.frc.org.uk/FRC-Documents/FRC/True-and-Fair-Opinion,-Moore,-21-April-2008.pdf (quoting the IASB Framework for the proposition that "true and fair" and "present fairly" are synonymous) [hereinafter Moore 2008]; Bompas, *supra* note 277, at 22 n.37 (quoting with approval U.K. Minister of Industry and the Regions, Margaret Hodge MP, to the effect that TFV and fair presentation are equivalent).

[297] *See* Moore 2013, at ¶¶ 72-73.

highly regarded 1983 QC opinion reasoned that TFV requires information in "sufficient quantity and quality to satisfy the reasonable expectations of the readers to whom [it is] addressed" and that because reader expectations are in part a function of customary accounting practice, so is TFV.[298]

Further emphasizing TFV's importance, the Companies Act 2006 requires auditors to opine separately on whether the financial statements (a) "give a true and fair view" of profit and loss (income statement) and "state of affairs" (balance sheet) and (b) conform to the relevant accounting framework.[299] The "a" in "a true fair view" signifies that TFV is dynamic and flexible, not unique or absolute,[300] in relation to circumstances and reasonable reader expectations.[301]

Scarce EU and U.K. case law on point generally holds that delivery of a TFV is of overriding importance, adherence to generally accepted accounting practices is prima facie evidence of TFV, and GAAP-compliant statements may fail to deliver a TFV. In contrast to the U.S. question-of-fact approach, whether financial statements give a TFV is a question of law with respect to which courts should treat accounting practice as persuasive authority.[302]

IV. CONCLUSIONS

Since 1942, when the SEC declared that financial statements exist to perform "the function of enlightenment," not to comply with GAAP,[303] the SEC,

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[298] LEONARD HOFFMANN QC & MARY H. ARDEN, LEGAL OPINION OBTAINED BY ACCOUNTING STANDARDS COMMITTEE OF TRUE AND FAIR VIEW, WITH PARTICULAR REFERENCE TO THE ROLE OF ACCOUNTING STANDARDS ¶ 8 (1983), *available at* https://www.frc.org.uk/FRC-Documents/FRC/True-and-FairOpinionHoffmann-and-Arden-13-Sept.pdf.

[299] Companies Act, 2006, c. 46, § 495(3) (Eng.).

[300] Supplemental Joint Opinion of Leonard Hoffman QC and MH Arden ¶ 5 (1984).

[301] *Id.* at ¶ 9.

[302] *See, e.g.*, Case C-234/94, *Tomberger v. Gebrüder Von Der Wettern*, 1996 E.C.R. I-3133 (prioritizing TFV over the German government's formalistic view of revenue recognition); Case C-275/97, DE + ES *Bauunternehmung GmbH v Finanzamt Bergheim*, 1999 E.C.R. I-5331 ¶ 40 (affirming the supremacy of TFV over detailed standards); *Balloon Promotions Ltd. v. Wilson* (Inspector of Taxes), [2006] S.T.C. (SCD U.K.) 167 ¶ 152 (holding that goodwill "should be construed in accordance with legal not accountancy principles" because U.K. GAAP's SSAP 22 is "deficient"); MARY ARDEN, OPINION: THE TRUE AND FAIR REQUIREMENT ¶ 2 (1993) (stating "whether accounts satisfy [TFV] is a question of law for the court" about which courts must consider evidence of accounting practice).

[303] *See supra* note 160 and accompanying text.

FASB, and PCAOB have aggressively pushed to eliminate fair presentation and professional judgment from financial reporting. As a proximate result, accounting experts have dissociated FASB GAAP from integrity and fairness, while federal judges have quarantined "accounting materiality" and FASB GAAP as irrelevant in leading federal securities cases.

Meanwhile, contemporary accounting research questions FASB GAAP's accuracy, relevance to investors, and usefulness in predicting future cash flows. Leaders of the accounting profession, domestic and international, have decried the U.S. obsession with GAAP compliance. In counterpoise, professionals, regulators, and courts in the United Kingdom have enshrined TFV as the overarching financial statement requirement before which even GAAP must bow.

