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United States Accounting Standards — Rules or Principles?

The Devil Is Not in the Details

MATTHEW A. MELONE*

The proliferation of corporate scandals in the past several years has swept up individuals and institutions in a wave of negative publicity and litigation. Corporate executives, Wall Street investment banks, independent auditors, law firms, and commercial banks have all been the subject of harsh criticism and, in some cases, significant financial settlements or bankruptcy proceedings. With the remarkable demise of Arthur Andersen as a result of its role in the vast Enron fraud, much criticism has been directed toward independent auditors. In response, Congress enacted the Sarbanes-Oxley Act of 2002.¹ The Act has made significant changes to the regulation of independent auditors and modestly altered the auditor-client relationship.²

Less noticed, however, was a provision in the legislation dealing with accounting standards. Section 108(d)(1) of the Act, resurrecting an issue that has been subject to debate for some time, orders the Securities and Exchange Commission (SEC) to “conduct a study on the adoption by the U.S. financial reporting system of a principles-based accounting system.”³ Critics of the present state of U.S. accounting standards have taken the opportunity provided by the recent scandals to allege that the accounting standards were significant contributors to the making of such scandals.

Part I of this Article provides an overview of the recent accounting reform proposals put forth by the Financial Accounting Standards Board (FASB) and the SEC. Part II describes the current U.S. accounting standards-setting process. Part III analyzes the arguments in support of reform and concludes that such proposals are misguided for numerous reasons. The present system functions reasonably well, and widespread adoption of principles-based standards will do little to alleviate the alleged defects in the current system. Moreover, the existing audit

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1. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.) [hereinafter Sarbanes-Oxley Act or the Act].

2. See *infra* notes 238-51 and accompanying text.

3. Sarbanes-Oxley Act, § 108(d)(1)(A).

model is inadequate to support the wholesale adoption of such principles.

I. CALLS FOR REFORM

Critics assert that U.S. accounting standards, as a result of inordinate complexity and detail, have made it increasingly difficult for accounting professionals to fully understand and master these standards. Moreover, the emphasis that such standards place on rule-driven implementation guidance have allowed clever professionals to engineer transactions that fall safely within their literal scope yet circumvent the intent and purpose of the rules. Harvey Pitt, then chairman of the SEC, asserted:

Much of the FASB's recent guidance has become rule-driven and complex. The areas of derivatives and securitizations are examples. The emphasis on detailed rules instead of broad principles has contributed to delays in issuing timely guidance. Additionally, because the standards are developed based on rules, not broad principles, they are insufficiently flexible to accommodate future developments in the marketplace. This has resulted in accounting for unanticipated transactions that is less transparent and less consistent with basic underlying principles that should apply. The development of rule-based accounting standards has resulted in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than achieve economic objectives.⁴

The FASB has issued a proposal for the development of a principles-based approach to standard setting.⁵ In the proposal, the FASB asserts that the detail and complexity that presently exist have resulted from several factors. First, the numerous existing exceptions to the standards increase the level of detail and complexity of the standards.⁶ Moreover, such exceptions often result in the promulgation of "bright-lines" and "on-off" switches that elevate the form of the transaction over its substance.⁷ Many of the exceptions are "demand-driven."⁸ For example, application exceptions are provided to achieve a desired accounting result such as limiting earnings volatility. Transition excep-

4. PROPOSAL: PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING 2 (Fin. Accounting Standards Bd. 2002), available at <http://www.fasb.org/proposals/index.shtml> (quoting Harvey Pitt in testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs on March 21, 2002) [hereinafter PRINCIPLES-BASED APPROACH].

5. *Id.* at 1. More than three years earlier a former chairman of the FASB argued that accounting standards were too complex. See Dennis R. Beresford, *It's Time to Simplify Accounting Standards*, J. ACCT., Mar. 1999, at 65.

6. PRINCIPLES-BASED APPROACH, *supra* note 4, at 2-3.

7. *Id.* at 3.

8. *Id.* at 2.

tions are provided to mitigate the effects of adopting a new standard.⁹

A second reason for the proliferation of accounting guidance is to ensure accounting comparability among entities.¹⁰ To some extent, the numerous exceptions that are often provided appear to conflict with the stated objective of comparability. Third, detailed guidance is also sought as a form of insurance against lawsuits and regulatory second-guessing. Compliance with rules is perceived to provide a defense against allegations of negligence or fraud.¹¹ Finally, increasingly complex standards are a natural response to increasingly complex business practices.¹² A more cynical view, and one that the FASB would hardly be expected to put forth, is that detailed guidance reduces the ability of companies to “shop” accounting firms in order to obtain its preferred accounting treatment.¹³

The FASB’s proposal calls for two broad reforms. First, few, if any, exceptions to the standards would be provided.¹⁴ Second, less interpretive and implementation guidance would be forthcoming.¹⁵

9. Exceptions to the standards generally fall within one of three categories. Scope exceptions are provided in order for certain transactions to be accounted for under other standards. *Id.* at 2-3.

10. The Association of Investment Management and Research, an organization of more than 40,000 investment professionals, in a letter to Financial Accounting Standards Board, stated that, in addition to information that reflects reality, comparability of financial information from firm to firm is critical to the sound operation of U.S. capital markets. *See id.*, at 1 (quoting from the aforementioned letter). Justice Scalia places importance in the predictability of law. In his view, it is difficult to demonstrate the inconsistency of two opinions based upon a “totality of circumstances.” In his view, rules serve as a means of judicial restraint. *See Antonin Scalia, The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175, 1179-80 (1989).

11. PRINCIPLES-BASED APPROACH, *supra* note 4. Rigorous SEC enforcement has also contributed to the demand by accounting professionals for specific and detailed rules. *See generally* Stephen A. Zeff, *A Perspective on the U.S. Public/Private-Sector Approach to the Regulation of Financial Reporting*, 9 ACCT. HORIZONS 52 (1995) (citing DAVID SOLOMONS, MAKING ACCOUNTING POLICY: THE QUEST FOR CREDIBILITY IN FINANCIAL REPORTING (1986)).

12. Derivatives are a case in point. Accounting standards for derivatives have been criticized as unduly burdensome. *See generally* ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 133 (Fin. Accounting Standards Bd. 1998). In fact, the FASB has created a Derivatives Implementation Group whose sole purpose is to offer implementation guidance in accounting for such activities. *See infra* notes 41-42 and accompanying text. Derivative products are extremely complex and have caused consternation among regulators, managers, and standard setters for years. *See, e.g.*, Henry Sender, *At Freddie, A Full House of Derivatives*, WALL. ST. J., June 20, 2003, at C-1 (describing the extent of Freddie Mac’s derivative positions); Jonathan Weil, *Volatility at Fannie, Freddie? The Two Are Firm in Denial*, WALL. ST. J. June 20, 2003, at C1 (describing the impact of accounting standards on Fannie Mae and Freddie Mac, the two largest mortgage financiers in the world). Difficulties in managing the complexity of derivatives have been known for some time. Bankers Trust Co. was sued in 1994 by both Procter & Gamble Co. and Gibson Greetings, Inc. over losses that resulted from derivative transactions marketed and sold by Bankers Trust. *See* Saul Hansell, *P.&G. Sues Bankers Trust over Swap Deal*, N.Y. TIMES, Oct. 28, 1994, at D1.

13. *See Zeff, supra* note 11, at 65.

14. PRINCIPLES-BASED APPROACH, *supra* note 4, at 7-8.

15. *Id.* at 8-9.

These reforms would result in increased reliance on the professional judgment of accounting professionals. The FASB would also strengthen the existing conceptual foundation on which the standards rest and possibly provide “fair and true override” provisions in the standards.¹⁶ To a certain extent, the FASB proposal would move accounting standard setting in the United States closer to international standards.¹⁷

Pursuant to section 108(d) of the Sarbanes-Oxley Act,¹⁸ the SEC in July 2003 submitted a study on the adoption of a principles-based accounting system to the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services.¹⁹ The study recommends that U.S. accounting standards move toward a principles-based regime. The study contrasts a principles-based regime with both a rule-based and principles-only approach to accounting standard setting.²⁰ According to the SEC, a rule-based standard is characterized by bright-line tests, multiple exceptions, a high level of detail, and internal inconsistencies.²¹ A principles-only standard is one that is broad-based but offers little, if any, operational guidance.²² A principles-based

16. *Id.* at 5-7. A “fair and true override” is a mechanism that allows for accounting standards to be overridden if their application fails to reflect to substance of the transaction in question. International accounting standards commonly provide such a mechanism.

