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Revenue Recognition and Corporate Counsel

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REVENUE RECOGNITION AND CORPORATE COUNSEL

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I. INTRODUCTION

CORPORATE lawyers now work in a world that has become tragically sensitized to executive greed and financial fraud and the consequential damage to our capital markets. The reported corporate accounting frauds during the past five years evidence an epidemic of infectious financial fraud involving an overwhelming number of companies, from the dot.coms to the blue chips. One writer has recently concluded that the executives of "the vast majority of major corporations" have been "artificially inflating their profits."[1] He concluded, as many others have, that extravagant executive stock options, a relatively recent phenomenon in executive compensation, have provided corporate managers with "a strong incentive to mislead investors about the true condition of their companies" by resorting to the exaggeration of corporate revenues.[2] When more than half of America's top two hundred chief executive officers have mega-options with an average value of over $50 million,[3] it is obvious, as economist Michael Jensen has concluded, that corporate managers facing internal financial difficulties will be heavily penalized for telling the truth and outrageously rewarded for lying, and that the resultant "unethical behavior [will be] extended to all sorts of things."[4] In a similar vein, a well-known accounting academic has stated that the Lucent Technologies scandal taught him that blatantly improper revenue recognition "could happen anywhere" and that "these blue chip companies were just as susceptible to accounting trickery as the small

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1. John Cassidy, *The Greed Cycle*, NEW YORKER, Sept. 23, 2002, at 64, 74. Similarly, Rep. John LeFalce has recently stated that corporate earnings manipulation has become a "common phenomenon." Richard Hill, LaFalce Takes Aim at Republican Bill, Calls Earnings Manipulation "Common," 34 Sec. Reg. & L. Rep. (BNA) 741 (May 6, 2002). *See also* Ken Brown, *Questioning the Books—Tweaking Results Is Hardly a Sometime Thing, Many Firms*, WALL ST. J., Feb. 6, 2002, at C1; Arthur Levitt, The Numbers Game, Remarks at the N.Y.U. Center for Law and Business (Sept. 28, 1998).

2. Cassidy, *supra* note 1, at 72; *see also* Gretchen Morgenson, *Corporate Conduct: News Analysis; Bush Failed to Stress Need to Rein in Stock Options*, N.Y. TIMES, July 11, 2002, at C1.

3. Cassidy, *supra* note 1, at 77.

4. *Id.* at 75.

ones."[5] Consequently, corporate counsel should reject any presumption of regularity and stop feigning ignorance when confronted with information that appears, at first blush, to raise accounting issues. All corporate lawyers must familiarize themselves with the various deceptive practices that have led to the downfall of so many publicly-held companies in the last five years. Corporate counsel must understand the mechanisms used in the past to distort corporate earnings in order to recognize the red flags of potential distortion in the future.

During the last five years, earnings restatements by publicly-held companies have increased dramatically. Long considered "a proxy for fraud,"[6] these restatements have grown from only three in 1981[7] to over two hundred last year.[8] The federal government's first in-depth study of earnings restatements, recently concluded by the U.S. General Accounting Office, found that earnings restatements had spiked 145%, from 92 in 1997 to 225 by June 30, 2002, a figure projected to increase to 170% by year-end.[9] Moreover, companies restating their earnings had average market capitalizations of over $2 billion, as compared to an average of $500 million five years ago.[10] The study identified *improper revenue recognition* as the major cause for these restatements and for the largest resultant decreases in stock prices.[11] The resultant negative impact on the market price of those restating companies' securities, before one even considers the disastrous systemic effect on market prices generally, has been well over $100 billion.[12] These restatements have led to civil and criminal proceedings brought, respectively, by the U.S. Securities and Ex-

5. *Id.* at 74. *See generally* HOWARD M. SCHILIT, FINANCIAL SHENANIGANS (2d ed. 2002); *Badly in Need of Repair*, ECONOMIST, May 2, 2002, at 66. For an insightful discourse on the endemic immorality of corporate management, the destructive impact of congressional and judicial deregulation, and the monitoring failures of the U.S. Securities and Exchange Commission (SEC) and the legal and accounting professions, see William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders, The Rise of the New Corporate Kleptocracy*, 8 STAN. J. L. BUS. & FIN. 69 (2002).

6. John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1407 (2002).

7. *See* Ianthe Jeanne Dugan, *Did You Hear the One About the Accountant? It's Not Very Funny*, WALL ST. J., Mar. 14, 2002, at A1.

8. U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES, GAO-03-138 (Oct. 2002) [hereinafter GAO RESTATEMENTS REPORT]; *see* Richard Hill, GAO Report Finds Restatements Rising; Revenue Recognition is Biggest Culprit, 34 Sec. Reg. & L. Rep. (BNA) 1771 (Oct. 28, 2002); *see also* Matt Krantz, *More Earnings Restatements on Way: Trend Growing, GAO Warns*, USA TODAY, Oct. 25, 2002, at 3B. The SEC Enforcement Director recently reported a huge spike in the SEC's financial reporting enforcement actions during 2002, rising to 149 actions from 112 in 2001 and 103 in 2000. *See* Kip Betz, New Regulatory, Enforcement Landscape Discouraging Legal "Creativity," Cutler Says, 34 Sec. Reg. & L. Rep. (BNA) 1582 (Sept. 30, 2002).

9. GAO RESTATEMENTS REPORT, *supra* note 8, at 14.

10. *Id.* at 17.

11. *Id.* at 19.

12. *Id.*

change Commission (SEC)[13] and the U.S. Department of Justice,[14] as well as numerous and well-publicized class actions against these corporations and their officers, directors, accountants, and lawyers.[15] The corporate defendants are not only immature, overly ambitious start-ups, but also are companies once considered among the all-stars of American capitalism, including Xerox, Enron, Global Crossing, WorldCom, Tyco, Qwest Communications, and Rite Aid.[16]

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13. *See, e.g.*, SEC v. Vinson, Accounting and Auditing Enforcement Act Release No. 1650 (Oct. 10, 2002); SEC v. Fastow, Accounting and Auditing Enforcement Act Release No. 1640 (Oct. 2, 2002); SEC v. Dunlap, Accounting and Auditing Enforcement Act Release No. 1623 (Sept. 4, 2002); SEC v. Kopper, Accounting and Auditing Enforcement Act Release No. 1617 (Aug. 21, 2002); SEC v. Oxford Health Plans, Accounting and Auditing Enforcement Act Release No. 1601 (July 25, 2002); SEC v. Adelphia Communications Corp., Accounting and Auditing Enforcement Act Release No. 1599 (July 24, 2002); SEC v. WorldCom, Inc., Accounting and Auditing Enforcement Act Release No. 1585 (June 27, 2002); SEC v. Hill, Accounting and Auditing Enforcement Act Release No. 1582 (June 21, 2002); SEC v. Xerox Corp., Accounting and Auditing Enforcement Act Release No. 1542 (Apr. 11, 2002); SEC v. Schilling, 74 S.E.C. Docket 1064 (Feb. 28, 2001); *see also* Susan Pulliam & Rebecca Blumenstein, *SEC Broadens Its Investigation into Revenue-Boosting Tricks*, WALL ST. J., May 16, 2002, at A1.

14. *See, e.g.*, United States v. Brown, No. 02-CR 1236 (S.D.N.Y. 2002); United States v. Waksal, No. 02-MAG-1186 (S.D.N.Y. 2002); United States v. Ganley, No. CR-02-007 (N.D. Cal. 2002); United States v. Thatcher, No. CR-02-0028 (N.D. Cal. 2002); United States v. Polishan, No. 3:96-CR-274 (M.D. Pa. 2002); United States v. Allan, No. CR 98-40167 (N.D. Cal. 2002); *see also* Kip Betz, Former Adelphia Exec Pleads Guilty to Securities Fraud, 34 Sec. Reg. & L. Rep. (BNA) 1860 (Nov. 18, 2002); John Herzfeld, Former WorldCom Accountants Enter Guilty Pleas for Roles in Scheme, 34 Sec. Reg. & L. Rep. (BNA) 1734 (Oct. 21, 2002); Jerry Markon, *WorldCom's Yates Pleads Guilty*, WALL ST. J., Oct. 8, 2002, at A3; James Bandler, *Xerox Faces Criminal Inquiry Tied to Financial Restatement*, WALL ST. J., Sept. 24, 2002, at A1; Calif. Jury Convicts Former Executive Accused in Scheme to Inflate Revenue, 34 Sec. Reg. & L. Rep. (BNA) 1426 (Aug. 26, 2002); Joyce Cutler, Former E-Mail Company Execs Named in Criminal, Civil Fraud Actions, 34 Sec. Reg. & L. Rep. (BNA) 231 (Feb. 11, 2002); Former Leslie Fay CFO Gets Nine Years for Role in Earnings Inflation Scheme, 34 Sec. Reg. & L. Rep. (BNA) 126 (Jan. 28, 2002).

15. *See, e.g.*, P. Schoenfeld Asset Mgmt., LLC v. Cendant Corp., 142 F. Supp. 2d 589 (D.N.J. 2001); *In re* Sunbeam Sec. Litig., 176 F. Supp. 2d 1323 (S.D. Fla. 2001); *In re* Peerless Sys. Corp. Sec. Litig., 182 F. Supp. 982 (S.D. Cal. 2002); *In re* SCB Computer Tech., Inc. Sec. Litig., 149 F. Supp. 2d 334 (W.D. Tenn. 2001); *In re* Ramp Networks, Inc. Sec. Litig., 201 F. Supp. 2d 1051 (N.D. Cal. 2002); DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385 (9th Cir. 2002); Aldridge v. A.T. Cross Corp., 284 F.3d 72 (1st Cir. 2002); *In re* Vantive Corp. Sec. Litig., 283 F.3d 1079 (9th Cir. 2002); Greebel v. FTP Software, Inc., 194 F.3d 185 (1st Cir. 1999); *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542 (6th Cir. 1999); Chu v. Sabratek Corp., 100 F. Supp. 2d 815 (N.D. Ill. 2000); Bell v. Fore Sys., Inc., No. 97-1265, 1999 U.S. Dist. LEXIS 7808 (W.D. Pa. May 25, 1999); Cooper v. Pickett, 137 F.3d 616 (9th Cir. 1997); *In re* Sys. Software Assoc., Inc. Sec. Litig., No. 97 C 177, 2000 U.S. Dist. LEXIS 3071 (N.D. Ill. Mar. 8, 2000); *In re* Northpoint Communications Group, Inc. Sec. Litig., 221 F. Supp. 2d 1090 (N.D. Cal. 2002); Sakhrani v. Brightpoint, Inc., No. IP 99-870-C H/G, 2001 U.S. Dist. LEXIS 5023 (S.D. Ind. Mar. 29, 2001); *In re* Secure Computing Corp. Sec. Litig., 184 F. Supp. 2d 980 (N.D. Cal. 2001); *In re* Galileo Corp. Shareholders Litig., 127 F. Supp. 2d 251 (D. Mass. 2001); *In re* Adaptive Broadband Sec. Litig., No. C 01-1092 SC, 2002 U.S. Dist. LEXIS 5887 (N.D. Cal. Apr. 2, 2002); Cheney v. Cyberguard Corp., No. 98-6879-CIV, 2000 U.S. Dist. LEXIS 16351 (S.D. Fla. July 31, 2001); *In re* Milestone Scientific Sec. Litig., 103 F. Supp. 2d 425 (D.N.J. 2000); Yadlosky v. Thornton, 120 F. Supp. 2d 622 (E.D. Mich. 2000); *In re* Livent, Inc. Sec. Litig., 148 F. Supp. 2d 331 (S.D.N.Y. 2001); *In re* Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371 (S.D.N.Y. 2001).

16. *See* Alex Berenson, *Tweaking Numbers to Meet Goals Comes Back to Haunt Executives*, N.Y. TIMES, June 29, 2002, at A1 (listing financial fraud investigations of Adelphia Communications, Computer Associates, Dynergy, Enron, Global Crossings, Qwest, Rite

These financial fraud scandals easily surpass in breadth and depth the last cycle of corporate immorality revealed during the massive savings and loan association failures of the 1980s.[17] While those failures primarily involved major regulatory failures in a single industry, the present scandals are systemic and generally involve a type of accounting fraud that has been variously termed *creative accounting*, *earnings management*, or *improper revenue recognition*.[18] The improper revenue recognition that has led to massively widespread overstatements of revenues has not resulted from mathematical errors, misperceptions of complex accounting principles, or good faith differences in judgment among reasonable accountants. Instead, corporate officers, working with corporate accountants, have fraudulently reported material overstatements of revenue based on contracts that were nonexistent, unperformed, or lacking economic substance. These overstatements were deliberately perpetrated by the use of deceptive schemes that corporate and securities lawyers would refer to as *manipulative devices* and what virtually everyone else would refer to as *garden-variety fraud*. These devices are just as flagrantly fraudulent as the notorious frauds of the more distant past, exemplified by Equity Funding's phony life insurance policies and fabricated death certificates[19] and Glenn Turner's Ponzi schemes.[20] The deceptive devices currently in vogue are variously known as "roundtripping," "boomer-

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Aid, Tyco International, WorldCom, and Xerox); *WorldCom: Another Cowboy Bites the Dust*, ECONOMIST, June 29, 2002, at 57 (listing a "rogues' gallery" including Enron, Global Crossing, Adelphia Communications, Peregrine Systems, Qwest Communications, WorldCom, Dynergy, ImClone, and Tyco International). Earnings restatements have resulted in shareholder derivative litigation that, during 2002 alone, has cost U.S. companies more than $1 billion in settlement payments, creating a crisis in director and officer liability insurance coverage. *See* Matthew J. Schlesinger, *Insurance Coverage Important for Directors and Officers Who Are Facing SEC Investigations or Suits Alleging Securities Fraud*, 17 CORP. COUNSEL WKLY. 328 (2002). Insurers increasingly resist coverage, seeking to rescind policies based on alleged misrepresentations in the application process. *Id.* They claim that misleading financial statements submitted with applications constitute material misrepresentations that void policies. *Id.*; *see, e.g.*, Am. Int'l Specialty Lines Ins. Co. v. Towers Fin. Corp., 1997 WL 906427 (S.D.N.Y. Sept. 12, 1997) (holding that misrepresentation of financial condition in an application was material). In addition, insurers are invoking dishonesty exclusions in policies, which are typically interpreted to permit denial of coverage upon proof of intentional dishonest, fraudulent or criminal conduct. *See, e.g.*, Little v. MGIC Indem. Corp. 836 F.2d 789 (3d Cir. 1987) (holding that dishonesty exclusion requires intentional dishonest conduct); *see also* Jonathan D. Glater & Joseph B. Treaster, *Insurers Scale Back Corporate Liability Policies*, N.Y. TIMES, Sept. 7, 2002, at B1.