The SEC's FR-70, FASB GAAP Hierarchy paragraph A10, PCAOB AU 411.04, and standard audit report all mislead by glossing over FASB GAAP's practical weaknesses and lack of real general acceptance. By naked diktat, FR-70 declares FASB GAAP "generally accepted." Paragraph A10 claims that selection of FASB GAAP principles "results in relevant and reliable financial information" but fails to anchor relevance to any objective or to acknowledge research impeaching FASB GAAP's reliability. PCAOB AU 411.04 requires auditors to opine on whether the financial statements "are informative of matters that may affect their use, understanding, and interpretation," while concealing their purposelessness and the systemic deficiencies of their FASB GAAP backbone.

Today's standard U.S. audit opinions are significantly less informative than those of 1933. Then, auditors certified their belief that the financial statements were *true and not misleading*. Until 1962, Andersen auditors opined separately on fair presentation and compliance, just as their modern U.K. counterparts separately address TFV. In unflattering contrast, today's U.S. auditors coyly concatenate "fairly presented" and "in conformity with GAAP," falsely leading readers to infer that these phrases offer separate, meaningful assurances. At the same time, their audit reports—endorsed by AICPA or PCAOB—fail to tell readers what they mean by *material*. Perhaps this is because the auditors themselves do not know what it means.

After sixty years of haphazard development, the alphabet soup of essential U.S. securities law terms—including *GAAP*, *materiality*, *reliability*, *not misleading*, and *fair presentation*—lacks generally accepted definitions and internal coherence. This fog of regulation harms markets and the law by simultaneously offering cover to accountants seeking to avoid professional responsibility and to plaintiffs, prosecutors, and courts too eager to stretch the law to their advantage. For example, the Fifth Circuit's subjectivist twist on materiality—tying materiality

to metaphysical musings of the "ordinary man"—introduces arbitrary legal risk into the calculus of corporate governance thereby endangering free markets and the rule of law.

The PCAOB's acceptance of accounting principles from multiple jurisdictions[304] casts FASB GAAP as but one accounting framework among many. So does SEC Regulation G, which defines GAAP for FPIs as whatever non-U.S.-GAAP principles the FPI uses in its financial statements.[305] AICPA Rule 203.05, which authorizes literally *any* comprehensive basis of accounting, similarly demonstrates the falsity of the PCAOB's claim that non-FASB-GAAP standards for judging fair presentation are lacking. They are not lacking. Rather, they are simply not used.

The Second Circuit's *Ebbers* mythology—that FASB GAAP requires that financial statements be not misleading, recognizes that technical compliance with particular GAAP rules may produce misleading financial statements, and requires that financial statements as a whole accurately reflect the financial status of the company[306]—is evidence that FASB GAAP misleads even highly educated readers by promising what it is not designed to deliver.

That bench and bar avoid FASB GAAP is hardly surprising. In federal securities cases, *Simon* long ago replaced GAAP with three words: *not materially misleading*. *Simon* and its progeny are the proximate result of the accounting profession's single-minded adherence to GAAP and rejection of principled fair presentation. Remember, "GAAP doesn't talk about misleading. GAAP doesn't talk about integrity. GAAP talks about accounting rules."[307] No expert could credibly say this about accounting practice in the United Kingdom, where the U.K. Companies Act has successfully prioritized TFV over GAAP for several decades. With U.S. accountants mechanistically following bright-line GAAP and the legal issue in securities cases reduced to whether financial statements are "misleading," accounting experts may understandably be seen as so much irrelevant sand in the legal machine.

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304 PCAOB AU § 411.01 (2013). Reconciliation of foreign-GAAP net income and shareholders' equity to equivalent FASB GAAP figures is required for non-IFRS statements. 17 C.F.R. § 210.4-01(a)(2) (2014). Thus, what prevents U.S. public companies from using IFRS or some other GAAP is not a PCAOB rule, but FR-70.

305 *See supra* note 271 and accompanying text..

306 U.S. v. Ebbers, 458 F.3d 110, 126 (2d Cir. 2006), *cert. denied*, 549 U.S. 1274 (2007).

307 *See* Skilling Transcript at 16724-823.

V. RECOMMENDATIONS

Conveniently, TFV under the U.K. Companies Act roughly equates to fair presentation. At the same time, SOX Sections 302 and 906 already require company executives to separately certify the fair presentation of their financial statements. All that remains to convert U.S. public companies to a bona fide fair presentation model is to clearly define fair presentation and expressly require accountants to follow the model.