17. International Accounting Standards refer to thirty core standards promulgated by the International Accounting Standards Committee, a body that was formed in 1973 with professional representation from ten countries that has since expanded to include ninety-one countries. On May 17, 2000, the International Organization of Securities Commissions, of which the SEC is a prominent member, recommended that its members adopt the International Accounting Standards. To date, the SEC has not accepted the international standards and continues to require foreign issuers to reconcile financial statements prepared in accordance with international standards to U.S. accounting standards. See generally Maureen Peyton King, Note, *The SEC's (Changing?) Stance on IAS*, 27 BROOK J. INT'L L. 315 (2001). The FASB has undertaken steps to further the goal of converging U.S. standards with international standards. See Fin. Accounting Standards Bd., *Converging with the International Accounting Standards Board (IASB)*, at http://www.fasb.org/intl/convergence_iasb.shtml (last visited Feb. 8, 2004). The FASB has also issued a comprehensive study comparing U.S. and international standards. See IASC — U.S. COMPARISON REPORT: A REPORT ON THE SIMILARITIES AND DIFFERENCES BETWEEN IASC STANDARDS AND U.S. GAAP (Fin. Accounting Standards Bd., 2d. ed. 1999).

18. See Sarbanes-Oxley Act, § 108(d)(1)(A).

19. STUDY PURSUANT TO SECTION 108(d) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM (U.S. Sec. & Exch. Comm'n 2003), available at <http://www.sec.gov/news/studies/principlesbasedstand.htm> [hereinafter Study Pursuant to Section 108(d)].

20. The report states that current accounting standards include rule-based, principles-based, and principles-only standards. See *id.* at 24-27.

21. *Id.* at 13.

22. *Id.* at 14. The report cites two examples of principles-only standards: impairment of long-lived assets and the historical cost model of recording depreciable assets. The report asserts that these standards establish a basic principle but fail to provide sufficient guidance for the application of judgment. *Id.* at 26.

standard, in contrast, attempts to bridge these two extremes by adopting an “objectives-oriented” process.

Objectives-oriented standards are drafted in accordance with objectives set by an overarching, coherent conceptual framework and eschew exceptions and bright-line tests.²³ Moreover, such standards clearly articulate the class of transactions to which they apply and contain sufficient detailed guidance to provide practitioners with a structure to aid in their implementation.²⁴ The study, however, does not state at what point implementation guidance results in the high level of detail for which rules-based standards are criticized. It appears the SEC would welcome some, but not too much, exercise of professional judgment. The study also recommends that standards be established under a balance sheet framework in contrast to a revenue-expense framework and recommends against the promulgation of “true and fair” override provisions.²⁵ By making the distinction between principles-only and principles-based standards and opposing “true and fair” override provisions, the SEC appears to be less confident than the FASB in the ability of accountants to exercise professional judgment.

II. ACCOUNTING STANDARDS IN THE UNITED STATES

A. *Private Sector Standard Setting*

U.S. accounting standards are, for the most part, established by the private sector.²⁶ From 1939 to 1973 the American Institute of Certified Public Accountants (AICPA) or its predecessor took the lead in the promulgation of accounting standards.²⁷ From 1939 to 1959, the Commit-

23. *Id.* at 13.

24. *Id.* Several standards are categorized by the report as principles-based. Among the more salient characteristics of these standards are the absence of “bright-line tests,” few if any scope restrictions, and adequate implementation guidance. *See id.* at 25-26.

25. *Id.* at 27-29, 34. A balance sheet approach to standard setting requires that primacy be given to identifying the assets and liabilities affected by the standard. Net income consequences flow residually from the changes to assets and liabilities during the period in question. A revenue-expense approach would place primary emphasis on identifying the revenue and expense accounts affected with the residual effects flowing to the balance sheet. Although in theory both approaches should yield the same result, the study concludes that focus on revenue and expenses invariably leads to standards that are either over- or under-inclusive. I agree with the SEC position. It is conceptually cleaner to focus on the balance sheet because such items are determined at one point in time.

26. *But see infra* notes 49-63 and accompanying text (for a discussion of the role of the SEC and Congress in the promulgation of accounting standards).

27. The AICPA is the largest trade group representing certified public accountants and continues to retain a role, albeit diminished, in the establishment of accounting standards. *See infra* notes 47-48 and accompanying text. The AICPA has a more central role in the establishment of auditing standards — a role that has been substantially diminished by the Sarbanes-Oxley Act. *See infra* notes 242-45 and accompanying text.

tee on Accounting Procedure and the Committee on Terminology, composed of public accountants and academics, issued fifty-one Accounting Research Bulletins.²⁸

In 1959, the AICPA established the Accounting Principles Board to replace the Committees on Accounting Procedure and Terminology.²⁹ Like its predecessor committees, the Accounting Principles Board was composed of part-time members although its membership, with representation from industry and the financial community, possessed a more diverse background. Authoritative pronouncements, in the form of thirty-one opinions, were issued by the Accounting Principles Board between 1959 and 1973.³⁰

In 1973 the FASB, composed of seven full-time members, was created. Unlike the Accounting Principles Board or its predecessors, the FASB is independent of any other business, industry, or trade organization.³¹ The FASB establishes accounting standards in myriad fashions, the most authoritative of which is through the issuance of Statements of Financial Accounting Standards. Prior to its issuance, a Statement is subject to rigorous due process. After reaching a conclusion on an issue, the FASB issues an Exposure Draft setting forth proposed standards of financial accounting and reporting, background information, effective dates, and transition rules.³² Public comment is then solicited, and at the

28. These committees were established by the American Institute of Accountants (AIA), which was renamed the American Institute of Certified Public Accountants in 1957. At that time, the committees became part of the AICPA. In 1953, the first forty-two of the Accounting Research Bulletins were revised, restated, or withdrawn with the issuance of Accounting Research Bulletin No. 43. See *RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, ACCOUNTING RESEARCH BULLETIN NO. 43* (Am. Inst. of Certified Pub. Accountants 1953). Eight of the forty-two Accounting Research Bulletins were issued by the Committee on Terminology and were not included in the restatement and revision project that culminated in the issuance of Accounting Research Bulletin No. 43. The Committee on Terminology also issued four Accounting Terminology Bulletins.

29. At its first meeting, the Accounting Principles Board approved a resolution that the Accounting Research Bulletins and Accounting Terminology Bulletins issued by the Committee on Procedure and Committee on Terminology should be considered as continuing with the same force and degree of authority as before. See 3 *ACCOUNTING STANDARDS* 4 (2002-03).

30. The AICPA also issued numerous Accounting Interpretations, the purpose of which was to provide timely guidance and clarification on accounting issues and practices without the formal procedures required for the issuance of Opinions. These pronouncements were issued by the AICPA staff and were not pronouncements of the Accounting Principles Board. See *id.* (reprinting AICPA Notice Regarding AICPA Accounting Interpretations). See *infra* notes 69-76 and accompanying text for a discussion of the hierarchy of accounting pronouncements.

31. FASB board members are selected by the Financial Accounting Foundation, a nonprofit corporation that provides funding for and general oversight of the FASB. The Board of Trustees of the Financial Accounting Foundation is composed of members from eight constituent organizations. See *FASB Facts*, available at <http://www.fasb.org/facts> (last visited Feb. 8, 2004).

32. See *How Topics Are Added to the FASB's Technical Agenda*, available at http://www.fasb.org/facts/tech_agenda.shtml (last visited Feb. 8, 2004).

end of the exposure period and final deliberation by the FASB, a Statement is issued.³³ As of June 1, 2003, the FASB has issued 150 Statements of Financial Accounting Standards.³⁴

The FASB also issues Interpretations. These pronouncements generally deal with implementation issues that arise under existing standards.³⁵ Additional guidance is issued by the staff of the FASB in the form of Technical Bulletins. In general, Technical Bulletins are issued when the guidance provided is not expected to cause a major change in practice for a significant number of entities and such guidance will not conflict with a broad fundamental principle or create a novel accounting practice.³⁶ Technical Bulletins are issued with less extensive due process although they are first issued in proposed form and subject to public comment.³⁷

In 1984, the FASB, in an effort to more timely identify, discuss, and resolve financial accounting issues within the existing authoritative framework, formed the Emerging Issues Task Force.³⁸ This group, through consensus positions, promulgates implementation guidance to reduce diversity in practice. In many cases the issues addressed by the Emerging Issues Task Force are extremely narrow.³⁹ In other cases the Task Force addressed issues that, due to technological changes or other factors, have reached a critical mass and that have resulted in diverse positions.⁴⁰ In 1998, the FASB created the Derivatives Implementation

33. *Id.*

34. See Summaries and Status of All FASB Statements, available at <http://www.fasb.org/st/> (last visited Feb. 8, 2004).

35. FASB Interpretations may be issued for Accounting Principles Board Opinions as well as Statements of Financial Accounting Standards. See ACCOUNTING CHANGES RELATED TO THE COST OF INVENTORY, INTERPRETATION No. 1 (Fin. Accounting Standards Bd. 1974) (interpreting APB Opinion No. 20).