17. *See* MICHAEL BINSTEIN & CHARLES BOWDEN, TRUST ME: CHARLES KEATING AND THE MISSING BILLIONS (1993); Carl Felsenfeld, *Symposium: Financial Institutions and Regulations, The S&L Crisis: Death and Transfiguration: The Savings and Loan Crisis*, 59 FORDHAM L. REV. 7 (1991); Daniel B. Gail & Joseph J. Norton, *A Decade's Journey From "Deregulation" to "Supervisory Regulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW. 1103 (1990).

18. *See generally* CHARLES W. MULFORD & EUGENE E. COMISKEY, THE FINANCIAL NUMBERS GAME, DETECTING CREATIVE ACCOUNTING PRACTICES (2002); Ken Brown, *Creative Accounting: How to Buff a Company*, WALL ST. J., Feb. 21, 2002, at C1.

19. *See* William Blundell, *A Scandal Unfolds: Some Assets Missing, Insurance Called Bogus At Equity Funding Life*, WALL ST. J., Apr. 2, 1973, at 1, col. 6; *see also* Dirks v. SEC, 463 U.S. 646 (1983).

20. *See* SEC v. Turner Enter., Inc., 474 F.2d 476 (9th Cir. 1973); *see also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

angs," "buy-backs," "fictitious orders," "conditional contracts," "cookie jar reserves," and "channel stuffing." These fraudulent practices clearly fall as much or more within the legal domain than the field of public accountancy. The fact that corporate officers are using these deceptive devices to create false numbers does not permit corporate lawyers to label these frauds as accounting problems. The abatement of these sham transactions and resultant disclosure failures is also corporate counsel's responsibility.

Again, the questions raised by Judge Stanley Sporkin in *Lincoln Savings & Loan Ass'n v. Wall* are being asked:

> Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?[21]

These questions are finally being answered. Congress, the SEC, the Justice Department, and class action securities lawyers have discovered that these professionals were there all the time, participating in the manipulation by structuring, negotiating, drafting, or rubber-stamping deceptive schemes.

Accountants for publicly-held companies do not appreciate the consequences. First, Arthur Andersen was indicted and convicted on felony charges related to the creative accounting services it performed for Enron, an apparently fatal event for the accounting firm.[22] Second, and most important, the entire accounting profession largely has forfeited its time-honored, traditionally sanctified privilege of establishing its own accounting and auditing principles and regulating itself.[23]

Similarly, corporate lawyers do not appreciate the consequences. Counsel for publicly-held companies have fought the SEC for years to protect their traditional privileges to establish their own principles of professional responsibility and to regulate themselves. They are now losing that war.[24] Corporate counsel, whether working in-house or externally,

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21. Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

22. *See* Andersen Fined $500,000, on Probation for Five Years in Enron Obstruction Case, 34 Sec. Reg. & L. Rep. (BNA) 1732 (Oct. 21, 2002); *see also* Cassell Bryan-Low, *Who Are the Winners at Andersen's Yard Sale?*, WALL ST. J., May 30, 2002, at C1.

23. Sarbanes-Oxley Act of 2002 § 201, 15 U.S.C. § 78j-1.

24. The SEC has long sought to cast corporate lawyers in the role of undercover policemen. *See, e.g.*, SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682, 712-17 (D.D.C. 1978). Although the SEC has infrequently utilized its Rule of Practice 102(e), 17 C.F.R. 201.102(e), to suspend or bar professionals from practice before the SEC for improper professional conduct, the SEC's Chairman has recently stated that if state bar associations continue to ignore SEC referrals of ethical breaches by corporate lawyers, the SEC will assume the disciplinary function. *See* Rachel McTague, Pitt Says SEC Will Take on Assignment of Disciplining Lawyers if State Bars Do Not, 34 Sec. Reg. & L. Rep. (BNA) 1529 (Sept. 23, 2002); *see also* Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section, Washington, D.C. (Aug. 12, 2002). Corporate counsel's role in the collapse of Enron Corporation, or, at least, their failure to

have been spotlighted for their role in these financial reporting frauds. In many cases, they have drafted or approved disclosure documents filed with the SEC or press releases and other publicly-disseminated information without fully disclosing their corporate clients' improper revenue recognition practices. In addition, they have negotiated or approved contracts, side agreements, and other documents that were used by corporate insiders to artificially inflate revenues. In some cases, they may have voiced objections to deceptive revenue recognition practices, but, nevertheless, acquiesced in the fraudulent conduct when their advice was not followed.

The SEC has now been joined by Congress in decisive efforts to elevate their standards of behavior. In the Public Company Accounting Reform and Investor Protection Act of 2002, popularly known as the Sarbanes-Oxley Act,[25] Congress has ordered lawyers to tell corporate directors about evidence of corporate fraud.[26] It has authorized federal regulation of corporate counsel and imposed a new federal duty to report evidence of fraud and breaches of fiduciary duty to their corporate clients' highest

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report to Enron's board of directors various transactions those counsel believed created conflicts of interest, appears to have convinced the SEC and Congress that federal regulation of lawyers was critically necessary. *See* Ellen Joan Pollack, *Limited Partners: Lawyers for Enron Faulted Its Deals, Didn't Force Issue*, WALL ST. J., May 22, 2002, at A1. An investigatory report done for Enron's board criticized its outside counsel for an absence of "objective and critical professional advice." *Id.*

25. 15 U.S.C. § 78j-1.

26. Section 307 of the Sarbanes-Oxley Act requires the SEC, within 180 days from the statute's July 30, 2002 enactment date, to adopt rules establishing minimum standards of professional conduct for attorneys and to amend its disciplinary rules specifically to require attorneys to report *evidence* of material violations of the securities laws, as well as breaches of fiduciary duty and similar violations of state law by their corporate clients to the company's highest authorities, beginning with the company's chief legal counsel or chief executive officer, and, if appropriate action is not taken, to the company's audit committee, independent directors or the board of directors as a whole. 15 U.S.C. § 7245. This congressional mandate is considerably more stringent than the American Bar Association's Model Rules of Professional Conduct, Rule 1.13, which only requires lawyers who detect *violations* to proceed as is reasonably necessary in the best interest of the company, and only *permitting* lawyers to refer the violations to the company's highest authorities. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2002).

Section 602 of the Act authorizes the SEC to censure, suspend, or deny any person the privilege of practicing before the SEC if that person is found not to possess the "requisite qualifications to represent others," or to be "lacking in character or integrity, or to have engaged in unethical or improper professional conduct," or to have willfully violated or aided and abetted a violation of the securities laws. 15 U.S.C. § 78d-3. Congress has codified SEC Rule of Practice 102(e)(1) as a new Section 4 of the Securities and Exchange Act of 1934 (1934 Act). *Id.* According to former SEC General Counsel Daniel Goelzer, the SEC could take the position that an entire law firm could be barred from SEC practice if one of the firm's lawyers has violated the SEC's minimum standards of conduct. *See Corporations Need to Take Action Now Despite Uncertainties in Sarbanes-Oxley Act*, 17 CORP. COUNSEL WKLY. 273 (2002). He has stated firms could protect themselves against disbarment by establishing and maintaining appropriate compliance programs. *Id. See generally* C. Evan Stewart, Holding Lawyers Accountable in the Post-Enron Feeding Frenzy, 34 Sec. Reg. & L. Rep. (BNA) 1587 (Sept. 30, 2002); Stephen J. Crimmins, *New U.S. Law Will Require Attorneys to Report Evidence of Corporate Client's Violations*, 8 WORLD SEC. L. REP. 31 (2002); Richard W. Painter, *Congress Tells Corporate Lawyers to Tell Directors About Fraud*, 6 WALL ST. LAW. 6 (2002); Richard B. Schmitt, *Lawyers Pressed to Report Fraud Under New Law*, WALL ST. J., July 25, 2002, at B1.

authorities, including the corporations' audit committees and boards of directors. This recently imposed duty to report evidence of fraud, enacted in an environment where most of the fraud has involved deceptive revenue recognition, requires all corporate counsel to have at least the competence of *a sophomore accounting major.* Without this minimum familiarity with basic accounting principles, corporate lawyers would be marginalized, unable to spot blatant evidence of financial fraud even while standing in its midst. The principle that basic accounting knowledge is integral to competency has long been recognized by corporate counsel engaged in due diligence for public offerings, mergers, and acquisitions.[27] Corporate counsel can no longer feign ignorance of financial fraud or simply abdicate their responsibilities to the accounting profession.

In this article, I will address, generally, the question of how lawyers must reposition themselves in their role as corporate advisors, not only to improve their traditional services in ensuring full public disclosure and compliance with other applicable laws, but also to fulfill their congressionally imposed duties to inform their clients' general counsel, chief executive officers, audit committees, and boards of directors about evidence of corporate fraud, including evidence of abusive revenue recognition practices. I will begin by focusing on our duty of competence and the intensifying demands that we develop basic accounting skills in order to competently perform our roles as corporate advisors. Many of the issues corporate counsel confront require at least a rudimentary knowledge of accounting principles, ranging from asset valuations in business formations and acquisitions to resolution of *materiality* issues in satisfying public disclosure requirements.

After my discussion of corporate counsel's enhanced duty of competence, I will analyze the materiality doctrine and describe the necessarily subordinate revenue recognition principles generally applied in connection with preparation of financial disclosures. As part of this discussion, I will explain that our continuing financial crisis may result in large measure from the continuing failure of both the legal and accounting professions to focus on the radical differences in their respective definitions of materiality. I will then describe the more commonly employed abusive revenue recognition practices that have caused the vast majority of revenue restatements in recent years.

Because improper revenue recognition has been at the core of many of the current financial scandals and continues to be a major corporate liability risk, I believe the essential competence required of corporate lawyers must include the ability to recognize the most common deceptive

27. For a general discussion of due diligence in the context of public offerings under the Securities Act of 1933, see *Escott v. BarChris Construction Corp.*, 340 F.2d 731 (2d Cir. 1965). *See also* Manning Gilbert Warren III, *The Primary Liability of Securities Lawyers*, 50 SMU L. REV. 383 (1996).

revenue recognition devices and the *red flags*[28] that indicate the possibility of their occurrence. Corporate counsel must apply these rudimentary skills for the benefit of their organizational clients not only through general vigilance, but also through random due diligence investigations to verify their clients' public disclosures. I will conclude that this enhancement of our competence will not only serve the interests of our corporate clients, but will also preserve what remains of the traditional role of the legal profession in establishing its own principles and standards of professional conduct.

II. CORPORATE COUNSEL'S DUTY OF COMPETENCE

A. THE TRADITIONAL DUTY OF COMPETENCE

The American Bar Association (ABA) has traditionally set the ethical rules for all lawyers, and, because these rules have been widely adopted by the states' highest courts, they have established the floor upon which standards for professional conduct have been built. The ABA's Model Rules[29] have been interpreted and, in many instances, amplified by the formal ethics opinions issued by the ABA's Committee on Ethics and Professional Responsibility.[30] The standards of care applicable to corporate lawyers' conduct are derived, of course, from many other sources, including the American Law Institute's (ALI) Restatement of the Law Governing Lawyers,[31] the common law of torts,[32] the SEC's administra-

28. "Red flags" have been described as those facts that come to the attention of a professional that would place a reasonable professional on notice that the client company or its officers or other employees are engaged in wrongdoing to the detriment of investors. *In re* Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1333 (M.D. Fla. 2002). One's failure to heed attention-grabbing red flags supports a reasonable inference of scienter in federal securities fraud litigation. *Id.*; *see also In re* First Merchants Acceptance Corp. Sec. Litig., 1998 WL 781118 (N.D. Ill. Nov. 4, 1998).

29. MODEL RULES OF PROF'L CONDUCT (2002). The ABA Model Rules of Professional Conduct, adopted by most of the states' highest courts, serve generally as the foundation of the corporate lawyer's standards of care. It is important to observe that these rules establish only *minimum* standards of conduct.

30. The ABA has amplified its ethical principles for lawyers through the formal opinions of its Committee on Ethics and Professional Responsibility. Perhaps the most pertinent of these formal ethics opinions are Formal Opinions 335 and 346, which specifically advised lawyers in unregistered securities transactions to fulfill their independent disclosure obligations by detecting and disclosing material facts and to do so without blind reliance on representations made by corporate representatives. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 335 (1974); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982). In Formal Opinion 92-366, lawyers were advised that they had a duty to repudiate any work product that they have reason to believe furthers future fraudulent conduct and failure to do so would be construed as assisting the client's fraud. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 92-366 (1992).

31. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS (2000). The ALI's restatement of the common law governing lawyers includes coverage at chapter four of lawyer civil liability for professional negligence, breach of fiduciary duties and other remedies, as well as vicarious liability and liability to non-clients. *Id.*

32. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 552(1) (1977). Section 552(1) provides:

> One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false informa-

tive and disciplinary proceedings,[33] and judicial opinions addressing the responsibilities of corporate lawyers.[34]

Model Rule 1.1 establishes the lawyer's basic duty of competence.[35] It provides: "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."[36] This duty readily subsumes all the other Model Rules because the broad competency concept naturally requires conduct that comports with the ethical standards of the legal profession. In fulfilling their duty of competence, corporate counsel must be especially mindful of their duty, under Model Rule 1.2(d), not to assist their clients' fraudulent conduct: "A lawyer shall not counsel a client . . . , or assist a client, in conduct that the lawyer knows is . . . fraudulent."[37] Moreover, they must always act in compliance with their own duty of honesty under Model Rule 8.4(c): "It is professional misconduct for a lawyer to . . . engage in conduct involving dishonesty, fraud, deceit or misrepresentation."[38]

In order to fulfill their duty of competence, corporate counsel must also comply with both their duty of candor under Model Rule 1.4 and their duty of independence under Model Rule 2.1. Model Rule 1.4(b) provides: "A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."[39] Model Rule 2.1 provides: "In representing a client, a lawyer shall exercise *independent* professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law, but other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."[40] The comment to Model Rule 2.1 explains that lawyers must provide their clients honest, straightforward advice, even if the advice involves "unpleasant facts and alternatives

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> tion for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Section 552 reflects a common law substitution of a foreseeability standard for the earlier requirement of privity of contract.

33. *See, e.g.*, *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Feb. 28, 1981); *In re* Keating, Muething & Klekamp, Exchange Act Release No. 15,982, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,124 (July 2, 1979); *In re* Ferguson, 5 S.E.C. Docket 37, S.E.C. Admin. Proc. File No. 3-4528 (Aug. 21, 1974); *In re* Fields, Securities Act Release No. 5404, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,407 (June 18, 1973).

34. *See, e.g.*, Molecular Tech. Corp. v. Valentine, 925 F.2d 910 (6th Cir. 1991); Breard v. Sachnoff & Weaver, Ltd., 941 F.2d 142 (2d Cir. 1991); SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973); SEC v. Frank, 388 F.2d 486 (2d Cir. 1968). *See generally* Warren, *supra* note 27; James H. Cheek, *Professional Responsibility and Self-Regulation of the Securities Lawyer*, 32 WASH. & LEE L. REV. 597 (1975).

35. MODEL RULES OF PROF'L CONDUCT R. 1.1 (2002).

36. *Id.*

37. MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002).

38. MODEL RULES OF PROF'L CONDUCT R. 8.4(c) (2002).

39. MODEL RULES OF PROF'L CONDUCT R. 1.4(b) (2002).

40. MODEL RULES OF PROF'L CONDUCT R. 2.1 (2002) (emphasis added).

that a client may be disinclined to confront" or that will be "unpalatable" to them.[41] It further provides that lawyers have a duty to offer that advice, even when clients have proposed courses of action that are likely to result in adverse legal consequences.[42]

The foregoing rules collectively establish that the competence concept is integrally related not only to lawyers' duties to maintain and apply the requisite knowledge, skill, thoroughness, and preparation in their engagements, but also to their obligations to act with honesty, independence, and candor in advising clients against all fraudulent or deceitful activities and refusing to assist them should that conduct continue.[43] Although this comprehensive duty of competence applies to all lawyers, it imposes particularly intense and difficult obligations on corporate lawyers who represent legally abstract corporate entities.

Model Rule 1.13 is emphatic in its insistence that corporate lawyers recognize that they represent their corporate, organizational clients and not the individual corporate directors, officers, or employees who may have retained them on the corporations' behalf.[44] The rule states, in effect, that if corporate counsel knows that a corporate officer or employee intends to act in violation of legal obligations to the corporation, including conduct that would be fraudulent or in breach of fiduciary duties, corporate counsel must proceed "as is reasonably necessary in the best interest of the organization," and are permitted to refer the matter up the chain to the corporation's highest authority.[45] Model Rule 1.13, by requiring corporate counsel to favor the abstract, artificial corporate entity over its corporate representatives, properly ignores the reality that corporate counsel's professional relationships have been established by and with those corporate representatives. Because the unlawful conduct of these agents will generally be attributed to the corporate principal, the organization's lawyers must fulfill their comprehensive duty of competence in protecting the organization from any harm proposed by its agents. This is the burden imposed by the traditional duty of competence and its related ethical responsibilities. Failure of corporate counsel to satisfy this burden in representing publicly-held corporate clients has substantially contributed to the endemic of financial fraud the country now endures. Congress has recognized this failure and has authorized the codification of this and other aspects of corporate counsel's fundamental ethical duties to their clients.

41. MODEL RULES OF PROF'L CONDUCT R. 2.1 cmt. (2002).
42. *Id.*
43. *See, e.g.*, ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 92-366 (1992).
44. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2002).
45. *Id.*

B. SARBANES-OXLEY ACT OF 2002

Congress, in the Sarbanes-Oxley Act, has required the SEC to rewrite Model Rule 1.13 to *require* attorneys for publicly-held companies to report not only *violations*, but also any *evidence* of violations of securities laws, fiduciary obligations, and similar misconduct up the chain of command from the organization's general counsel to its chief executive officer, audit committee, and, ultimately, to its board of directors until an appropriate resolution has been achieved.[46] This federal modification of Model Rule 1.13 is only the beginning of a new era of federal regulation of corporate counsel's conduct. Congress has further directed that the SEC adopt, within 180 days of the Act's July 30, 2002 effective date, not only rules implementing the lawyer's duty to report evidence of misconduct, as discussed above, but also a federal code of legal ethics for lawyers representing publicly-held corporations.[47]

As a result of Congress's mandate to the SEC to promulgate federal standards of professional conduct, we will see substantial preemption of the state law standards that have been traditionally applied to measure corporate counsel's professional performance. Because the SEC's response to its standards-setting mandate has not yet been framed, we cannot know how extensively the SEC will act in proposing standards for lawyer's conduct and how those standards might materially modify our present standards of professional conduct.[48] However, it is certain that the new federal ethics rules will be considerably more stringent than traditional, state-established rules and will lead to much higher national standards of care for corporate counsel.

It is equally clear that the new statutory duty to report evidence of fraud and breaches of fiduciary duty imposes an obligation on all corporate counsel to ensure that they possess a level of competence sufficient to perform that duty. The federal statutory reporting requirement will establish a new minimum standard, or floor, upon which lawyers must construct standards of care through common behavior. Lawyer behavior that comports with or improves upon this federally imposed duty will build a national standard of care that necessarily will be incorporated into the traditional duty of competency under the Model Rules. Competence for corporate lawyers now must include those skills reasonably necessary to fulfill the federally-imposed duty to recognize and report evidence of financial fraud.

Similarly, the lawyer's reporting standard and the competency level necessary to satisfy it will also be incorporated into the common law stan-

46. 15 U.S.C. § 7245 (2002).

47. *Id.*

48. The ABA understandably desires to influence the SEC's development of minimum standards of conduct for corporate attorneys. It has recently established the ABA Task Force on Implementation of Section 307 of the Sarbanes-Oxley Act of 2002 to coordinate the ABA's response to the SEC's proposals. *See* ABA Creates Task Force to Provide Views on SEC's Professional Conduct Rule, 34 Sec. Reg. & L. Rep. (BNA) 1854 (Nov. 18, 2002).

dard of care for civil liability, as expressed in the ALI's Restatement of the Law Governing Lawyers: "For purposes of liability . . . , a lawyer who owes a duty of care must exercise the competence and diligence normally exercised by lawyers in similar circumstances."[49] By undertaking this federally-imposed duty to report, the lawyer for the publicly-held company implicitly represents to the client that he or she has the requisite competence to perform the lawyer's obligation to recognize and report evidence of financial fraud. If the corporate lawyer fails to develop this competence, personal liability could result. According to a former chair of the ABA Committee on Ethics and Professional Responsibility, the Sarbanes-Oxley Act's lawyer reporting provisions constitute "a lawyer liability act."[50] However, if there is a bright side, the federal duty to report may provide corporate lawyers with considerably more leverage in convincing corporate executives to reform their conduct in making public disclosures of financial information.[51]

In order to perform *competently* the duty to recognize and report financial fraud, corporate lawyers must have at least a rudimentary understanding of basic accounting principles. As one prominent professor of corporate law has recently stated, "the professional duty of competence should compel business lawyers to obtain a minimum level of accounting knowledge."[52] Because an overwhelming number of corporate scandals in recent years have involved abusive revenue recognition practices, corporate attorneys, in order to fulfill their duty of competence, must be able to understand and recognize the recurrent types of deceptive practices that have and continue to be used to distort financial information disclosed to the SEC and the securities markets.

C. Corporate Counsel's New Duty of Competence

The SEC, in promulgating the mandatory reporting obligation and other rules of professional conduct, should specifically address the corporate lawyer's duty of competency. Corporate counsel have long been obligated to ensure that their publicly-held corporate clients fully comply with federal disclosure and other regulatory requirements imposed by the Securities Act of 1933 (1933 Act)[53] and the Securities Exchange Act of 1934 (1934 Act).[54] In addition, federal courts interpreting these requirements have repeatedly emphasized what Judge Kaufmann affirmed in *SEC v. Spectrum, Ltd.*, that "the legal profession plays a unique and piv-

49. Restatement (Third) of Law Governing Lawyers § 52(1) (2000).

50. *See* Schmitt, *supra* note 26.

51. *Id.* According to Professor Richard Painter, ethics rules imposing reporting duties on corporate counsel should provide lawyers "a lot more leverage in dealing with intransigent clients." *Id.*

52. Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 Bus. Law. 1421, 1423 (2002); *see also* Ted J. Fiflis, *Thoughts Evoked by "Accounting and the New Corporate Law,"* 50 Wash. & Lee L. Rev. 959 (1993).

53. 15 U.S.C. § 77a (2002).

54. 15 U.S.C. § 78a (2002).

otal role in the effective implementation of the securities laws."[55] More recently, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Supreme Court warned the legal profession that "any person . . . including a lawyer . . . who employs a manipulative device or makes a material misstatement (or omission) . . . may be liable as a primary violator under rule 10b-5."[56]

Thus, corporate lawyers, in protecting their corporate clients and themselves from liability under the federal securities laws, must adhere to an enhanced national standard of competency. Corporate lawyers must not only have sufficient accounting expertise to read and understand corporate financial statements, but also must possess a familiarity with generally accepted accounting principles (GAAP). In defining lawyer competency in the publicly-held corporation area of practice, the SEC should adopt a duty of competence that expressly requires basic accounting knowledge. Federal standardization of this enhanced duty of competency, given the SEC's congressional mandate to rewrite the rules of conduct for corporate lawyers, would be of significant practical benefit to the legal profession, the publicly-held corporations they represent, and to those corporations' employees, retirees, and investors.

The SEC's inclusion of basic accounting knowledge in the corporate lawyers' federal duty of competence should not prove particularly onerous. Most of the abusive practices used to perpetrate financial fraud have been remarkably easy to comprehend. It is not at all difficult to develop a familiarity with basic revenue recognition principles and the more common deceptive revenue recognition practices, including the red flags that suggest their occurrence. If corporate lawyers are to perform any meaningful role in the abatement of revenue-related fraud, they must be knowledgeable of its contours. Corporate counsel must be integrally involved in their organizational clients' public disclosure process, and, among other things, should be fully aware of their clients' revenue recognition policies, should independently verify whether those policies are being consistently applied, and should skeptically review all agreements with affiliates, as well as contracts and other arrangements used to generate late-quarter revenues. Corporate counsel's fulfillment of their enhanced duty of competency would markedly improve the mandatory disclosure process and could help restore the public's confidence in publicly-held corporations and their securities.[57]

55. SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973).

56. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994).

57. *See generally* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983).

III. MATERIALITY AND GENERAL REVENUE RECOGNITION PRINCIPLES

A. THE MATERIALITY DOCTRINE

Corporate counsel's development of the requisite competence to detect and report any form of financial fraud must begin with an understanding of the materiality doctrine. After all, the determination of materiality of information is the central issue in satisfying corporate disclosure requirements and in avoiding civil and criminal liabilities under the federal securities laws.[58] Materiality is also the central issue in the public disclosure of corporate financial results and, through its definition and related presumptions, constitutes the predominant principle of revenue recognition. It has long been said that for corporate lawyers, materiality is "the name of the game."[59] They should know that materiality is the name of the game *not only for the prose but also for the numbers* that publicly-held corporations disclose to the market.

The common law has long defined a fact as material if "a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question."[60] The Supreme Court has functionalized this definition by changing the elusive "reasonable man" to the equally elusive "reasonable investor."[61] In doing so, the Court expanded the common-law definition, changing "would attach importance" to "a substantial likelihood" that he "would attach importance" to the information at issue, in order to enable corporate executives and counsel to make materiality assessments in advance of public disclosures. The Court's definition of materiality may be restated as follows: A misrepresented fact or an omitted fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. It does not require proof of a substantial likelihood that truthful disclosure of the fact would have been a *determinative factor* in making an investment decision. Instead, it requires only a showing that the misrepresented fact or the omitted fact would have *assumed actual significance* in the deliberations of a reasonable investor. In other words, there must be a substantial likelihood that the misrepresented fact or the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.