As John C. Burton noted, fair presentation is meaningful only in relation to financial statement objectives.[308] Thus, financial statements could be defined, by statute or regulation, as fairly presented and therefore not misleading when they satisfy Concepts No. 8's three usefulness criteria—helpfulness in predicting cash flows, relevance, and representational faithfulness—through the eyes of reasonable equity investors and creditors as defined by AICPA AU-C § 320. Materiality would serve as a pervasive constraint. Satisfaction of May's inferential imperative would signal representational faithfulness and would fully satisfy the securities law "not misleading" mandate as interpreted by *Simon* and its progeny. The model could include a rebuttable presumption that compliance with any accounting framework achieves fair presentation. Consistent with the IAS 1 and U.K. Companies Act paradigms, financial statements would be required to depart from the applicable accounting framework whenever necessary to achieve fair presentation. Thus, financial statements and audit reports would say what they mean and mean what they say, offering users the best available information in the core financial statements and thereby rendering remedial disclosure unnecessary.

Beyond mandating fair presentation, Congress should statutorily decide what auditors and company officers must tell financial statement readers about it *and* its relationship to GAAP compliance. Even in the United Kingdom, where courts have made law for nearly a millennium, Parliament statutorily controls this question. Currently, SEC regulations do not require auditors to opine on fair presentation, GAAP compliance, or not misleading status. SOX requires officers to certify all three while, in contrast, the PCAOB and AICPA allow auditors to ignore "not misleading." Statutory definition of fair presentation as outlined above would resolve these inconsistencies and redundancies. It should be paired with the requirement that audit opinions separately address fair presentation and compliance in a manner consistent with the U.K. Companies Act.

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[308] *See* Burton, *supra* note 160 and accompanying text.

Absent these recommended reforms, the best protection for accountants is May- and Burton-style fair presentation. Case law warns that the putative GAAP safe harbor is illusory. Taking FASB GAAP and other SEC model elements as they now are, audit opinions that satisfy *Simon* and current PCAOB requirements[309] should include language like the following:

In our opinion, the accompanying financial statements meet the usefulness criteria of FASB Concepts No. 8 and the fair presentation requirements of PCAOB AU 411.04 in all material respects, where "material" is defined by AICPA AU-C § 320 which assumes that readers have reasonable knowledge of business and accounting, diligently study the financial statements and appreciate their inherent uncertainty. They were prepared in accordance with the FASB Codification, except as explained in Note X, and provide probabilistic estimates, within practical limits, of the Company's historical financial position, earnings, and cash flows based partly on historical transaction amounts and partly on fair values as of the balance sheet date.

Advocates of the status quo may argue that these proposals would lead to chaos for analysts, investors and accountants confronted with a multiplicity of accounting frameworks and audit opinions. But the status quo is chaos. In court, costly FASB GAAP expert testimony is dismissed as irrelevant while defendants suddenly confront unforeseen legal exposure. Similarly, latent chaos lurks in the market where misleading FASB GAAP financial statements misinform investors and periodically precipitate debilitating financial shocks like *Enron*, *Worldcom*, and *Lehman*.

Public companies and their auditors should be unambiguously obligated to depart from FASB GAAP when necessary to avoid misleading readers. Non-public and non-U.S. companies already are, with the blessing of SEC, PCAOB and AICPA. As a side benefit, practical access to a fair presentation override for U.S. public companies can be expected to openly highlight misleading FASB GAAP and thereby hasten positive change.

FASB apologists may counter that fair presentation can always be finagled within FASB GAAP. Yet, the extensive record—including the FASB's response to *Lehman*—suggests that FASB, SEC, PCAOB and U.S. accounting profession know otherwise. Meanwhile, the unitary U.K. regulator points clearly and consistently to true and fair view and fair presentation.

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309 *See* PCAOB AU § 411.04.

For the good of markets and securities litigants, accountants should be taken seriously in court but only if they exercise independent professional judgment in preparing and auditing financial statements. Eight decades of bright-line SEC regulation have proven what George May, the AIA, and J.M.B. Hoxsey knew in 1933. "There is no dispensing with judgment in the preparation of accounts," "uniform financial statements simply will not solve the problem," and investors are "deceived, rather than protected, by such requirements."[310] Beyond deceiving investors, uniformity shrinks the arena for exercise of professional judgment about which courts might solicit expert testimony. Benchmarking financial statement fair presentation against Concepts No. 8 would better inform financial statement users, require accountants to take professional responsibility for their decisions, and make expert accounting testimony more relevant and compelling in U.S. courtrooms.

[310] Memorandum from George O. May to the U.S. Senate Committee on Banking and Currency 4-5 (Mar. 10, 1934) (on file with author).