36. See generally PURPOSE AND SCOPE OF FASB TECHNICAL BULLETINS AND PROCEDURES FOR ISSUANCE, TECHNICAL BULLETIN 79-1 (Fin. Accounting Standards Bd. 1984).

37. *Id.*

38. See Fin. Accounting Standards Bd., Emerging Issues Task Force (EITF): General Information, at <http://www.fasb.org/eitf/index.shtml> (last visited Feb. 8, 2004). The FASB's Director of Technical Application and Implementation Activities chairs the task force. The Chief Accountant of the SEC and the chairperson of the Accounting Standards Executive Committee of the AICPA have observer status. See *id.*

39. See, e.g., SALES OF PUT OPTIONS ON ISSUER'S STOCK THAT REQUIRE OR PERMIT CASH SETTLEMENT, EMERGING ISSUES TASK FORCE ISSUE No. 96-1 (Fin. Accounting Standards Bd. 1996); REVENUE RECOGNITION ON EQUIPMENT SOLD AND SUBSEQUENTLY REPURCHASED SUBJECT TO AN OPERATING LEASE, EMERGING ISSUES TASK FORCE No. 95-4 (Fin. Accounting Standards Bd. 1995).

40. See, e.g., REPORTING REVENUE GROSS AS A PRINCIPAL VERSUS NET AS AN AGENT, EMERGING ISSUES TASK FORCE ISSUE No. 99-19 (Fin. Accounting Standards Bd. 1999); ACCOUNTING FOR ADVERTISING BARTER TRANSACTIONS, EMERGING ISSUES TASK FORCE ISSUE No. 99-17 (Fin. Accounting Standards Bd. 1999). Both of these consensus issues arose from the proliferation of Internet based transactions. The first referenced consensus issue addressed the

Group to assist the FASB in answering questions faced by companies when they began implementing *Statement of Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities*.⁴¹ This group is patterned after the Emerging Issues Task Force with certain differences.⁴²

The staff of the FASB also issues Staff Implementation Guides that address questions considered to have widespread relevance. These Guides are published in question and answer format. In February 2003, the FASB also instituted a new form of application guidance, the FASB Staff Position. The purpose of the Staff Position is to inform the accounting and financial community of the accounting or reporting treatment of transactions that have widespread relevance and for which the FASB staff believes there is a single appropriate resolution. This guidance is issued in proposed form and posted on the FASB website during a comment period after which it is posted in final form.⁴³

In 1978, the FASB began to establish a more formal foundational underpinning for the establishment of accounting standards with the issuance of *Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises*.⁴⁴ Subsequently, six additional Statements of Financial Accounting Concepts were issued, the last of which was issued in 2000.⁴⁵ These statements are intended to

accounting of exchanges of advertising on websites. The second referenced consensus issue addressed the accounting for the sale of goods via the Internet through independent warehouses.

41. STATEMENT OF ACCOUNTING STANDARDS NO. 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (Fin. Accounting Standards Bd. 1998).

42. The Derivatives Implementation Group is unique in that it has been formed prior to the effective date of the Statement of Financial Accounting Standard for which it was created. The statement became effective for all fiscal quarters of all fiscal years beginning after June 15, 1999. *Id.* § 48. Moreover, unlike the Emerging Issues Task Force, no formal voting process is in force to establish a consensus on an issue. Instead, the chair of the group has the responsibility to identify a consensus position on an issue. Tentative positions are posted on FASB's website and, once cleared by the FASB, they become part of a FASB staff implementation guide in question and answer format. See Fin. Accounting Standards Bd., Derivatives Implementation Group, at <http://www.fasb.org/derivatives/index.shtml> (last visited Feb. 8, 2004).

43. See Fin. Accounting Standards Bd., *FASB Staff Positions (FSP)*, at http://www.fasb.org/fasb_staff_positions/final_fsp.shtml (last visited Feb. 8, 2004). As of June 14, 2003 two FASB Staff Positions have been issued. See ACCOUNTING FOR INTELLECTUAL PROPERTY INFRINGEMENT INDEMNIFICATIONS UNDER FASB INTERPRETATION NO. 45, GUARANTOR'S ACCOUNTING AND DISCLOSURE REQUIREMENTS FOR GUARANTEES, INCLUDING INDIRECT GUARANTEES OF INDEBTEDNESS OF OTHER, STAFF POSITION (Fin. Accounting Standards Bd., June 11, 2003); ACCOUNTING FOR ACCRUED INTEREST RECEIVABLES UNDER FASB STATEMENT NO. 140, ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Staff Position (Fin. Accounting Standards Bd., April 14, 2003).

44. STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1, OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES, (Fin. Accounting Standards Bd. 1978).

45. See QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 2 (Fin. Accounting Standards Bd. 1980); ELEMENTS OF FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES: STATEMENT OF FINANCIAL ACCOUNTING

establish objectives and concepts that the FASB itself will use in developing standards. They are non-authoritative and do not establish generally accepted accounting principles.⁴⁶ The FASB intended itself as the most direct beneficiary of the guidance provided by these statements, principally as tools for resolving issues.

The AICPA, despite the demise of the Accounting Principles Board in 1973, continues to have a role in the promulgation of accounting standards.⁴⁷ After the FASB replaced the Accounting Principles Board in 1973, the AICPA formed the Accounting Standards Executive Committee to serve as the AICPA's senior technical committee on accounting matters. This committee issues letters of comment and public statements concerning accounting issues. This committee will often take up certain narrow issues for resolution under FASB oversight. The AICPA Accounting Standards Team staffs the committee and issues AICPA Statements of Position, Accounting and Auditing Guides, and Practice Bulletins.⁴⁸

CONCEPTS NO. 3 (Fin. Accounting Standards Bd. 1980); OBJECTIVES OF FINANCIAL REPORTING BY NONBUSINESS ORGANIZATIONS, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 4 (Fin. Accounting Standards Bd. 1980); RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 5 (Fin. Accounting Standards Bd. 1984); ELEMENTS OF FINANCIAL STATEMENTS: A REPLACEMENT OF FASB CONCEPTS STATEMENT NO. 3 (INCORPORATING AN AMENDMENT OF FASB CONCEPTS STATEMENT NO. 2), STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6 (Fin. Accounting Standards Bd. 1985); USING CASH FLOW INFORMATION AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 7 (Fin. Accounting Standards Bd. 2000). The sixth concept statement superceded the third. Therefore, six Statements of Financial Accounting Concepts are currently in force.

46. See *infra* notes 76-77 and accompanying text.

47. The AICPA is the primary private sector provider of auditing standards. See *infra* notes 64-66, 242-45 and accompanying text for a discussion of the AICPA's role in setting auditing standards and the increased public sector role as a result of the Sarbanes-Oxley Act of 2002.

48. Statements of Position provide guidance on financial accounting and reporting matters, typically for specialized transactions or industries, which are not otherwise covered in other authoritative literature. See, e.g., ACCOUNTING BY PRODUCERS OR DISTRIBUTORS OF FILMS, STATEMENT OF POSITION 00-2 (Am. Inst. of Certified Pub. Accountants 2000); REPORTING ON THE COSTS OF START-UP ACTIVITIES, STATEMENT OF POSITION 98-5 (Am. Inst. of Certified Pub. Accountants 1998); REPORTING ON ADVERTISING COSTS, STATEMENT OF POSITION 93-7 (Am. Inst. of Certified Pub. Accountants 1993). Audit and Accounting Guides provide guidance to auditors in examining and reporting on financial statements. Audit and Accounting Guides also provide guidance to auditors and accountants on an industry-wide basis. For example, Audit and Accounting Guides have been issued for the casino, airline, insurance, health care, and construction industries. Statements of Position and Accounting and Audit Guides that contain auditing guidance must be approved by the Director and Chair of the AICPA's Auditing Standards Board. Practice Bulletins address narrow reporting or accounting issues. For example, among the Practice Bulletins that have been issued are those that provide guidance on foreign debt-equity swaps, direct response advertising, and accounting by Limited Liability Companies and Limited Liability Partnerships. Statements of Position and Accounting and Auditing Guides are considered to be of equal authoritative weight and are the most authoritative guidance issued by the AICPA with respect to accounting standards. Practice Bulletins, although considered

B. *Public Sector Input*

The establishment of accounting standards is not left exclusively to the private sector. The SEC possesses the statutory authority to establish financial accounting and reporting standards for public companies.⁴⁹ The SEC has generally relied on the private sector for the establishment of accounting principles.⁵⁰ The SEC does, however, guide the form and substance of disclosure of financial information through Regulation S-X, which sets forth rules for preparation of SEC filings and audited financial statements required by the Securities Act of 1933 and the Securities Exchange Act of 1934.⁵¹

In addition, from 1937 to 1982, the SEC issued 307 Accounting Series Releases containing the SEC's position on accounting and auditing matters.⁵² In 1982, Accounting Series Releases were replaced by Financial Reporting Releases and Accounting and Auditing Enforcement Releases, the latter communicating enforcement actions taken against auditors.⁵³ In 1975, the SEC's Division of Corporate Finance and Office of the Chief Accountant began issuing Staff Accounting Bulletins. These pronouncements reflect the views of the SEC staff regarding accounting related disclosure practices but are not considered rules of the SEC nor are they officially approved by the SEC.⁵⁴ Oftentimes, the requirements of SEC pronouncements create redundancies with private sector requirements.⁵⁵

authoritative, are ranked below both Statements of Position and Accounting and Auditing Guides in the standards hierarchy. See *infra* note 77 and accompanying text. For a listing of AICPA Statements of Position, Accounting and Auditing Guides, and Practice Bulletins, see 3 ACCOUNTING STANDARDS, *supra* note 29.