In applying this functional, legal definition of materiality, corporate counsel must make their materiality determinations based on what they objectively believe the reasonable investor would consider important in a wide variety of company, industry, and market related contexts. Lawyers

58. *See* 15 U.S.C. §§ 77k, 77l, 77q(a), 78j(b), 78n(e) (2002).
59. RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 1000 (8th ed. 1998).
60. *See* RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (1977).
61. The Supreme Court's definition of materiality was established in *TSC Industries, Inc. v. Northway*, 426 U.S. 438 (1976), and later reaffirmed in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), and *Virginia Bankshares, Inc., v. Sandberg*, 501 U.S. 1083 (1991).

for publicly-held companies should not assume that others involved in the disclosure process understand materiality under the federal securities laws or that they are not applying inconsistent definitions of materiality. More particularly, counsel must recognize that the functional definition they use in assessing their clients' disclosure obligations may substantially differ from the definition understood or applied by the accounting profession.

Accountants generally do not have legal training and certainly do not possess the requisite expertise in the application of the securities laws or familiarity with securities fraud case law resolving materiality issues. Accountants (at least those acting without the assistance of securities lawyers) are ill-equipped to make the legal materiality determinations required by the SEC's mandatory disclosure system. Corporate counsel and their clients should not expect accountants to engage in the unauthorized practice of securities law and should not rely on accountants to resolve materiality issues on their own.

Moreover, it is critical that corporate lawyers realize that *accounting* materiality is substantially distinct from *legal* materiality. The accounting profession's traditional definition states that information is material if "the magnitude of an omission or misstatement of accounting information, in the light of surrounding circumstances, makes it probable that the judgment of a *reasonable person* relying on the information would have been changed or influenced by the omission or misstatement."[62] The more obvious contrasts between accounting materiality and legal materiality are the former's focus on the implicitly numerical *magnitude* rather than the actual *significance* of the information, its inherent limitation to accounting information, and its reference to the information's probable effect on changing the reasonable person's judgment. Moreover, although the definition requires consideration of surrounding circumstances, it fails to suggest that consideration must be given not simply to information within the accountant's rather limited domain, but to the total mix of information their corporate clients have made available to investors. Indeed, accounting materiality does not even refer to reasonable *investors*, but to the a priori rationality of reasonable *persons*.

Accountants are generally unaware of the broader context in which legal materiality assessments must be made and are not competent to make those determinations. Moreover, accountants have generally viewed the materiality doctrine as a mechanism that protects corporate clients and themselves against their own mistakes and not as a concept that facilitates a full disclosure system for the protection of investors. In a leading text on auditing standards, the authors state that "materiality represents a *cushion* that the auditor allows for the necessary imprecision in applying auditing procedures to detect misstatements of the financial

62. QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2, § 132 (Fin. Accounting Standards Bd. 1980) [hereinafter FASCON 2].

statements."[63] While acknowledging the non-existence of any authoritative standards for percentage guidelines in assessing materiality, they have stated that common guidelines used by auditors are five to ten percent of income or one percent of total assets or revenues.[64] The large gap between accountants' numerical, quantitative perspective on materiality and lawyers' more broadly contextual, qualitative perspective, may have contributed disastrously to the systemic financial fraud we have recently experienced.[65]

The necessity of legal resolutions for materiality questions becomes equally obvious when one appreciates that the assessment of materiality is far more qualitative than quantitative. This principle obviously flows

63. DAN M. GUY ET AL., AUDITING 137 (4th ed. 1996).

64. *Id.* at 137-38.

65. Another significant contributing factor to the present systemic failure in financial reporting may be the basic change over the last twenty years in auditing methodology. Generally accepted auditing standards (GAAS) have long required auditors to secure evidentiary support for their audit opinions through inspection, observation, inquiries, and confirmations. AU § 326.01. However, in what can only be described as meta-auditing, auditors have come to focus more on how their corporate clients generate financial data through computerized bookkeeping systems and internal controls rather than on actual numbers. Increasingly, auditors are moving away from their traditional methodology under which they reviewed large numbers of actual transactions to verify bookkeeping results. According to a recent study by Professors Steve Sutton and Charles Cullinan, this radical change in approach by auditors, relying more on internal controls than review of specific accounts, has resulted in a significantly reduced capacity for fraud detection. Ken Brown, *Auditors' Methods Make It Hard to Catch Fraud by Executives*, WALL ST. J., July 8, 2002, at C1. Although computer programs and internal controls may prevent fraud by low level employees, the study concludes that these controls can be readily circumvented by corporate executives. *See* Steve G. Sutton & Charles P. Cullinan, *Defrauding the Public Interest: A Critical Examination of Reengineered Audit Processes and the Likelihood of Detecting Fraud*, 13 CRITICAL PERSP. ACCT. 297 (2002). The authors, analyzing some 276 SEC enforcement actions during the period from 1987 to 1999, found that the defendant companies' chief executive officers were involved in roughly seventy percent of these frauds. *Id.*

Moreover, accountants performing the auditing function may not view fraud detection as within the scope of their relationships with their corporate clients. Audits conducted pursuant to GAAS rarely involve the authentication of underlying transactional documents. *See* Scott J. Paltrow, *Accounting-Overhaul Plans Draw Skepticism*, WALL ST. J., July 8, 2002, at C1. Despite the recommendation of an SEC panel of experts, auditors are not required to make unannounced visits to corporate client locations, surprise recounts of inventory, or requests to customers and vendors for written confirmation of underlying transactions. *Id.* According to the auditing director of the American Institute of Independent Certified Accountants, "[i]f management wants to hire their CPA to conduct a fraud investigation or a forensic audit we are more than willing to enter into those types of special engagements." *Id.* One can only conclude that if corporate counsel relies on corporate accountants and corporate accountants rely on corporate counsel to detect financial fraud, little, if any, corporate fraud will be detected.

In addition to the accounting profession's weak form materiality doctrine, its reliance on meta-auditing, and its perceived limitations on scope of review, another contributing factor to the current financial crisis may be accounting firms' unconscious bias in favor of their corporate clients' management. Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, 80 HARV. BUS. REV. 97 (2002). The authors of a recent article addressing auditor bias have concluded that the Sarbanes-Oxley Act does not address this fundamental problem. *Id.* They have recommended, among other things, that Congress impose mandatory rotation on auditing firms, prohibit auditor termination during the contract term, and bar auditors from employment by corporate clients for at least five years after the contract term. *Id.*

from the Supreme Court's refusal to adopt bright-line rules for materiality on the basis that any such rules would always be over-inclusive or under-inclusive, given the radically different disclosure contexts in which decisions must be made.[66] In fact, most decisions resolving materiality issues have not focused so much on quantitative financial reporting errors as they have on qualitative issues like managerial competence. For example, in *In re Franchard Corporation*, the SEC stated that the quality of a corporation's management was "of cardinal importance in any business," and that "evaluation of the quality of management . . . is an essential ingredient of informed investment decision."[67] The concept of qualitative materiality addresses not only managerial ability and performance, but also numerous concerns that reflect on managerial integrity, conflicts of interest, violations of criminal and civil laws, and, of course, managerial representations to investors, particularly where management has publicly emphasized the information as important to attainment of its goals. The SEC has continually affirmed the principle that qualitative criteria should predominate over quantitative criteria in making materiality determinations.

The SEC, in its Staff Accounting Bulletin 99 (SAB 99), reaffirmed its position that *no quantitative presumptions* should be followed in making materiality determinations.[68] The SEC stated that quantitative standards were not acceptable and had no support under the accounting and auditing literature.[69] The SEC issued this bulletin primarily to remind accountants and others involved in satisfying corporate disclosure obligations that percentage-based rules of thumb were critically deficient. Many accounting professionals have continued to apply a presumption that information that accounts for ten percent or more of a company's total assets, revenues, or net earnings is material, along with a corollary presumption that information that accounts for less than five percent is not material, leaving a materiality purgatory of information that accounts for five to ten percent. According to the SEC, "qualitative factors may cause misstatements of quantitatively small amounts to be material."[70] The SEC was influenced by the Financial Accounting Standards Board's position that "magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment."[71]

In SAB 99, the SEC identified a number of qualitative factors that could cause misstatements of quantitatively small amounts to be material. These factors included, among others, the following:

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66. *See* Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

67. *In re* Franchard Corp., 42 S.E.C. Docket 163 (1964).

68. SEC Staff Accounting Bulletin No. 99, Release No. SAB 99, Fed. Sec. L. Rep. (CCH) ¶ 75,563 [hereinafter SAB 99].

69. *Id.*

70. *Id.*

71. *See* FASCON 2, *supra* note 62.

- Whether the misstatement masks a change in earnings or other trends,
- Whether the misstatement hides a failure to meet analyst's expectations,
- Whether the misstatement changes a loss into income or vice versa,
- Whether the misstatement concerns an area of the company's business that has been identified as being significant to its operations or profitability,
- Whether the misstatement affects the company's compliance with loan covenants or other contractual requirements,
- Whether the misstatement results in an increase in management's compensation, and
- Whether the misstatement involves concealment of an unlawful transaction.[72]

Each of these factors explains why *quality rules quantity* in materiality determinations.

The SEC's position in SAB 99 has been highly persuasive in materiality litigation. For example, in *Ganino v. Citizens Utilities Co.*, the defendant corporation, to make up for a revenue loss in 1996, booked $22 million of guaranty fees actually received in 1995.[73] The company allegedly recognized revenues prematurely in order to manage its income trends. Because these fees accounted for only 1.7% of the company's 1996 revenue, the lower court applied the so-called five percent rule to conclude that the misstatements of revenue were immaterial.[74] The Second Circuit, agreeing with SAB 99, reversed.[75] The court held that because the corporation reached its publicly-announced earnings projections through improper revenue recognition, a reasonable investor would have considered the misstatements to have materially altered the total available mix of information about the company.[76]

Similarly, in *In re Unisys Corp. Securities Litigation*, the company's press releases touted increased demands for its services and disclosed large contracts with British Telecommunications and the U.S. government as evidence of heightened demand.[77] The corporation failed to disclose the uncertain nature of these contracts and that the revenues represented were not definitely committed.[78] The company argued that the misrepresentation was not material because each contract represented only .6% of its annual revenue.[79] Relying on the Third Circuit's opinion in *In re Westinghouse Securities Litigation*, which expressly disapproved of any reliance on a quantitative materiality threshold,[80] the court

72. SAB 99, *supra* note 68.
73. Ganino v. Citizens Utils. Co., 228 F.3d 154, 159 (2d Cir. 2000).
74. *Id.* at 158.
75. *Id.* at 171.
76. *Id.* at 166.
77. *In re* Unisys Corp. Sec. Litig., 2000 WL 1367951, at *1 (E.D. Pa. Sept. 21, 2000).
78. *Id.* at *4.
79. *Id.* at *5.
80. *In re* Westinghouse Sec. Litig., 90 F.3d 696 (3d Cir. 1996).

rejected any mathematical approach to materiality.[81] The court in *Unisys* found the disclosure of the two indefinite contracts material. It applied one of SAB 99's qualitative tests of materiality, questioning whether the misstatement concerned some portion of the company's business that had been identified as playing a significant role in the company's operations.[82] Corporate counsel should always recognize that qualitative materiality requires consideration of each piece of information in the larger totality of corporate information made available to investors.

In developing their understanding of qualitative materiality, corporate counsel have considerable resources, including the generally applicable disclosure principles set forth in the SEC's disclosure rules, numerous administrative and judicial pronouncements, and well-regarded disclosure guides.[83] In applying these principles, corporate counsel must be completely familiar with the client-specific information found in their clients' financial and compliance audits, SEC filings, press releases, and conference calls, as well as various analyses of their clients published in the financial press. Perhaps most importantly, counsel must develop their own independent understanding of the economic substance of their clients' business operations and its related plans and strategies. Obviously, this requires continual effort by counsel to inform themselves about the ongoing strengths and weaknesses of their clients' operations. By comparing their continually updated understanding of the economic substance of their clients' business operations with publicly-disseminated information about their clients, corporate counsel will be reasonably positioned to notice and inquire about inconsistencies. In many, if not most, instances, corporate counsel's diligence should result in internal resolutions of issues precluding resort to their new reporting obligations under the Sarbanes-Oxley Act of 2002.

Despite their inability to apply bright-line rules in making materiality assessments, corporate counsel should, as a practical matter, recognize and apply certain presumptions of materiality. They can be grouped into four categories: (1) information subject to obligatory disclosure under the SEC disclosure rules (the *regulatory materiality presumption*); (2) information regarding misconduct involving illegality, undisclosed self-dealing, or conduct otherwise bearing on managerial integrity (the *integrity issues presumption*); (3) information identified by the company as important to assessments of its financial position (the *emphasized information presumption*); and (4) information strongly related to issues of concern to financial analysts and journalists that have been publicly expressed (the

81. *Unisys*, 2000 WL 1367951, at *5.

82. *Id.* at *6.