49. The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted by Congress in the aftermath of the 1929 stock market crash, the former primarily regulating registration disclosure requirements for companies contemplating a public offering of securities and the latter regulates the periodic reporting of companies whose securities are publicly traded. The SEC has broad authority under these statutes to regulate the disclosure of financial and accounting information. See generally James D. Redwood, *Qualitative Materiality Under SEC Proxy Rules and the Fifth Amendment: A Disclosure Accident Waiting to Happen or Two Ships Passing in the Night?*, 1992 WIS. L. REV. 315, 322 (1992) (describing the broad authority of the SEC to promulgate disclosure rules).

50. In 1973, the SEC publicly announced, in Accounting Series Release No. 150, that the standards promulgated by the FASB will be considered to have substantial authoritative support. Prior to the issuance of this release, the policy had never been publicly enunciated. For a general discussion of the SEC's approach to the setting of accounting standards, see Zeff, *supra* note 11. See also Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 144-48 (2003).

51. See 17 C.F.R. § 229 (2003).

52. See Zeff, *supra* note 11, at 63.

53. *Id.*

54. See U.S. Sec. & Exch. Comm'n, *Selected Staff Accounting Bulletins*, at <http://www.sec.gov/interp/account.shtml> (last visited Feb. 8, 2004); see also Zeff, *supra* note 13, at 56.

55. The Business Reporting Research Project, sponsored by the FASB, issued a report

The SEC also provides significant input to the private sector standard setters. SEC staff members communicate frequently with the staffs of the FASB and AICPA. The Chief Accountant of the SEC attends the quarterly meetings of FASB's Advisory Council and is an observer at meetings of the Emerging Issues Task Force.⁵⁶ Occasionally, the SEC will request that a standard setting body provide guidance on an issue. For example, the SEC Chief Accountant, in a 1999 letter to the FASB Director of Research and Technical Activities, provided a list of issues that the SEC believed should be addressed by the Emerging Issues Task Force.⁵⁷ Guidance was subsequently provided for several of the issues specified in the letter.⁵⁸ Moreover, many SEC Chief Accountants have occupied important standards-setting positions in the private sector.⁵⁹

On occasion, accounting standards capture the attention of Congress, generally when influential constituencies are sufficiently opposed to a proposed accounting standard. The two most noteworthy examples of congressional interference with accounting standards are with respect to the accounting for the investment tax credit and the issuance of compensatory stock options.⁶⁰ The accounting for the issuance of compensatory stock options remains a controversial subject and is discussed below.⁶¹

The investment tax credit, enacted during the Kennedy administra-

identifying the redundancies that exist between generally accepted accounting principles and SEC disclosure requirements. GAAP-SEC DISCLOSURE REQUIREMENTS (Fin. Accounting Standards Bd., Mar. 6, 2001), available at <http://www.fasb.org/brtp/brtp3.shtml>.

56. See *supra* note 40 and accompanying text. See also Luppino, *supra* note 54, at 140-42; Zeff, *supra* note 13. The Financial Accounting Standards Advisory Council was formed in 1973 and its primary function is to advise the FASB on issues on the FASB's agenda and suggest possible new agenda items. Its members are drawn primarily from the executives in industry, senior partners of public accounting firms, and academia. See Fin. Accounting Standards Bd., *Financial Accounting Standards Advisory Council*, at <http://www.fasb.org/fasac/> (last visited Feb. 8, 2004).

57. See Thomas J. Phillips Jr. et al., *The Right Way to Recognize Revenue*, J. ACCT., June 2001, at 39 (describing a host of revenue recognition issues, many of which related to internet transactions).

58. *Id.* at 41.

59. The current chief accountant of the SEC, Donald Nicolaisen, was a senior partner at PricewaterhouseCoopers. See Deborah Solomon, *SEC Appoints Nicolaisen to be Chief Accountant*, WALL ST. J., Aug. 15, 2003, at A3.

60. Legislation may also indirectly influence the application of accounting standards. For example, in order to apply the last-in, first-out method of accounting for inventories for tax purposes, a taxpayer must also use that method for financial statement purposes. See I.R.C. § 472(c) (2002). Political pressure on accounting standard setters is not solely a U.S. phenomenon. See Floyd Norris, *Showdown Looms in Europe Over Proposals on Accounting*, N.Y. TIMES, July 11, 2003, at C1 (describing the political pressure applied by various European leaders on the International Accounting Standards Board with respect to proposals that would require fair market value accounting for derivatives).

61. See *infra* notes 264-66 and accompanying text.

tion, provided taxpayers with a tax credit based on a percentage of qualified investments acquired, in an attempt to spur economic activity. The Accounting Principles Board, responsible for setting standards at that time, concluded that the tax credit should be recognized periodically over the life of the asset to which the credit applied.⁶² This generated significant resistance within the Kennedy, Johnson, and Nixon administrations because such accounting treatment, administration officials believed, would diminish the incentive to acquire qualified property, thereby working at cross-purposes with the credit. Finally, after years of informal pressure, the Nixon administration was able to obtain congressional action to stifle the implementation of the accounting standard.⁶³

C. Auditing Standards

Auditing standards play a significant role in determining whether the application of accounting principles is appropriate for a particular transaction. The AICPA is the primary private sector promulgator of auditing standards through its Auditing Standards Board.⁶⁴ This fifteen-member body establishes the rules for how an auditor determines whether information reported in financial statements is reasonable and whether it conforms to generally accepted accounting principles. The Auditing Standards Board, in establishing auditing standards, has a role analogous to that of the FASB in determining accounting standards. Audit standards are promulgated in Statements on Auditing Standards,

62. See ACCOUNTING FOR THE "INVESTMENT CREDIT," ACCOUNTING PRINCIPLES BOARD OPINION NO. 2 (Am. Inst. of Certified Pub. Accountants 1962). The opinion treated the investment credit as a reduction in the cost of the acquired asset for which the credit was generated. Consequently, the tax benefit of the credit would be recognized into income over the life of the asset. The alternative favored by the various administrations would account for the benefit of the tax credit in the year it was generated.

63. Revenue Act of 1971, § 101(c), Pub. L. No. 92-178, 85 Stat. 499 (1971) (providing that no taxpayer shall be required to use any particular method to account for the investment tax credit).

64. The Auditing Standards Board was formed in 1978 to succeed the AICPA's Auditing Standards Executive Committee. The first auditing standards were issued in 1939 by the American Institute of Accountants, the predecessor of the AICPA. The audit profession has been principally self-regulated. A system of mandatory peer review was instituted by the AICPA in 1977. A Public Oversight Board was formed in 1977 to oversee the peer review process, quality control processes, and the Auditing Standards Board. The Public Oversight Board, an independent body with its own board, budget, and staff, also performed field reviews of all CPA firms with 30 or more SEC clients and occasional reviews of other CPA firms. This body was subject to severe criticism in the wake of the recent accounting and auditing scandals, particularly the Enron and Arthur Andersen implosions. See American Inst. of Certified Pub. Accountants, *A Brief History of Self-Regulation*, at www.aicpa.org/info/regulation02.htm (last visited Feb. 8, 2004). The Sarbanes-Oxley Act has dramatically altered the regulatory landscape of the accounting and auditing professions with the establishment of the Public Company Accounting Oversight Board, sounding the death knell for the Public Oversight Board. See *infra* notes 242-45 and accompanying text.

and are subject to due process akin to that applicable to the issuance of Statements of Financial Accounting Standards.⁶⁵ Additional guidance is provided by Interpretations of Statements on Auditing Standards, Statements of Position, and Accounting and Audit Guides.⁶⁶

Statement on Auditing Standards No. 1 requires an auditor who has audited financial statements in accordance with generally accepted auditing standards to opine whether those statements are presented fairly in accordance with generally accepted accounting principles, a term that includes rules, procedures, and conventions that define accepted accounting practice at a given time.⁶⁷ Prior to 1992, Statements of Financial Accounting Standards issued by the FASB, Opinions of the Accounting Principles Board, and Accounting Research Bulletins issued by the AICPA were the highest authoritative sources for determining whether an accounting practice was generally accepted. All other sources were of equally lesser weight in making such a determination. In 1992, the Auditing Standards Board issued *Statement on Auditing Standards No. 69*, which provides a hierarchal guide for determining generally accepted accounting principles.⁶⁸

Official pronouncements promulgated by a body designated by the AICPA, pursuant to Rule 203 of the AICPA Code of Professional Conduct, are considered the most authoritative form of guidance.⁶⁹ Application of accounting principles specified in such pronouncements, termed Category A pronouncements, are deemed to almost always result in the fair presentation of financial position, results of operations, and cash

65. The Auditing Standards Board also issued Statements on Standards for Attestation Engagements and Statements on Quality Control Standards. The AICPA Code of Conduct requires auditors to abide by such standards. See CODE OF PROFESSIONAL CONDUCT §202, Rule 202 (Am. Inst. of Certified Pub. Accountants 1988).

66. See *supra* note 48 and accompanying text.

67. CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, STATEMENT ON AUDITING STANDARDS NO. 1, STATEMENT ON AUDITING STANDARDS NO. 1 (Am. Inst. of Certified Pub. Accountants 1972). The AICPA Code of Professional Conduct provides that generally an auditor should not express an unqualified opinion on financial statements if such statements contain a material departure from pronouncements by bodies designated by the AICPA to establish accounting principles. See CODE OF PROFESSIONAL CONDUCT, *supra* note 65, § 203, Rule 203. See *infra* notes 94-100 and accompanying text for a discussion of the term "fairly" and whether such term provides auditors the opportunity to assess substance over form issues or otherwise challenge mechanical application of rules. Note that auditors may opine on financial statements prepared in accordance with requirements that differ from generally accepted accounting practice, such as regulatory agency requirements. In such cases, auditors are to comply with other requirements. See RESTRICTING THE USE OF AN AUDITOR'S REPORT, STATEMENT ON AUDITING STANDARDS NO. 87 (Am. Inst. of Certified Pub. Accountants 1998).

68. THE MEANING OF PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN THE INDEPENDENT AUDITORS REPORT, STATEMENT ON AUDITING STANDARDS NO. 69 (Am. Inst. of Certified Pub. Accountants 1992).

69. *Id.* § 69.05.

flows.⁷⁰ Four types of pronouncements are included in this category: FASB Statements of Financial Accounting Standards; FASB Interpretations of Statements of Financial Accounting Standards; Accounting Principles Board Opinions; and AICPA Accounting Research Bulletins.⁷¹

If guidance is not forthcoming from a Category A source, then guidance is to be sought, successively, from sources in categories B through D.⁷² Category B sources are FASB Technical Bulletins, AICPA Audit and Accounting Guides, and AICPA Statements of Position.⁷³ Category C pronouncements are AICPA Practice Bulletins and Consensus Positions of the FASB Emerging Issues Task Force.⁷⁴ Finally, Category D pronouncements include AICPA accounting interpretations and implementation guides, question and answer guidance published by the FASB staff, and practices that are widely recognized and prevalent, either generally or in the industry.⁷⁵ With respect to Category D, *Statement on Auditing Standards No. 69* provides no guidance on how the determination is to be made whether a practice is widely recognized and prevalent in general or within a particular industry.

In the event guidance cannot be found in any of the above referenced sources, other material may be considered. Such other material, depending on the particular circumstances, the specificity of the guidance, and the reputation of the issuer or author, includes pronouncements of regulatory agencies and professional associations, textbooks, and articles.⁷⁶ FASB Statements of Financial Accounting Concepts may be considered and, in comparison with other extraneous sources, would normally be more influential.⁷⁷

III. *Rules vs. Principles*

In the aftermath of the Enron and WorldCom scandals, accounting standards have come under criticism for contributing to the environment

70. *Id.*

71. *Id.* § 69.10. For public companies, SEC rules and releases also fall within this category. Although SEC Staff Accounting Bulletins are discussed, the standard makes no explicit categorization of such pronouncements. *Id.*

72. Statement on Auditing Standards No. 69 does not categorically prohibit the application of an accounting standard in a lower category if guidance is provided in a higher category pronouncement. However, use of such standard must be justified. *Id.* § 69.07.

73. *Id.* § 69.10. AICPA pronouncements are not to be considered authoritative unless cleared by the FASB. For this purpose, the FASB has cleared a pronouncement if it has not objected to the issuance of the pronouncement. *Id.* § 69.05. Unless the pronouncement indicated otherwise, it should be presumed that such pronouncement has been cleared by the FASB. *Id.* § 69.10.

74. *Id.*

75. *Id.*

76. *Id.* § 69.11.

77. *Id.*

that made such scandals possible. Specifically, accounting standards are criticized because they are too rules-based. By rules-based, the critics refer to standards that are laden with “bright-line” thresholds, exceptions, and voluminous implementation guidance.⁷⁸ They assert that such standards diminish the quality and transparency of financial accounting and reporting. In general, the criticisms leveled at current accounting standards are twofold.

First, and most significantly, rules-based standards allow management to structure transactions to circumvent the rules, thereby violating the intent and spirit of the standards. Rules-based systems tend to be overinclusive or underinclusive. This argument echoes the familiar criticisms leveled at rule utilitarians and legal formalists, and to an extent, proponents of principles-based standards are analogous to act utilitarians or legal realists.⁷⁹

Similar to act utilitarians, proponents of principles-based accounting standards are unwilling to tolerate a “bad” result in the application of a rule. Similarly, legal realists abhor devotion to rules when such devotion produces a result contrary to their notions of fair play and justice. In contrast, critics assert that rule utilitarians slavishly follow the rules even though departure from the rules in a particular case will yield a better outcome. As a consequence, rule utilitarianism tends to elevate form over substance.

A second criticism is that rules-based standards have introduced inordinate complexity, expense, and rigidity into the financial accounting and reporting system. Rules-based standards have led to standards overload and make the system slow to react to changes in the marketplace because unanticipated transactions or developments are difficult to handle within such a system.

These criticisms may have some validity in exceptional cases but not as generalizations. Rule utilitarianism, instead of focusing on indi-

78. See PRINCIPLES-BASED APPROACH, *supra* note 5, at 2-4; STUDY PURSUANT TO SECTION 108(d), *supra* note 21, at 12-14. See also Mark W. Nelson, *Behavioral Evidence on the Effects of Principles-and Rules-Based Standards*, 17 ACCT. HORIZONS 91 (2003). The distinction between rule-based and principle-based standards does not imply that rule-based standards have no foundation in broad principles. Detailed standards are based on the conceptual foundation set forth in the Statements of Financial Accounting Concepts. See *supra* notes 49-50 and accompanying text.

79. Utilitarianism is an ethical theory under which the rightness of an act is measured by whether the act produces greater good than harm. Jeremy Bentham, the founder of the utilitarian movement, and John Stuart Mill are its most well-known proponents. See generally DAVID STEWARD & H. GENE BLOCKER, *FUNDAMENTALS OF PHILOSOPHY* 296-300 (3d ed. 1992); HENRY SIDGWICK, *THE METHOD OF ETHICS*, 411-17 (7th ed. 1982). This theory has significant application in the formulation of commercial legislation and in business decision-making. A familiar evolution of the theory is the cost-benefit analysis.

vidual acts, seeks to arrive at rules that, if adhered to by society, will yield the greatest good for the greatest number.⁸⁰ An occasional injustice is tolerated because the rules generate other benefits — be it predictability, consistency, or some other socially desirable attribute — that more than compensate for the aberrant bad result.⁸¹ Whether the benefit of rules outweighs the occasional “bad result” depends on several factors.⁸² Reflexive aversion to rules is simplistic. As Justice Scalia once noted “[t]here are times when even a bad rule is better than no rule at all.”⁸³

Arguments in support of principles-based standards suffer from two defects. First, such arguments vastly overstate the problem in several respects. Second, and more significantly, they fail to consider a significant consequence of adopting a principles-based system. The movement toward such a system necessarily entails a shift from *ex ante* to *ex post* problem resolution. Such a shift raises profound questions about whether the existing client-auditor model is up to the tasks such a shift will bring to bear.