83. *See, e.g.*, J. ROBERT BROWN, JR., THE REGULATION OF CORPORATE DISCLOSURE (3d ed. 1999); ARNOLD S. JACOBS, MANUAL OF CORPORATE FORMS FOR SECURITIES PRACTICE (1981); HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW (2d ed. 1998); A.A. SOMMER, JR., SECURITIES LAW TECHNIQUES (1985); ALAN S. GUTTERMAN, REGULATORY ASPECTS OF THE INITIAL PUBLIC OFFERING OF SECURITIES (1991).

public issues presumption). Although these presumptions are hardly exclusive and are not expressly established by the SEC or the courts, prudent corporate counsel have long used these presumptions both in conducting due diligence in connection with their clients' securities offerings and in resolving materiality issues incident to their clients' periodic reporting obligations, press releases and other public disclosures.

The *regulatory presumption* of materiality arises from the disclosure requirements imposed upon publicly-held corporations by the 1933 Act, the 1934 Act,[84] and by the SEC's rules and forms under both statutes. Because Congress and the SEC have made policy decisions resulting in specific mandatory disclosure of certain types of information, a strong presumption exists that information specifically required to be disclosed is material. Accordingly, "lawyers can safely assume that required disclosure items may be presumed to be material."[85] However, the corollary is not true. In other words, the failure of SEC rules to require the disclosure does not suggest that the information at issue is not material. In fact, Rule 408 under the 1933 Act states: "In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."[86] Similarly, Rule 12b-20 under the 1934 Act, and incorporated into the SEC's periodic report forms, states: "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."[87] Consequently, the determination of materiality always begins with the SEC's rules and forms, but rarely, if ever, ends there.

The *integrity issues presumption* of materiality results from the overriding significance of managerial integrity to investors. Under the standard corporate governance model, investors, as shareholders, are protected by fiduciary obligations owed to them by the directors and officers who have voluntarily assumed managerial responsibility for the corporation's assets on behalf of shareholder investors. These corporate managers, while protected themselves by a presumption of regularity in their business judgments,[88] have common law and statutory duties to investors not to engage in illegal acts,[89] self-dealing, or any other breaches of trust that would

84. *See supra* notes 53-54 and accompanying text.

85. *See* JENNINGS ET AL., *supra* note 59, at 1010; *see also* Howing Co. v. Nationwide Corp., 927 F.2d 263 (6th Cir.), *rev'd*, 502 U.S. 801 (1991) (holding that information required by SEC Rule 13e-3 created a *presumption* of materiality). "The presumed fact—that the investor would likely find disclosure of such information significant—follows from [the rule's] insistence that the information be stated." *Howing*, at 265.

86. 17 C.F.R. § 230.408 (2002).

87. 17 C.F.R. § 240.12b-20 (2002).

88. *See, e.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982). *See generally* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE (3d ed. 1989).

89. *See, e.g.*, Miller v. AT&T, 507 F.2d 759 (3d Cir. 1974).

violate their duty of loyalty.[90] Given the continual emphasis by the SEC and the courts on the critical importance of managerial integrity to investors, information related to illegal conduct or breaches of the duty of loyalty owed to shareholders should be viewed as presumptively material.[91]

The *emphasized information presumption* is based on the premise that investors in publicly-held companies place a high degree of credibility on information emphasized by management in their public disclosures. In *Virginia Bankshares, Inc. v. Sandberg*, the Court explained that investors attach a great deal of significance to corporate managers' statements of reasons, opinions, or beliefs because "[s]hareholders know that directors usually have knowledge and expertness far exceeding the normal investor's resources, and the directors' perceived superiority is magnified even further by the common knowledge that state law customarily obliges them to exercise their judgment in the shareholders' interests."[92] As emphasized by the Ninth Circuit in *In re Apple Computer Securities Litigation*, "the investing public justifiably places heavy reliance on the statements and opinions of corporate insiders."[93] Consequently, it should be presumed that there is a substantial likelihood that information emphasized by management in its press releases, conference calls, and reports would be viewed by the reasonable investor as significant in making investment decisions.

Similarly, the *public issues presumption* of materiality is based on the high degree of credibility accorded by investors to analysts' reports, as well as articles in the financial press, publicly raising issues regarding the financial positions of publicly-held companies. Information regarding these issues would generally be viewed by the reasonable investor as significant in making investment decisions. It is well-known that analysts have a duty to independently investigate the principal determinants of financial performance, competitive outlook, and major risks faced by a company. For example, if an analyst in a research report has raised serious questions about growth in quarterly sales revenues, management's disclosures regarding the issues raised by the analyst would be viewed as significant by the reasonable investor. The same would be true with respect to issues raised in the financial press. Management frequently reacts with outright denials or undertakes twists or spins to refute or neutralize the adverse impact of analysts' reports on investor perceptions about a given company. Certainly, informational issues considered important by analysts and financial journalists would also be considered important by the less sophisticated reasonable investor.

Corporate counsel who have a developed comprehension of qualitative materiality and the foregoing presumptions of materiality are well-posi-

90. *See, e.g.*, Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

91. *See, e.g.*, Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981) (holding that information involving a breach of trust or self-dealing is presumptively material).

92. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1091 (1991).

93. *In re* Apple Computer Sec. Litig., 886 F.2d 1109, 1116 (9th Cir. 1989).

tioned to address revenue recognition issues that regularly confront corporate managers. However, they also must be generally familiar with established principles of revenue recognition. Given their new federally mandated ethical responsibilities, the corporate lawyer should ignore Alexander Pope's maxim: "A little learning is a dangerous thing."[94] It has become much more dangerous, at least for lawyers, not to have a little knowledge of basic accounting principles. At the very least, corporate counsel possessing general familiarity with revenue recognition principles will tend to be less deferential and less gullible in confrontations with corporate representatives professing financial or accounting expertise.

B. General Revenue Recognition Principles

In addition to securing a fundamental grounding in the materiality doctrine, the corporate lawyer must possess at least an elemental understanding of the principles applicable to the financial determination of their corporate clients' revenues. As indicated previously, a large percentage of financial frauds in recent years have involved abusive revenue recognition practices. The appropriate recognition of revenues is largely determined by GAAP. The most important of these accounting principles, and certainly the beginning point for corporate counsel in this area, is that companies must always exalt the substance of a transaction over its form.[95] The SEC has repeatedly emphasized that the best established tenet of GAAP is that transactions must be accounted for in accordance with their substance rather than their form.[96] This is the first cardinal rule, both for corporate lawyers and corporate accountants.

The second cardinal rule for corporate counsel to recognize is that the financial statements of their clients must be prepared in accordance with GAAP or they will be presumed to be misleading under the SEC's Regulation S-X.[97] The GAAP most often referred to in the determination of

94. Alexander Pope, *An Essay on Criticism*, *in* The Complete Poetical Works of Alexander Pope 70 (Henry W. Boynton ed., Riverside Press 1903).

95. FASCON 2, *supra* note 62, § 169.

96. *In re* Cypress Bioscience, Inc., Accounting and Auditing Enforcement Act Release No. 817 (Sept. 19, 1996).

97. 17 C.F.R. § 210.4-01(a)(1) (2002). For lawyers generally unfamiliar with Regulation S-X, the accountant's counterpart to the SEC's Regulation S-K, 16 C.F.R. § 229.300 (2002), useful guidance is available. *See, e.g.*, William J. Grant, Jr., *Regulation S-X: A Primer for the Practitioner*, *in* Securities Underwriting: A Practitioner's Guide 343 (1985). Although failure to follow GAAP creates a presumption that the financial statements are misleading, the corollary is not true. In other words, compliance with GAAP does not create a presumption that the financial statements are not misleading. Recently, the SEC's chief accountant stated that financial statements technically in compliance with GAAP could still be materially misleading if those financial statements do not accurately reflect the company's financial position. Steve Liesman, *SEC Accounting Cop's Warning: Playing by Rules May Not Ward Off Fraud Issues*, Wall St. J., Feb. 12, 2002, at C1. Corporate lawyers must recognize that GAAP often provides accountants wide latitude to make judgment calls and, therefore, lawyers must act as gatekeepers in ensuring that materiality and economic substance always overrule technical GAAP decisions. *See In re* Adaptive Broadband Sec. Litig., No. C 01-1092 SC, 2002 U.S. Dist. LEXIS 5887 (N.D. Cal. Apr. 2, 2002) (GAAP violations support inference of intent to deceive); *In re* McKesson HBOC, Inc. Sec. Litig., 126 F. Supp. 2d 1248, 1273 (N.D. Cal. 2000) (observing that "books

when revenues are *realized* and, hence, should be *recognized* by a corporate enterprise, include the following:

- Recognition and Measurement in Financial Statements of Business Enterprises, Statement of Accounting Concepts No. 5 (FASCON 5),[98]
- SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101),[99]
- Revenue Recognition When Right of Return Exists, Statement of Financial Accounting Standards No. 48 (FAS 48),[100]
- American Institute of Certified Public Accountants, Software Revenue Recognition, Statement of Position No. 97-2 (SOP 97-2),[101]
- Long-Term Construction-Type Contracts, Accounting Research Bulletin No. 45 (ARB 45),[102] and
- Accounting for Performance of Construction-Type and Certain Production-Type Contracts, Statement of Position 81-1 (American Institute of Certified Public Accountants 1981) (SOP 81-1).[103]

If these principles were reduced to their simplest form, all would reiterate the adage, "[d]on't count your chickens before they hatch,"[104] perhaps adding, "and before they are unconditionally sold, shipped, delivered, and accepted by creditworthy customers."

For corporate counsel, understanding the SEC's Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101),[105] should substantially contribute to their development of the necessary familiarity with revenue recognition principles. The SEC issued this bulletin in late 1999, at least partly in response to the Treadway Commission Committee of Sponsoring Organization's (COSO) report, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies.*[106] The COSO Report concluded that over half of the financial reporting

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do not cook themselves"); Gelfer v. Pegasystems, Inc., 96 F. Supp. 2d 10, 15 (D. Mass. 2000) (violations of company's accounting standards probative of scienter); Simpson v. Specialty Retail Concepts, Inc., 908 F. Supp. 323, 328 (M.D.N.C. 1995) (GAAP violations indicate violations of antifraud rules).

98. RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, Statement of Accounting Concepts No. 5 (Fin. Accounting Standards Bd. 1984).

99. SEC Staff Accounting Bulletin No. 101, Release No. SAB 101, 64 Fed. Reg. 68,936 (Dec. 9, 1999) [hereinafter SAB 101].

100. REVENUE RECOGNITION WHEN RIGHT OF RETURN EXISTS, Statement of Financial Accounting Standards No. 48 (Fin. Accounting Standards Bd. 1981) [hereinafter FAS 48].

101. SOFTWARE REVENUE RECOGNITION, Statement of Position No. 97-2 (Am. Inst. of Certified Pub. Accountants 1997) [hereinafter SOP 97-2].

102. LONG-TERM CONSTRUCTION-TYPE CONTRACTS, Accounting Research Bulletin No. 45 (Am. Inst. of Accountants 1955). *See generally* David Herwitz, *Accounting for Long-term Construction Contracts: A Lawyer's Approach.*, 70 HARV. L. REV. 449 (1957).

103. ACCOUNTING FOR PERFORMANCE OF CONSTRUCTION-TYPE AND CERTAIN PRODUCTION-TYPE CONTRACTS, Statement of Position No. 81-1 (Am. Inst. of Certified Pub. Accountants 1981).

104. *In re* Microstrategy, Inc. Sec. Litig., 115 F. Supp. 2d 620, 638 (E.D. Va. 2000).

105. SAB 101, *supra* note 99.

106. MARK S. BEASLEY ET AL., FINANCIAL REPORTING: 1987-1997, AN ANALYSIS OF U.S. PUBLIC COMPANIES (Inst. of Internal Auditors 1999).

frauds during the ten year period had involved the overstatement of revenue. SAB 101 described the basic framework for recognizing revenues by identifying four bedrock principles, which state that revenue becomes *realized* or *realizable* and earned when all of the following criteria are satisfied:

- persuasive evidence of an arrangement exists,
- delivery has occurred or services have been rendered,
- the seller's price to the buyer is fixed or determinable, and
- collectibility is reasonably assured.

According to the SEC's former Chief Accountant, Lynn E. Turner, this general framework "could not be simpler—it is based on the common sense notion that revenue on a sale should not be recognized until the seller has fulfilled its obligations to the buyer under the sale arrangement."[107]

Shortly after the SEC issued SAB 101, an accounting professor described the SEC's bulletin as "promulgating the obvious."[108] He had conducted an undergraduate class exercise in which he asked his students what criteria should be met before a company recognized revenue. In less than four minutes, they listed three requirements: an actual sale of goods or services, a specified price, and the ability to collect. He subsequently posed the same question to a group of professional auditors, who listed the same criteria in the same amount of time. The criteria quickly identified by both students and accounting professionals are strikingly similar to the core revenue recognition principles identified in SAB 101. The accounting professor concluded, "[i]t is regrettable when the SEC feels a need to promulgate, as a formal rule, that which should be totally obvious to even marginally qualified accountants," and that "[w]e accountants need to look at ourselves and how we have participated in or even been the architects of management fraud."[109] Corporate counsel, in order to comport with their own standards of care, must also look at themselves and ask whether they too have participated in or have been the architects of management fraud. It is patently clear that they can no longer defer to the accounting profession on the larger issues of materiality and the core principles of revenue recognition.

Corporate counsel, in developing their general understanding of revenue recognition principles, could reasonably synthesize SAB 101 and its underlying GAAP as a basic rule that states as follows.

Revenue should only be recognized when:

- the company has persuasive evidence of a firm agreement,

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107. Lynn E. Turner, Revenue Recognition, Presentation at the USC SEC and Financial Reporting Institute (May 31, 2001), *available at* http://www.sec.gov/news/speech/spch495.htm.

108. Ronald M. Mano, *The SEC Promulgates the Obvious*, ACCT. TODAY, Apr. 17, 2000, at 16.

109. *Id.*; *see also* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000).

- the company has made a favorable assessment of the buyer's creditworthiness,
- the company has completed the earnings process,
- the company's goods or services have been exchanged for cash or claims to cash,
- the company's goods have been shipped to the buyer and the risks and rewards of ownership have passed to the buyer,
- the company's goods must not be subject to a right of return (unless the amount of future returns can be reasonably estimated and a reasonable reserve for returns has been established),
- the company's right to payment is not otherwise conditional, voidable or cancelable, and
- the company has satisfied the foregoing criteria within the same reporting period.

Corporate counsel should readily observe that this basic rule requires consideration of contractual performances by their corporate clients, an area that squarely falls within their education, training, and experience in handling business transactions. It would be tantamount to malpractice to abdicate their responsibilities as legal experts to corporate accountants and then cower behind those accountants when the corporate client is subsequently charged with financial fraud.

IV. COMMON DECEPTIVE REVENUE RECOGNITION PRACTICES

A general review of the more common deceptive revenue recognition practices will illustrate dramatically how far afield these schemes are from both the four bedrock principles identified by the SEC in SAB 101 and from the basic rule I have distilled from GAAP. Corporate counsel should readily recognize these practices as manipulative devices that raise material issues not only regarding corporate financial statements but also the lack of managerial integrity that permitted their use in the first place. Consequently, these schemes are virtually always accompanied by major breaches of corporate disclosure obligations to publicly disclose the actual use of these schemes, the names of managerial perpetrators and their degree of participation in structuring, executing, and approving these schemes, in addition to the actual revenues that should have been reported had these deceptive devices not been employed. These devices, all violative of GAAP, include, among others, fictitious contracts, roundtripping or boomerangs, unordered shipments, unshipped orders, misdated contracts, consignment transactions, improper bill and hold sales, ship and store sales, inventory parking, buy back transactions, contingent sales, try-buy contracts, improper right of return contracts, inflated barter transactions, cookie jar reserves, and channel stuffing. Each of these devices is described below to provide general familiarity with their peculiar characteristics.

A. Fictitious Contracts

The creation of fictitious contracts and booking nonexistent revenues from those contracts is the most extreme deceptive revenue recognition device. In order to avoid detection by auditors, corporate personnel often fabricate purchase order forms, shipping documents, and invoices. Where the fabricated contracts involve the sales of goods, corporate personnel may physically conceal the inventory purportedly sold, either by storage at different warehouses or by shipment for storage by third parties who have no obligation to make payment. Of course, this manipulative practice creates phony accounts receivable, often due from either nonexistent customers or from specially created entities that in turn sell goods or services to the company at offsetting prices in what amounts to wash transactions or simple exchanges of checks with no economic substance.

In one recent case, *SEC v. Anderson*, the SEC charged that a company's chief executive officer personally forged contracts, e-mails, purchase orders, correspondence, and an audit confirmation while creating three fake transactions and then booked $13.7 million in revenues from these nonexistent sales.[110] In one instance, the same officer simply altered a $1.5 million purchase order to $6 million worth of the company's goods and services in order to exaggerate revenues.[111] In another case, *Holmes v. Baker*, the company's headquarters allegedly would generate false invoices for aircraft engines at the end of the company's financial quarters and recognize revenues based on those invoices.[112] Subsequently, it would transmit those phony invoices by computer to its warehouses, where the company's warehouse supervisors would instruct employees not to ship the products. After the close of the quarter, the orders would be manually concealed.[113] Recognition of revenue based on fictitious orders, as indicated by this example, frequently involves numerous corporate employees, generally acting at the direction of supervisors and upper-level management.[114]

B. Roundtripping

Roundtripping is another commonly used device to create revenue in order to falsely show demonstrable growth in a corporation's business activities. To implement this device, a company simply provides funds to its customers or other third parties to finance their purchases of the company's goods or services without any reasonable expectation that these customers will ever repay those funds. The customer pays for the goods or services with the company's funds, creating revenues for the company,

110. SEC v. Anderson, 77 S.E.C. Docket 2069 (May 20, 2002).
111. *Id.*
112. Holmes v. Baker, 166 F. Supp. 2d 1362 (S.D. Fla. 2001).
113. *Id.* at 1368.
114. *See, e.g.*, SEC v. Madera Int'l, Inc., Accounting and Auditing Enforcement Act Release No. 1453 (Sept. 19, 2001).

while the customer is not expected to repay the funds advanced by the company to fund the purchase. In one case, *SEC v. Mikailli*, the company used the foregoing device, as well as two other variants.[115] In one of the other variants, the company covered the advance of funds to customers by contracting to purchase services from customers through "funded development agreements."[116] The customers never provided those services and used the company's funds to buy the company's products. In the other variant, the company made an investment in another entity and then used most of the invested funds to buy its own products.[117] As a result of these deceptive devices, the company was able to overstate its revenue over four fiscal quarters in amounts ranging from 61% to 150% per quarter.[118] In all three types of manipulative transactions, the company booked revenues by causing its own funds to take a roundtrip through the customer's or another entity's hands.

The roundtripping device has numerous variants. In a recent enforcement action, *SEC v. Hill*, the SEC charged a company's officers with fraud for recognizing revenue from a purported $3 million software sale initiated on the last day of the company's reporting period.[119] Due to the company's failure to close a large contract with a major customer by quarter-end, the company's general counsel allegedly arranged a sham transaction with a distributor. To induce this last minute sale, he orally agreed that the distributor would not have to pay for the subject software because the seller itself would effect resales to end users. He also orchestrated the provision of $4 million in letters of credit to finance the distributor's payment of the resulting $3 million receivable and delivered false board resolutions to the lender.[120] A company's recognition and reporting of revenues on these types of transactions obviously constitutes flagrant financial fraud.

C. Unordered Shipments

In order to inflate revenues, a company may ship goods to third parties that never ordered the goods and immediately book revenues represented by the price of those shipments, even though it is highly probable that the products will be returned or, in any event, that the company's invoices will never be paid. For example, in *Chu v. Sabratek Corp.*, it was alleged that the company, among other things, shipped almost $1 million of inventory to a medical firm that had never ordered from or even distributed products for the company.[121] It was also alleged that another

115. SEC v. Mikailli, Accounting and Auditing Enforcement Act Release No. 1559 (May 20, 2002).
116. *Id.*
117. *Id.*
118. *Id.*
119. SEC v. Hill, Accounting and Auditing Enforcement Act Release No. 1582 (June 21, 2002).
120. *Id.*; *see also* SEC Files Actions Against Several Officials at Software Firm, Yielding Two Settlements, 34 Sec. Reg. & L. Rep. (BNA) 1074 (July 1, 2000) at 1074.
121. Chu v. Sabratek Corp., 100 F. Supp. 2d 815, 821 (E.D. Ill. 2000).

firm received "so many [unordered] excess Sabratek pumps that they used them as impromptu workspace dividers."[122] In another case, *In re McKesson HBOC, Inc. Securities Litigation*,[123] a hospital customer engaged in negotiations with McKesson HBOC broke off negotiations on a large purchase order, but McKesson HBOC, after being told the deal was not going to close, went ahead and invoiced the sale, shipped the products, and booked the revenue.[124] According to one of McKesson HBOC's salesmen, "[i]t was common knowledge that if you thought you would get the order, and it was close to the end of quarter, then you'd tell them to ship the software."[125] Consequently, the company would book the revenue represented by the shipped product regardless of whether it was actually ordered by the customer.[126]

D. Unshipped Orders

In many instances, a company will book revenue on existent orders before shipping the ordered products. In *SEC v. Gallo*, the SEC alleged that a company's president ordered a sales manager to record the sale of the company's products prior to shipment in order to fraudulently increase the company's revenues.[127] To avoid detection, the president then ordered the chief financial officer to hold the company's books open past the quarter end while the sales manager backdated sales invoices and shipping documents.[128] These practices not only violated GAAP, but also the company's own revenue recognition policy that sales revenues would only be recognized when products were actually shipped.[129] According to the SEC, the company routinely recorded revenues prior to shipment for almost three years, primarily at the end of each quarter to increase its reported quarterly and annual revenues.[130] This practice violates GAAP largely because the company has not passed the risks and rewards of ownership in its products to customers. The company, accordingly, was not permitted to book revenue on sales of products prior to

122. *Id.* (alteration in original).
123. *In re* McKesson HBOC, Inc. Sec. Litig., 126 F. Supp. 2d 1248 (N.D. Cal. 2000).
124. *Id.*
125. *Id.* at 1257.
126. For other examples of the unordered shipment device, see *In re Adaptive Broadband Sec. Litig.*, No. C 01-1092 SC, 2002 U.S. Dist. LEXIS 5887 (N.D. Cal. Apr. 2, 2002) and *In re Beth A. Morris & Stephen H. Grant*, Accounting and Auditing Enforcement Act Release No. 1243 (Mar. 29, 2000). *See also* Calif. Firm, Executive Settle Charges; Auditor Faces Action in Reporting Case, 34 Sec. Reg. & L. Rep. (BNA) 66 (Jan. 14, 2002) (California Software Corp. settled SEC charges that the company recognized revenue on unordered shipments of software).
127. SEC v. Gallo, Accounting and Auditing Enforcement Act Release No. 1521 (Mar. 13, 2002); *see In re* IGI, Inc., 77 S.E.C. Docket 258 (Mar. 12, 2002); *In re* Donald J. Macphee, 77 S.E.C. Docket 55 (Mar. 12, 2002); *In re* William Dickson & Stephen Collins, 77 S.E.C. Docket 251 (Mar. 12, 2002); *see also* SEC Sues Former IGI President, Seeks Return of Stock Options, Bonuses, 34 Sec. Reg. & L. Rep. (BNA) 455 (Mar. 18, 2002).
128. SEC v. Gallo, Accounting and Auditing Enforcement Act Release No. 1521 (Mar. 13, 2002).
129. *Id.*
130. *Id.*

delivery to its customers.[131] In another case, *In re Secure Computing Corp. Securities Litigation*, it was alleged that the defendant company deliberately warehoused unfinished hardware ordered by the National Security Agency.[132] Despite the absence of delivery and any payment obligation, the company recognized the revenues represented by the order. The court found that, for pleading purposes, these allegations were sufficient to support a finding that the company's revenue recognition was deliberately reckless.[133]

E. Misdated Contracts and Related Timing Abuses

Companies have frequently resorted to misdating contracts in order to manipulate the timing of revenue recognition. Companies challenged by quarter-end revenue goals implement this abusive revenue recognition device by backdating contracts, thereby borrowing revenue from the current quarter to inflate revenues for the preceding quarter. In one illustrative case, a company prematurely recognized revenues in one quarter and directed its personnel to misdate packing lists, shipping records, and invoices in order to conceal that shipments were not made until the succeeding quarter.[134]

Related timing abuses are often perpetrated by companies without backdating their contracts. A company may simply elect to recognize revenues before those contracts come into existence. This fraudulent practice is best exemplified by allegations in *In re Microstrategy, Inc. Securities Litigation*.[135] According to the complaint, the company recognized license revenues in the third quarter of 1999 from a contract with NCR, even though the agreement was not finalized until the fourth quarter of 1999.[136] Because this contract accounted for almost half of the company's license revenue for the third quarter, the company's recognition of these revenues allowed the company to report a profit of $.09 per share versus a loss of $.30 per share for the quarter. In addition, it recognized revenues in the fourth quarter from two large contracts that were not executed by the parties until after the company's fiscal year ended on December 31, 1999. Again, improper revenue recognition converted substantial losses for the quarter into substantial profitability. Remarks by the company's president during a *Washington Post* interview came back to haunt him in this case. In the interview, he stated that "[i]n the public world there's a difference between 11:59 and 12:01, the last day of March."[137] He explained that if a major contract is signed at 12:01 and

131. *Id.*; *see also In re* Peritus Software Serv., Inc., Accounting and Auditing Enforcement Act Release No. 1247 (Apr. 13, 2000).
132. *In re* Secure Computing Corp. Sec. Litig., 184 F. Supp. 2d 980 (N.D. Cal. 2001).
133. *Id.* at 988-99.
134. *In re* Pinnacle Micro, Inc., Accounting and Auditing Enforcement Act Release No. 975 (Oct. 3, 1997).
135. *In re* Microstrategy, Inc. Sec. Litig., 115 F. Supp. 2d 620 (E.D. Va. 2000).
136. *Id.* at 626.
137. *Id.* at 640.

revenue is recognized in the first quarter, "the stock is up $500 million"; if the revenue is recognized in the second quarter, "you've just torched the life and livelihood of a thousand families."[138] He asked, "Would you sacrifice a thousand people's lives for one minute of integrity, or would you, like, put the clock back?" and explained that this was a dilemma he had to "deal with . . . every quarter."[139] Taking such statements into account, the court found that the company's president had "a particularized awareness of the importance of timing in accounting for contract revenues," which provided an unfortunate, but "valuable insight" into his state of mind and the issue of intent to deceive.[140]

F. Consignment Transactions

Although consignment transactions often are legitimate, they are sometimes used by a company as a fraudulent device to improperly recognize revenue. A consignment transaction may be generally described as an arrangement in which the owner of the goods transfers possession, but not title, to those goods to a third party for the purpose of effectuating sales of those goods to others. A company that recognizes revenue on the consignment itself, as opposed to recognizing revenue upon any subsequent sale of the goods, engages in an abusive revenue recognition practice. In *In re Polaroid Corporation Securities Litigation*, the plaintiff class alleged that Polaroid had recognized and reported revenue of at least $16 million in revenues on consignment film sales to a Hong Kong firm, which had no obligation to pay Polaroid until the firm had resold the film to its customers.[141] The consignment sales to this one firm, according to plaintiffs, accounted for fifteen percent of Polaroid's actual earnings for the quarter.[142] Courts consistently have found this kind of improper revenue recognition to be sufficiently flagrant to constitute fraud.[143]

G. Bill and Hold Sales

The bill and hold sales device takes various forms, but may generally be described as a manipulative technique in which the seller retains physical possession of goods ordered by the customer until the customer requests shipment to a designated location. Similar to the unshipped orders device, the company retains the risk and rewards of ownership, but nevertheless books revenue as if it has delivered these products to customers.