A. *Problem Overstated*

A standard critique of rules-based standards is that such standards are inevitably defective. Rules are overinclusive and underinclusive. They are overinclusive when the purpose of the standard would be furthered by not applying the rule, even though the language of the rule should apply. Alternatively, rules are underinclusive in circumstances where the language of the rule does not reach, but where the rule’s purpose would be furthered through its application. Rules tend to suppress facts because they focus on some, but not all, facts and circumstances surrounding a transaction. Consequently, the application of rules-based standards can produce absurd results. There are four problems with this argument.

First, the argument is largely based on an exaggerated sense of the deficiencies that exist in the present system. Second, the argument virtually ignores the existence of mechanisms within the present system to mitigate, if not prevent, the gamesmanship that the present system allegedly accommodates so comfortably. Third, the recent spate of scandals, used to buttress such an argument, is evidence that the problem does not lie with the standards. To the contrary, the recent scandals should serve

80. See STEWARD & BLOCKER, *supra* note 83, at 300.

81. It can be argued that equality, for example, is an attribute with such fundamental value that equally unfair results are preferable to unequal, yet fairer, results. See Scalia, *supra* note 10, at 1178.

82. See *infra* notes 196-97 and accompanying text.

83. Scalia, *supra* note 10, at 1179.

to mute the proponents of principles-based standards. Finally, the argument rests on certain questionable assumptions about the operation of a principles-based system.

1. DEFECTS MORE ABERRATIONAL THAN SYSTEMIC

Critics of the present state of U.S. accounting standards overstate their case in two respects. First, assuming *arguendo* that U.S. accounting standards are predominately rules-based, such rules operate admirably in the vast majority of cases. In most cases, there is agreement as to the meaning of the rule, its purpose, and the facts and circumstances surrounding the transaction in question. For example, *Statement of Financial Accounting Standard No. 13, Accounting for Leases* is considered paradigmatic of rules-based standards due to its promulgation of bright-line thresholds for determining whether a lease should be treated as such or, alternatively, should be treated as a purchase of the asset putatively leased.⁸⁴ However, most leases will fall comfortably below or above the thresholds, and little dispute will arise about whether, in substance, an asset has been leased or not. Standard automobile or office leases, for example, present little accounting difficulty. Likewise, despite the alleged abuse of consolidation accounting by Enron, the applicable accounting standards are easily applied to the vast majority of investments.⁸⁵ Most corporate owned investments are either wholly owned subsidiaries or have relatively small minority interests outstanding.

Second, critics of U.S. accounting standards overstate the extent to which such standards are, in fact, rules-based. The study conducted by the SEC, mandated by the Sarbanes-Oxley Act, says as much. According to that study, current U.S. accounting standards are best described as a mixture of rules- and principles-based standards.⁸⁶ Rules-based standards are, in general, limited to very specialized transactions and issues. Accounting standards for lease and derivative transactions, consolidation of entities, post-retirement benefits accounting and reporting, stock-based compensation arrangements, and accounting for income taxes

84. In general, the standard provides four tests for classifying a lease as either an operating lease or capital lease. The tests focus on whether the lease transfers ownership at the end of the lease term or contains a bargain purchase option. The tests also measure the lease term and lease payments against the economic life of the property and its fair market value, respectively. See *infra* note 191 and accompanying text.

85. See *infra* notes 140-50 and accompanying text.

86. See STUDY PURSUANT TO SECTION 108(d), *supra* note 21, at 24-27. This report breaks down U.S. accounting standards into three categories: rules-based standards; principles-based standards; and principles-only standards. The last type of standard is criticized by the SEC report because, in the opinion of the report's authors, it lacks an appropriate framework for the application of judgment. See *id.* at 26.

constitute the majority of rules-laden standards.⁸⁷ At first glance, this is not surprising given the complexity of the subject matter governed by such standards.⁸⁸ Moreover, many of the issues addressed by such standards can be expected to be applicable to most, if not all, entities. As discussed later in this work, frequency of occurrence suggests that rules-based standards may be the most effective approach for standard setters to pursue.⁸⁹

2. MECHANISMS EXIST TO DEAL WITH ABERRATIONAL CASES

The criticism of the present state of accounting standards discounts the extent to which the present standards provide auditors with the opportunity to exercise the judgment and discretion to elevate the substance of a transaction over its form. The fact that such discretion is not exercised often enough calls into question the efficacy of the auditing profession more than it serves to indict the current state of accounting standards.

The standard form auditor's report — the so-called unqualified opinion — states that the financial statements “present fairly” the company's financial position, results of operations, and cash flows in accordance with generally accepted accounting principles.⁹⁰ The adverb “fairly” has been more or less ignored. The SEC's position, expressed as early as 1938, was that “present fairly” meant present in accordance with generally accepted accounting principles.⁹¹ The AICPA's Code of Professional Conduct states that members may opine that a company's financial statements are presented fairly in accordance with generally

87. *Id.* at 24-25.

88. Technological developments have contributed to the complexity of certain transactions. This is especially true in the case of derivatives. Increases in computing power have enabled the creation of derivative instruments whose existence — and complexity — would have been unthinkable a generation ago. In other cases, the issues are complex because the legal infrastructure underlying the transaction is complex. Accounting for income taxes is a case in point. Federal, state, and foreign income tax accounting rules contain frequent departures from generally accepted accounting principles. In most cases, the differences that arise are differences in timing. Tax rules may require the recognition of income or expense at a point in time different from the point at which the revenue or expense item is recognized under generally accepted accounting principles — depreciation expense and loss accrual timing differences are ubiquitous. Other differences are permanent. For example, certain interest income is exempt from taxation and certain fines and penalties are not deductible. *See* I.R.C. §§ 103; 162(f). Multinational corporations must account for tax expenses associated with multiple taxing jurisdictions and the Byzantine complexity of the foreign tax credit rules. Accounting for income taxes reflects the inherent complexity in the Internal Revenue Code and other applicable taxing regimes.

89. *See infra* notes 196-97 and accompanying text.

90. The phrase “present fairly” has been in use since 1934 when the American Institute of Accountants, later to be renamed the American Institute of Certified Public Accountants, introduced it in the first standard form report.

91. *See Zeff, supra* note 11, at 55 n.10 (citing ACCOUNTING SERIES RELEASE No. 4 (1938)).

accepted accounting principles even though they contain a departure from authoritative pronouncement, but only if the departure is necessary to prevent the statements from being misleading.⁹² Consequently, some room for departure from the rules is provided, but the evidentiary hurdle is high⁹³ — but not so high as to have failed to prevent some of Enron's shenanigans.⁹⁴

Statement on Auditing Standards No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report, appears to provide ample flexibility in the application of accounting standards. This pronouncement makes clear that "fairness" is to be determined within the framework of generally accepted accounting principles.⁹⁵ However, the "auditor's opinion that financial statements present fairly . . . in conformity with generally accepted accounting principles should be based on his or her judgment as to whether . . . the accounting principles are *appropriate in the circumstances*."⁹⁶ Moreover, this auditing standard unambiguously states that generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance, and further states that auditors should consider whether the substance of a transaction differs materially from its form.⁹⁷

Unfortunately, the standard's rather clear mandate is made opaque by subsequent language in the standard. As discussed earlier in this work, generally accepted accounting principles have their genesis in various sources and a hierarchy of accounting standards has developed.⁹⁸ *Statement on Auditing Standard No. 69* provides that the auditor should be prepared to justify departures from accounting principles in categories B, C, and D. However, nowhere does the statement discuss departures from Category A, the most authoritative source of standards. Despite the admonition to ascertain the substance of a transaction, an auditor can reasonably infer that no departures from Category A pronouncements may be justified.

92. CODE OF PROFESSIONAL CONDUCT, *supra* note 65, § 203, Rule 203.

93. Rule 203 has been interpreted to mean that there is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading. "Unusual circumstances" may arise on occasion that would justify a departure from established accounting principles. New legislation or the evolution of a new form of business transaction are the two examples of such "unusual circumstances" that are provided. CODE OF PROFESSIONAL CONDUCT § 203, INTERPRETATIONS UNDER RULE 203-1 (Am. Inst. of Certified Pub. Accountants 1993).

94. See *infra* notes 154-57 and accompanying text.

95. THE MEANING OF PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN THE INDEPENDENT AUDITORS REPORT, *supra* note 72, § 69.03.

96. *Id.* § 69.04 (emphasis provided).

97. *Id.* § 69.06.

98. See *supra* notes 69-77 and accompanying text.

In any event, the notion that rule-driven standards allow companies to hide behind the form of a transaction with impunity and that the fix must lie with the accounting standards themselves is nonsense. Auditing standards could be clarified by giving some content to the phrase “present fairly” and by making clear that the application of accounting standards should not be a mechanical exercise devoid of professional discretion and judgment.