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138. *Id.*
139. *Id.*
140. *Id.*
141. *In re* Polaroid Corp. Sec. Litig., 134 F. Supp. 2d 176, 187 (D. Mass. 2001).
142. *Id.*
143. *See, e.g.*, Cooper v. Pickett, 137 F.3d 616, 626 (9th Cir. 1997) (overstating revenues by reporting consignment transactions as sales is materially misleading); Malone v. Microdyne Corp., 26 F.3d 471 (4th Cir. 1994) (reporting consignment transactions as sales supportive of action for securities fraud); *In re* Baan Co. Sec. Litig., 103 F. Supp. 2d 1 (D.D.C. 2000).

However, the bill and hold sales device differs because the company does not act unilaterally by booking revenues on unshipped goods, but acts bilaterally pursuant to bill and hold arrangements with various customers. Frequently, the bill and hold arrangement does not involve the customer's contractual commitments to purchase, but a conditional or contingent contract dependent on the customer's acceptance criteria.

In *In re Seriologicals Corp.*, for example, the company periodically sent pre-purchase product samples to customers for testing, pursuant to a bill and hold arrangement with its customer.[144] If the customer failed to reject the sample within six to ten weeks after receipt, the company would automatically invoice the customer for an entire lot of unshipped product and immediately recognize the revenue. The customer, however, retained the right to reject product samples and to obtain refunds of any payments if the samples did not meet its acceptance criteria. In addition, the customer never made any fixed commitment to purchase any particular lot and never specified any fixed delivery schedule. The company stored the lots at a leased warehouse until such time as the customer requested shipment, and, if and when the customer made that request, the company would ship the goods.[145] Revenue recognition under these circumstances is a highly deceptive practice. Although bill and hold arrangements, particularly where risk of loss has passed to the buyer, may not always be abusive, they generally should be viewed with suspicion.[146]

H. Ship and Store Sales

The ship and store abusive revenue recognition practice is a variant of the bill and hold device. In order to meet or exceed projected revenue goals, a company may induce customers to sign ship and store agreements pursuant to which the company will ship its products to a storage facility and immediately invoice the customer with the understanding that the customer would not have to pay for the products until it requested shipment and actually received the products. The company, by recognizing revenue at the time of invoicing and before shipment, deceptively inflates revenues, thereby distorting investor perceptions of the company's financial performance. For example, in *In re Cylink Securities Litigation*, the plaintiffs alleged that Cylink, among other misconduct, recognized revenue on a $1.3 million purchase order from Citibank which instructed

144. *In re* Seriologicals Corp., Accounting and Auditing Enforcement Act Release No. 1551 (May 1, 2002).

145. *Id.*

146. *See In re* Stewart Parness, Accounting and Auditing Enforcement Act Release No. 108 (Aug. 5, 1986). In its release, the SEC articulated the following "stringent accounting criteria" applicable to bill and hold sales: (1) the buyer, not the seller, must request the bill and hold arrangement; (2) the buyer must have a substantial business purpose for requesting the bill and hold transaction; and (3) the risks of ownership must have passed to the buyer. *Id. See generally In re* Arthur Andersen & Co., S.E.C. Docket 1346 (June 22, 1991); SEC v. Electro-Catheter Corp., Accounting and Auditing Enforcement Act Release No. 196 (July 15, 1988); *In re* Cypress Bioscience, Inc., Accounting and Auditing Enforcement Act Release No. 817 (Sept. 19, 1996).

Cylink not to invoice the sale until Citibank designated the installation site and Cylink actually shipped the ordered equipment.[147] Cylink simply shipped the equipment to a third party warehouse and recognized the revenue. The court concluded that the allegations of Cylink's premature revenue recognition provided strong circumstantial evidence that Cylink's chief financial officer acted with deliberate recklessness.[148]

I. INVENTORY PARKING

Inventory parking is a fraudulent scheme in which a company arranges with its distributors to place bogus orders for company products that they do not agree to buy in order to help the company meet its revenue goals. The company then makes a bookkeeping entry, recording the amount of the orders as revenue. In some instances, the product is actually shipped to these purported customers followed by a preauthorized return of the product in subsequent quarters. In *Bell v. Fore Systems, Inc.*, it was alleged that the defendant company reported for one quarter almost $2 million in revenue on shipments of its products to one distributor and during the subsequent three quarters virtually all of the products shipped were returned to the company.[149] The company then issued credit memos to the distributor reversing the revenue previously recorded on these transactions. The company entered similar transactions with another distributor, improperly recognizing almost $5 million in revenues for products shipped during the last week of a quarter and then authorizing the return of virtually all of the products during the following two quarters.[150]

J. BUY-BACK TRANSACTIONS

The buy-back transaction is another frequently used device to create false revenues. In this frequently used arrangement, the seller recognizes revenue on a contract after inducing a purported buyer to purchase the seller's products by promising to repurchase the same products in a subsequent reporting period. In *Holmes v. Baker*, the plaintiff class alleged the company shipped aircraft engines to various cooperative companies at the end of its quarters and immediately recognized revenues.[151] These buyers would hold the engines until after the end of the next quarter and either return the engine for credit or would break down the engines and resell the parts back to the company or its affiliates.[152] This device permitted the company to inflate its revenues through, essentially, wash transactions, which had no economic substance.

147. *In re* Cylink Sec. Litig., 178 F. Supp. 2d 1077, 1081 (N.D. Fla. 2001).
148. *Id.* at 1082; *see also In re* Navarre Corp. Sec. Litig., 299 F.3d 735 (8th Cir. 2002).
149. Bell v. Fore Sys., Inc., No. CIV.A. 97-1265, 1999 U.S. Dist. LEXIS 7808, at *7-8 (W.D. Pa. May 25, 1999).
150. *Id.* at *8.
151. Holmes v. Baker, 166 F. Supp. 2d 1362 (S.D. Fla. 2001).
152. *Id.* at 1368.

K. CONTINGENT SALES

Recognition of revenue based on contingent or conditional sales contracts has been used by numerous companies to inflate their quarter-end and year-end sales revenues. Like other abusive devices, this scheme has many variations. Generally, it involves the company's recognition of revenue on contracts that provide for eventual payment only upon the occurrence of various events not subject to its control. For example, the SEC brought an action against officers of Legato Systems, Inc., for recognizing millions of dollars in revenue on orders that were contingent on the customers' ability to resell the products through to end users or contingent on the customer's rights to return the products or to cancel the orders altogether.[153] The company's vice president, during negotiations on an order, drafted a side letter agreement providing cancellation rights, in which he stated that "this contingency may not be expressly stated in the order letter because of the impact on revenue recognition."[154] The SEC concluded that "[t]he side agreements granted rights of return or other terms that made the sales contingent, and, thus, made it improper for Legato to recognize revenue on those transactions."[155]

In the software industry, contingent contracts frequently involve the use of value added resellers that buy products from a software company for subsequent resale to end users. Payment for these products is often expressly conditioned on the value added resellers' collections on sales to their customers.[156] In another variant, payment for a company's products may be made contingent on approval by a third party. In *In re Ramp Networks, Inc. Securities Litigation*, the plaintiffs alleged that Ramp Networks improperly recognized and reported revenues on product sales to a buyer that was to resell the products to Microsoft employees.[157] Although the buyer's payment obligation allegedly was conditioned on Microsoft's testing, approval, and pricing of the products, Ramp Networks nevertheless recognized the revenues as if those conditions had been satisfied.[158] Contingent contracts obviously leave the selling company with substantial economic risks and are clearly not eligible for revenue recognition.

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153. *In Re* Legato Sys., Inc. & Stephen Wise, Accounting and Auditing Enforcement Act Release No. 1557 (May 20, 2002).

154. *Id.*

155. *Id.*

156. *See, e.g.*, DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385 (9th Cir. 2002); Cheney v. Cyberguard Corp., No. 98-6879-CIV, 2000 U.S. Dist. LEXIS 16351 (S.D. Fla. July 31, 2000). See SOP 97-2, *supra* note 101, which provides, among other things, that if a company's arrangement to deliver software does not require significant production, modification or customization of the software, revenue should be recognized only when all of the following criteria are satisfied: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the seller's fee is fixed or determinable, and (4) revenue collectibility is reasonably probable.

157. *In re* Ramp Networks, Inc. Sec. Litig., 201 F. Supp. 2d 1051, 1069 (N.D. Cal. 2002).

158. *Id.* at 1069-70.

L. Right of Return Contracts

As this designation suggests, right of return or "take back" contracts are contracts providing customers with a right to return products after shipment and delivery. Companies frequently use these types of contracts to induce customers to purchase their products, particularly in situations where a particular product is in its developmental stage or where the customer is a middleman and positioned to demand a right of return if unable to sell the product to end customers. A company that proceeds to recognize revenue on these contracts despite the possibility of return clearly transgresses applicable accounting principles. Unless the company has booked appropriate reserves for the reasonable likelihood of returns, recording revenue on contracts subject to a right of return is blatantly improper.[159]

M. Try-Buy Contracts

The try-buy contracts device involves a company's practice of recognizing revenues upon delivery of its products to customers on a trial basis. It is a frequently used variant of right of return contracts, and only becomes a mechanism for abuse when a company elects to prematurely recognize revenues. Try-buy contracts are ineligible for such recognition because these sales contracts are incomplete. For example, in *In re Sensormatic Electronics Corp. Securities Litigation*, the plaintiff class alleged that the company, instead of delaying recognition of revenue until final acceptance of its products and completion of the sales, artificially inflated revenues by prematurely recognizing revenues from try-buy contracts.[160] These allegations, taken together with other alleged misleading disclosures, were found sufficiently particularized to overcome the defendant's motion to dismiss.[161]

N. Inflated Barter Transactions

It is not uncommon for companies to exchange nonmonetary assets, and these exchanges may result in appropriate recognition of revenues if the valuations of the exchanged assets are reasonable. However, a company may act abusively by blatantly overvaluing the assets received while undervaluing the assets transferred in order to recognize exaggerated rev-

159. *See* FAS 48, *supra* note 100; *see also* Aldridge v. A.T. Cross Corp., 284 F.3d 72, 81 (1st Cir. 2002) (dealing with allegations of improper revenue recognition on sales of CrossPads subject to a take back guarantee); *In re* Telzon Corp. Sec. Litig., No. 5:98-CV-2876, 2000 U.S. Dist. LEXIS 20192 (N.D. Ohio Sept. 29, 2000) (considering allegations of improper revenue recognition for goods shipped subject to right of return); *In re* Scholastic Corp. Sec. Litig., 252 F.3d 63, 73 (2d Cir. 2001), *cert. denied*, 534 U.S. 1071 (2001) (allegations of improper revenue recognition on book shipments subject to right of return); SEC v. Sys. Software Assoc., Inc., Accounting and Auditing Enforcement Act Release No. 1285 (July 14, 2000) (regarding improper revenue recognition on shipment of dysfunctional software).

160. *In re* Sensormatic Elecs. Corp., No. 01-8346-CIV, 2002 U.S. Dist. LEXIS 10715, at *9 (S.D. Fla. June 8, 2002).

161. *Id.* at *20.

enues from the transaction. Under GAAP, in order to recognize revenue from a barter transaction, a company must establish not only the fair value of either the property it transferred or the property it received but also that the ascribed value of the property received reasonably reflects the company's expected actual use of the property.[162] Exchanges between parties to a barter transaction of offsetting monetary consideration, such as a swap of checks or promissory notes for roughly equal amounts, cannot be used to evidence the fair value of the transaction.[163] Recently, the SEC charged Critical Path, Inc., an e-mail services company, with violations of the federal securities laws for its deceptive recognition of over $3 million in revenues from an inflated barter transaction with a third party.[164] In order to meet the company's profitability projections, it allegedly employed an inflated barter transaction without fairly valuing the assets exchanged by both parties to the transaction.[165] The SEC has frequently treated these transactions as transparent shams.[166]

O. Cookie Jar Reserves

The use of so-called cookie jar reserves to time and inflate revenue recognized by a company has become the subject of increasing scrutiny in recent years by both the SEC and the plaintiffs' bar. A company, in order to develop a resource for smoothing out or otherwise inflating revenues in future reporting periods, may create inflated reserves for future contingencies. If it significantly overreserves for those contingencies, a company will have created a pool of potential revenues available to mask future revenue shortfalls. It can produce these revenues at any time by reducing the reserves. Perhaps the most abusive use of these cookie jar reserves was reflected by the behavior of "Chainsaw Al" Dunlap and his confederates at Sunbeam.[167]

In order to reinforce his reputation as a corporate turnaround wizard, Dunlap caused the creation of exaggerated reserves for unlikely contingencies to provide a source of inflated revenues whenever necessary in the future. By creating excessive reserves in the disastrous year when he came to power, Dunlap positioned himself to inflate Sunbeam's income in the successive year, enabling him to produce the false picture of a rapid

162. Accounting for Nonmonetary Transactions, APB Opinion No. 29 (Accounting Principles Bd. 1973).

163. Accounting for Advertising Barter Transactions, Emerging Issues Task Force No. 99-17, ¶ 4 (Fin. Accounting Standards Bd. 1999).

164. *In re* Critical Path, Inc., Accounting and Auditing Enforcement Act Release No. 1503 (Feb. 5, 2002).

165. *Id.*

166. *See, e.g.*, SEC v. Ickovics, S.E.C. Docket 1681 (Sept. 28, 1999).

167. *See* SEC v. Dunlap, Accounting and Auditing Enforcement Act Release No. 1395 (May 15, 2001); *In re* David C. Fannin, Accounting and Auditing Enforcement Act Release No. 1394 (May 15, 2001); *In re* Sunbeam Corp., Accounting and Auditing Enforcement Act Release No. 1393 (May 15, 2001); *see also* SEC v. Dunlap, No. 01-8437-CIV, 2002 U.S. Dist. LEXIS 10769 (S.D. Fla. Mar. 27, 2002); *In re* Sunbeam Sec. Litig., 176 F. Supp. 2d 1323 (S.D. Fla. 2001).

turnaround in Sunbeam's financial performance.[168] As a result of his abusive behavior at Sunbeam, Dunlap paid the largest fine ever assessed against an individual in a financial fraud action, was forever barred from serving as an officer or director of a publicly-held company, and was forced to personally shell out $15 million to settle a related class action for fraud.[169]

The SEC is now vigorously prosecuting companies that it determines are using cookie jar reserves to smooth out earnings. It recently settled charges against Microsoft that the company had created unsubstantiated reserves in order to manipulate future earnings reports.[170] The SEC claimed that the company, during the three-year period from 1995 to 1998, had created numerous reserve accounts totaling $200 to $900 million that did not have properly substantiated bases and documentary support. Fortunately for Microsoft, the SEC apparently did not have sufficient evidence to prove that Microsoft's improper revenue recognition actually caused losses to investors, especially since the company demonstrated offsetting understatements of revenue. Consequently, the SEC did not require Microsoft to restate any financial results.[171] Given the recent emphasis the SEC has placed on the exploitation of reserves to manage or otherwise manipulate revenue, corporate counsel should be particularly wary of this revenue recognition device.[172]

P. CHANNEL STUFFING

The term "channel stuffing" refers to a sales practice frequently employed by publicly-held companies to artificially increase revenues to meet Wall Street expectations by inducing their distributors, typically through price cuts, extended payment and delivery terms, and other incentives, to purchase more product than they would have purchased in the normal course of business. Channel stuffing is often compounded by the accompanying use of other deceptive revenue recognition devices, including side agreements providing distributors or other customers with generous rights of return, conditional payment obligations, or cancellation rights. Although channel stuffing allows a manufacturing company to meet financial targets in a given quarter and thus satisfy market expec-

168. *See* SEC v. Dunlap, Accounting and Auditing Enforcement Act Release No. 1395 (May 15, 2001).

169. SEC v. Dunlap, Accounting and Auditing Enforcement Act Release No. 1623 (Sept. 4, 2002); *see also* Floyd Norris, *Former Sunbeam Chief Agrees to Ban and a Fine of $500,000*, N.Y. TIMES, Sept. 5, 2002, at C1.

170. *In re* Microsoft Corp., Auditing and Accounting Enforcement Act Release No. 1563 (June 3, 2002); *see also* SEC, Microsoft Settle Charges Company Skewed Earnings Reports, 34 Sec. Reg. & L. Rep. (BNA) 945 (June 10, 2002).

171. *In re* Microsoft Corp., Accounting and Auditing Enforcement Act Release No. 1563 (June 3, 2002).

172. *See, e.g.*, SEC v. Xerox, Accounting and Auditing Enforcement Act Release No. 1542 (Apr. 11, 2002); James Bandler & Mark Maremont, *Harsh Spotlight: Accountant's Work with Xerox Sets New Test for SEC*, WALL ST. J., May 6, 2002, at A1; *see also* SEC v. Guenther, Accounting and Auditing Enforcement Act Release No. 1489 (Jan. 8, 2002); P. Schoenfeld Asset Mgmt., LLC v. Cendant Corp., 142 F. Supp. 2d 589 (D.N.J. 2001).

tations, it generally leads to reduced revenues in succeeding periods because distributors would then have a greater supply of inventory than needed to satisfy their own customers' requirements in the ordinary course of business.

Some indications or red flags suggesting that channel stuffing may have occurred include large quarter-end sales, significant increases in accounts receivables, special late quarter discounts, extended payment terms, and distributors' receipt of large, one-time shipments in excess of current inventory requirements. While channel stuffing may not be inherently fraudulent, companies employing this device have duties to disclose both its use and the material impact it will likely have on future revenues.[173] Companies rarely, if ever, confess their use of this practice, and its use generally contradicts their public disclosures regarding both their distribution and revenue recognition policies, as well as previously announced business trends.[174] Consequently, companies engaged in undisclosed channel stuffing fraudulently distort investor perceptions and artificially inflate the market value of their securities.

The deceptive revenue recognition devices identified above are those that have been the most frequently exposed in recent years by SEC investigations and private securities fraud litigation. Variants of these devices and a host of more creatively fraudulent schemes have been and continue to be exploited to inflate corporate revenues in order to deceive investors and the marketplace. However, the ones I have described should be sufficient to alert the corporate bar that these frauds are being used with impunity, that they involve deception that has little to do with mathematical questions or accounting complexities, and that perhaps no profession is any better equipped than corporate counsel to identify these deceptive practices and report evidence of their use to their corporate clients' highest authorities. This is their federal mandate under the Sarbanes-Oxley Act of 2002, under the ABA Model Rules of Professional Conduct, and under their evolving standards of care.

Corporate counsel obviously must be familiar with each of the commonly used fraudulent revenue recognition schemes if they are to protect the interest of their publicly-held organizational clients. These practices, even apart from their actual impact on reported financial results, may constitute manipulative devices prohibited by federal securities laws. Clearly, corporate counsel must possess a fundamental understanding of their clients' businesses and general familiarity with these abusive practices. However, they must become better positioned to detect the actual

173. For examples of alleged channel stuffing, see *In re Trex Co., Inc. Sec. Litig.*, 212 F. Supp. 2d 596 (W.D. Va. 2002), *Harvey M. Jasper Ret. Trust v. Ivax Corp.*, 920 F. Supp. 1260 (S.D. Fl. 1995), and *In re Compaq Sec. Litig.*, 848 F. Supp. 1307 (S.D. Tex. 1993).

174. Management's discussion and analysis "shall provide information . . . with respect to liquidity, capital resources and results of operations," including "any known trends or . . . uncertainties" that are reasonably believed to "have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a) (2002).

use of these devices. They should undertake independent, random inquiries of their clients' personnel engaged in sales, marketing, and distribution of the clients' goods and services, as well as inquiries of their clients' distributors and other major customers. They should also review contractual arrangements and documentation used by their clients in effecting sales to customers, and, especially, all revenue producing agreements with their clients' affiliates. In making these inquiries, corporate counsel should be particularly vigilant regarding late quarter revenue generation. They must recognize that corporate personnel are subject to mounting pressures to achieve projected results during the final weeks of reporting periods, and, hence, more likely to succumb to fraudulent techniques. This is not to suggest that counsel engage in full-blown due diligence for all periodic reports, press releases, and other public disclosures.

For counsel to be effective professional participants in their corporate clients' disclosure processes, they must engage in a modified, or short-form, due diligence investigation to protect their clients and their clients' shareholder owners from internally generated financial fraud.[175] In implementing this recommended short-form due diligence, corporate counsel will develop the parameters of their clients' random due diligence and thereby set their own standards as professionals representing publicly-held corporations. Should corporate counsel fail to recognize their enhanced responsibilities in the detection, abatement, and disclosure of financial fraud, they and their firms may reap the whirlwind suffered by Arthur Andersen.

V. CONCLUSION

In this article, I have noted that corporate counsel, working in an environment of systemic financial fraud, have lost whatever comfort they have enjoyed in treating accounting standards as off-limits to their world of legal principles. I have discussed their evolving duty of competence, and the critical link between the materiality doctrine and elemental accounting principles, particularly those addressing the proper recognition of corporate revenues. The legal and accounting professions have not understood the critical differences in their respective definitions of materiality and their respective perceptions of their roles in ensuring full dis-

175. In the *Report of the SEC Advisory Committee on Capital Formation and Regulatory Processes*, it was noted that a significant portion of publicly-held companies reporting under the 1934 Act did not access public markets and, consequently, are never subjected to the due diligence investigations contemplated by the 1933 Act. *See* S.E.C. Release No. 33-7314, S.E.C. Docket 1046 (July 25, 1996). The committee concluded that because the secondary or trading markets dwarf the primary markets for these companies' securities, the present disclosure system disserves the investing public by imposing higher disclosure standards on episodic public offerings than on the periodic reports filed by publicly-held companies. *Id.* It specifically recommended that these companies establish a "disclosure committee" of outside directors to investigate periodic disclosures on a continuous basis. *Id.* While I concur fully with this recommendation, I believe corporate counsel, in fulfilling their own independent duties of competency, must conduct their own investigations on a random basis.

closure to investors in the prose and the numbers that publicly-held companies must disseminate. In my discussion of the materiality doctrine, I have emphasized that quality rules quantity and have synthesized from materiality law and practice four vitally important materiality presumptions corporate counsel should apply in making materiality assessments. I have then described the GAAP that should be applied before publicly-held companies recognize and report revenues. In doing so, I have intended not only to demystify those principles but also to expose for corporate counsel the essentially legal, contractual nature of many of the applicable criteria. Last, I have briefly described the more commonly used deceptive revenue recognition practices.

While my coverage of these abusive practices has not been exhaustive in any sense, I have set forth their primary elements to demonstrate that these practices, all variants "on a limited catalog of established themes,"[176] are each fraudulent and manipulative devices corporate counsel must recognize in order to ensure their clients' compliance with federal disclosure laws. In Congress's opinion, as expressed in the politically reactive Sarbanes-Oxley Act of 2002, corporate counsel's failure to do so has forfeited their traditional privilege to regulate their own behavior in providing professional services to publicly-held corporate clients.

The SEC will soon promulgate standards of professional conduct for corporate counsel pursuant to its Congressional mandate. The SEC will require that corporate counsel honor the corporate client—not the corporate officers that retain them on the corporation's behalf—by assuming duties to report any evidence of fraud or its kindred breaches of fiduciary duties to the highest corporate authorities. To fulfill those new duties, corporate counsel must develop sufficient competence to recognize the more common deceptive recognition practices used in the past and the red flags that suggest their recurrence. This could have been done before, but for too long they have wrongfully assumed that accountants, through their auditing processes, would somehow resolve legal materiality issues regarding the financial results of their publicly-held clients and would somehow insist that those clients make the required disclosures under federal securities laws.

Now, faced with federal preemption of their standards of care, corporate lawyers must reassume their responsibilities to ensure compliance with those laws. They also must reassess their competence as professionals. As lawyers charged with responsibility for materiality assessments and compliance with complex federal securities legislation and SEC regulations, they must have a fundamental understanding of their clients' business operations and how those clients should properly measure and report their economic performance. They should also develop and implement short-form, random due diligence practices to ensure that their clients' periodic financial disclosures are not the product of manipulative

176. Richard C. Sauer, *Financial Statement Fraud: The Boundaries of Liability Under the Federal Securities Laws*, 57 BUS. LAW. 955, 957 (2002).

devices engineered by their clients' management. Corporate counsel obviously can no longer defer to the accounting profession. Although they hardly have to become accountants, attorneys can easily understand the general standards applicable to measurements of their clients' financial position. In elevating their competence, corporate lawyers will better serve the interest of their corporate clients. They may also be able to regain their role as objective professionals, setting higher standards for themselves than crisis-driven political representatives ever could.

Editors' Note: After Professor Warren's article was submitted for publication, the SEC issued Exchange Act Release No. 34-46868 (Nov. 21, 2002) proposing a fairly comprehensive rule of professional conduct for attorneys in implementation of Section 307 of the Sarbanes-Oxley Act of 2002. Under the proposed rule, both outside and in-house counsel for publicly-held reporting companies would be required, among other things, to make "up the ladder" reports of material evidence of breaches of securities laws and fiduciary duties to the chief legal counsel, audit committee, board of directors, or, alternatively, a "qualified legal compliance committee." Upon failing to obtain an appropriate response, counsel would be required to make a "noisy withdrawal," reporting the evidence of misconduct to the SEC.

After reviewing extensive comments, the SEC adopted its final rule, 17 C.F.R. § 205, but excepted out its noisy withdrawal proposal for further comments. *See SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act*, S.E.C. NEWS DIG., Jan. 24, 2003. As an alternative to noisy withdrawal, the SEC proposed that the issuer be required to publicly disclose counsel's withdrawal in its Form 8-K within two days after notice of the withdrawal. Should the issuer fail to disclose the withdrawal, counsel would be permitted to inform the SEC. *Id.* It is significant that the final rule, in defining "evidence of a material violation," establishes an objective standard, triggering up the ladder reports where counsel has credible evidence that would make it "unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur." *Id.* In order "to provide issuers, attorneys and law firms sufficient time to put in place procedures to comply with its requirements," the final rule will not become effective until 180 days after its publication in the *Federal Register*. *Id.*