B. *Evidence From Recent Scandals*

The evidence presented by the recent scandals does not support the critics of the present system. Despite the complexity and notoriety of Enron’s fraudulent accounting, the majority of the accounting improprieties that have come to light in recent years have resulted from more pedestrian tactics — simple earnings management.⁹⁹ In most cases, accounting manipulations took place within the confines of basic accrual accounting concepts.¹⁰⁰ The WorldCom fraud, the largest accounting fraud in U.S. history, involved nothing more elaborate than the capitalization of operating expenses.¹⁰¹ Basic income and expense accruals often involve significant judgment and, consequently, managerial discretion. One commentator, citing former SEC Chairman Arthur Levitt, noted:

The method of achieving earnings management primarily involves the use of accounting techniques created primarily to allow and encourage companies to be *flexible* in the recording of their transactions in order to facilitate the primary goal of generally accepted accounting principles, that of *ensuring substance over form* in the

99. Earnings management refers to practices that manipulate earnings either through aggressive application of accounting standards or by flagrant abuse of such standards. The number of companies beating earnings estimates by exactly one cent per share quadrupled between the years 1992 and 1999. See Jerry Useem, *In Corporate America It's Cleanup Time*, FORTUNE, Sept. 16, 2002, at 63-64. In many cases, corporations actually seek to decrease earnings in an effort to smooth earnings fluctuations. For a recent example, see Patrick Barta & John D. McKinnon, *Freddie Mac May Have Understated Profits by up to \$4.5 Billion*, WALL ST. J., June 26, 2003, at C1. Forthcoming research by Professor Lawrence Brown of Georgia State University will report that investors reacted more harshly to companies’ failure to meet analysts’ earnings estimates than they did to decreased earnings or losses. See Ken Brown, *Corporate Reform: The First Year: Wall Street Plays Numbers Game with Earnings, Despite Reforms*, WALL ST. J., July 22, 2003, at A1.

100. Under the accrual basis method of accounting, revenues are recognized when the earnings process is complete and expenses are recognized when incurred. Moreover, expenditures that create a benefit extending substantially beyond the year in which such expenditures are made are capitalized and charged to expense periodically over their useful life. In contrast, the cash basis method of accounting recognizes revenues and expenses as cash is received or expended.

101. See Kurt Eichenwald & Simon Romero, *Turmoil at WorldCom: The Decision Making; The Latest Corporate Scandal Is Sudden, Vast and Simple*, N.Y. TIMES, June 27, 2002, at A1.

recognition of an accounting transaction whenever possible.¹⁰²

Oftentimes, distortions of financial information occur entirely outside the purview of generally accepted principles as evidenced by the questionable use of pro forma earnings.¹⁰³ Most often, however, accounting improprieties incident to earnings management generally exploit relatively straightforward accounting standards.¹⁰⁴ Such standards usually provide general guidance and leave much room for managerial discretion in their application. Ironically, the scandals have involved the broad, principles-based standards for which the critics clamor. Among the more common manipulations are those involving revenue recognition and expense accruals.

During the so-called “bubble years” of the late 1990s, earnings became passé and new metrics were introduced to support ever-higher

102. Manuel A. Rodriguez, Comment: *The Numbers Game: Manipulation of Financial Reporting by Corporations and Their Executives*, 10 U. MIAMI BUS. L. REV. 451, 460 (2002) (emphasis provided).

103. Pro forma financial information relies on various measures of financial performance that depart from generally accepted accounting principles. Metrics could include earnings exclusive of so-called “nonrecurring” charges and non-cash charges such as depreciation and amortization. Companies had almost unfettered discretion to issue pro forma figures that presented the results of financial statements in a favorable light. Section 401(b) of the Sarbanes-Oxley Act of 2002, 107 Pub. L. No. 204, 116 Stat. 786, requires the SEC to issue regulations to prevent perceived abuses in the issuance of pro forma earnings. In general, the regulations should require companies to present such information in a manner that is not misleading and reconcile such information to figures prepared under generally accepted accounting principles. The SEC issued final regulations, in the form of new Regulation G, effective March 28, 2003. See 17 C.F.R. §§ 244.100 – 244.102 (2003) (implementing the directive in the legislation). As a consequence, many firms have discontinued releasing pro forma information. See Phyllis Plitch, *More Companies Say They Avoid Releasing Pro Forma Statements*, WALL ST. J., June 12, 2003, at C9 (reporting that one survey of 600 companies found that more than forty percent of companies surveyed reported results strictly in accordance with generally accepted accounting principles). The replacement of compensatory stock options with grants of restricted stock has led some companies to mute the resulting earnings charge by excluding such charges in their presentation of pro forma earnings. See Nick Wingfield, *Options Move May Be at Expense of Accounting Purists*, WALL ST. J., July 14, 2003, at C1 (reporting that Amazon.com has excluded expenses associated with grants of restricted stock from their pro forma earnings). See *infra* notes 264-75 and accompanying text for a discussion of stock option accounting. In addition to pro forma financial information, other metrics outside the scope of generally accepted accounting principles were often used to paint an overly optimistic — if not misleading — picture of a company’s operations. See, e.g., Julia Angwin, *A Bulk-Sales Initiative by AOL May Have Inflated Subscriptions*, WALL ST. J., July 25, 2003, at A1 (describing AOL’s practice of including heavily discounted bulk subscriptions sold to corporate customers in publicly disclosed subscriber figures); Shawn Young, *Talking Up ‘Net Debt’ Allows Some Firms To Take a Load Off*, WALL ST. J., July 28, 2003, at C1 (discussing the practice, employed by a number of firms, of reporting total debt net of cash and cash equivalents as “net debt.”).

104. In a recent comparative study of earnings opacity in many countries, earnings opacity was measured by earnings aggressiveness, loss avoidance, and earnings smoothing. Earnings aggressiveness and earnings smoothing are often achieved through manipulation of accruals. See Utpal Bhattacharya et al., *The World Price of Earnings Opacity*, 78 ACCT. REV. 641, 645-49 (2003).

stock prices. Top-line revenue growth was one such metric.¹⁰⁵ Under generally accepted accounting principles, revenues are recognized when the earnings process is complete. Long-standing conceptual guidance, but very little authoritative guidance, exists for this bedrock principle. An entity earns revenue by delivering or producing goods, rendering services, or other activities that constitute its major operations, and revenues are considered earned when the entity has substantially accomplished what it must do to be entitled to the revenues.¹⁰⁶ Such a broad formulation invariably invites the exercise of discretion in its application to the myriad factual situations that enterprises encounter in conducting their business.

One study reported that more than half of the financial reporting frauds among public companies between 1987 and 1997 involved revenue overstatements.¹⁰⁷ Common techniques for manipulating revenue have involved attempts at accelerating the timing of income. In addition to flagrant manipulations aimed at accelerating revenue recognition, such as backdating documents, less odious methods, such as channel-stuffing, have been employed.¹⁰⁸ In addition to the general conceptual guidance described above for revenue recognition, authoritative guidance does exist for recognizing revenues in more specific settings. The Accounting Principles Board issued Opinion No. 29, providing authoritative guidelines for the accounting of nonmonetary transactions — transactions that involve exchanges of assets.¹⁰⁹ A.P.B. Opinion No. 29 sets forth the general rule that, in nonmonetary exchanges, the fair market value of the asset surrendered is the measure of the value received in

105. Some metrics that were used bordered on the absurd. For example, the number of “eyeballs” for a company’s web-based business was often used as benchmark of success.

106. RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS No. 5, *supra* note 49, § 83b. Earlier conceptual guidance was issued by the Accounting Principles Board. *See id.*, § 83, n.54-56.

107. *See* Thomas J. Phillips, Jr. et al., *The Right Way to Recognize Revenue*, J. ACCT., June 2001, at 39 (reporting the findings of Committee of Sponsoring Organizations of the Treadway Commission).

108. Channel-stuffing refers to the practice of shipping to customers quantities of product well in excess of their needs with the tacit understanding that unsold merchandise may be returned. The former controller of Network Associates, Inc., for example, pleaded guilty to federal charges of securities fraud for his role in an alleged plan that included secret payments to distributors to hold unsold inventory of software products. *See* Don Clark & Deborah Solomon, *SEC Focuses on Videogame Industry*, WALL ST. J., July 21, 2003, at A3. Sunbeam Corporation restated its financial results from the fourth quarter of 1996 to the first quarter of 1998 in large part due to the overstatement of revenues from so-called bill and hold contracts and guaranteed consignment sales. Sunbeam’s problems generated much publicity, but mainly due to its outspoken and controversial chief executive officer, Albert Dunlap. *See* Dana Canedy, *Sunbeam Restates Results, and “Fix” Shows Significant Warts*, N.Y. TIMES, Oct. 21, 1998, at C6.

109. ACCOUNTING FOR NONMONETARY TRANSACTIONS, ACCOUNTING PRINCIPLES BOARD OPINION No. 29 (Am. Inst. of Certified. Pub. Accountants 1973).

the exchange and, hence, the amount of revenue to be recognized from the transaction.¹¹⁰ In the event that the fair market value of the asset received is more clearly evident than that of the asset surrendered, then the fair market value of the asset received should be used in recording the transaction.¹¹¹

Two exceptions are made to the general rule. The earnings process is not deemed complete in situations where the asset exchanged is held for sale in the ordinary course of business and is exchanged for an asset that is similarly held.¹¹² In addition, in the case of a productive asset not held for sale in the ordinary course, the earnings process is not deemed complete if that asset is exchanged for a similar asset.¹¹³

The accounting standard is relatively straightforward. Revenue is recognized in non-cash transactions, but only if the transaction results in a substantive change in the position of the party to the exchange. Merely swapping inventory or similar productive assets does culminate the earnings process.¹¹⁴ This is hardly a detailed or complex standard yet many of the reported accounting scandals involved asset swaps that improperly inflated revenues and, in some cases, earnings.¹¹⁵

110. *Id.* § 18.

111. *Id.*

112. *Id.* § 21a.

113. *Id.* § 21b.

114. To a certain extent, the accounting rules are analogous to the tax-free exchange rules of I.R.C. § 1031. For federal income tax purposes, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that is similarly held. Gain, however, is recognized to the extent other property is received in addition to qualifying like kind property. *See* I.R.C. §§ 1031(a)-(b) (2002). There are numerous nonrecognition provisions in the Internal Revenue Code, and these provisions are a matter of legislative grace that defer the incidence of taxation until a more substantial change in the form of the assets held takes place. *See, e.g.*, I.R.C. §§ 351 (deferring gain from the contribution of assets to a controlled corporation); 354 (deferring gain from the receipt of stock or securities in certain qualifying reorganizations); 721 (deferring gain from the contribution of assets by a partner in exchange for a partnership interest).

115. A swap is a barter-type transaction in which enterprises exchange goods or services. Some firms abused these transactions by not only recognizing revenue from swaps of similar productive assets but, in some cases, actually recording the value of their obligation under the swap as a capital expense, thereby increasing earnings. The telecommunications industry and web-based businesses were especially abusive in this regard. The practices of both Qwest Communications International and Global Crossing are the subject of congressional investigations. *See* Simon Romero, *Internal Notes Questioned Qwest's Swaps*, N.Y. TIMES, Sept. 25, 2002, at C4. A variant of the swap transaction is the "round-trip" transaction. Such a transaction appears to be an arms-length sale but has no economic substance because the purchaser receives advanced funds in some form by the seller and a reciprocal obligation to purchase is placed on the seller. *See* Daniel V. Dooley, *Financial Fraud: Accounting Theory and Practice*, 8 FORDHAM J. CORP. & FIN. L. 53, 71 (2002); *see also* David D. Kirkpatrick, *Shares Are Up, But Lawsuits May Unsettle AOL's Future*, N.Y. TIMES, July 7, 2003, at C1 (reporting on pending legal action against AOL as a result of the company's inflating revenue by \$190 million over twenty-one months by use of "round-trip" transactions); David D. Kirkpatrick, *Guilty Pleas*

The general concept for revenue recognition was clarified in its application to transactions with multiple elements, specifically sales of product and services. Although these types of transaction have long taken place, their use increased dramatically with the growth of the software industry. Sales of software are often bundled with maintenance, installation, and integration services. Whether the earnings process is complete, and to what extent, is less clear for such arrangements because the seller's service obligations may extend for a significant time after the sale.

The AICPA and the SEC addressed the issue of revenue recognition in connection with multiple-element arrangements in general and software transactions in particular.¹¹⁶ The principle set forth is straightforward — revenues should be allocated among the elements of a multiple-element transaction according to the respective fair market value of the elements. Fair market value estimates are to be supported by verifiable objective evidence, and mere reliance on stated or agreed-upon prices is prohibited.¹¹⁷ The determination of fair market value requires, in most cases, managerial judgment and discretion. Such discretion is subject to, and has resulted in, abuse. Through mischaracterization of the terms or nature of the contract elements, distortion of the significance of various components, misstatement of pricing information, and artificial bifurcation of the contract into separate contracts, firms have been able to manipulate the accounting for such arrangements.¹¹⁸ As a consequence, the FASB has revisited this issue on numerous occasions.¹¹⁹ Arguably, the inordinate amount of attention that standard set-

Are Expected At Homestore, N.Y. TIMES, Sept. 25, 2002, at C1 (describing the use of "round-tripping" at Homestore's web-based operation).

116. See SOFTWARE REVENUE RECOGNITION, STATEMENT OF POSITION 97-2 (Am. Inst. of Certified. Pub. Accountants 1997); *Revenue Recognition in Financial Statements*, SEC STAFF ACCOUNTING BULLETIN No. 101 (Dec. 3, 1999), available at <http://www.sec.gov/interps/account/sab101.htm>.

117. The rationale for this requirement is the belief that, in a multiple-element arrangement, prices may not be representative of the value of the individual elements because the prices of individual components can be altered in negotiations and still result in the same overall consideration. See *Revenue Recognition in Financial Statements*, *supra* note 121, at Question 5.

118. See Dooley, *supra* note 120, at 73. See also Nancy Dillon, *KPMG Hit with Fraud Charge — SEC Links 4 Partners to Xerox Scam*, N.Y. DAILY NEWS, Jan. 30, 2003, at 37 (reporting that the SEC charged KPMG and four of its partners with fraud in connection with Xerox accounting irregularities. Such irregularities principally involved the inflation of revenue by recognizing income prematurely on equipment and servicing contracts).

119. The FASB's Emerging Issues Task Force reached consensus on Issue 00-21, *Revenue Arrangements with Multiple Deliverables*. Moreover, the Emerging Issue Task Force had under consideration three other issues: Issue No. 00-24, *Revenue Recognition: Sales Arrangements That Include Specified Price Trade-in Rights*; Issue No. 03-05, *Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*; Issue No. 02-G, *Recognition of Revenue from Licensing Arrangements on Intellectual Property*. A consensus was reached on Issue No. 03-05,

ters have devoted to this issue in recent years is a reaction to perceived abuse and not a cause of abuse.

The FASB has issued specific rules for revenue recognition when the buyer has certain rights of return.¹²⁰ The standard is conceptually simple. Certain conditions are identified that indicate that the earnings process has not been complete. Revenue should be deferred if one or more of those conditions exist. Those conditions are: The price is not fixed or determinable; the buyer is not obligated to pay the seller until the product is resold to an end-user; the buyer is not obligated to pay in the event the product is stolen, destroyed, or lost; the buyer has no economic substance apart from the seller; the seller has significant obligations to aid the buyer in the resale of the product; or the amount of future returns cannot be reasonably estimated.¹²¹ These conditions, however, have been manipulated through various means, including use of side agreements or oral promises that disguise rights of return and use of straw parties to conceal the true nature of the arrangements.¹²²

The accounting irregularities involving manipulation of revenues are by no means limited to those above.¹²³ However, revenue recogni-

but the FASB was not asked to ratify the consensus for procedural reasons. Issues No. 00-24 and 02-G have been removed from the task force's agenda because the FASB has agreed to add a major revenue recognition to its agenda. See Emerging Issues Task Force: Description and Status of Current Issues, available at <http://www.fasb.org/eitf/eitfissu.shtml>.

120. *Revenue Recognition When Right of Return Exists*, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 48 (Fin. Accounting Standards Bd. 1981).

121. *Id.* § 6.

122. See Dooley, *supra* note 115, at 68-70. Certain round-trip transactions also flout Statement of Accounting Standards No. 48 because the buyer is advanced funds from the seller and, in substance, encounters no economic risk from the transaction.

123. For example, gains from the disposition of assets may be classified as part of operating revenues, thereby giving the impression that operating results are more robust than is actually the case. Alternatively, nonrecurring income from the sale of a business unit may be classified as a reduction in general and administrative expenses, a classification IBM employed. Such a classification presents a more favorable impression of results from ongoing operations. See Jim Krane, *Report of Probe Hits IBM Stock*, ALBANY TIMES UNION, Apr. 12, 2002, at E1. Apparently, classification issues are not limited to revenues. R.J. Reynolds Tobacco Holdings, Inc. is under formal investigation by the SEC with respect to classification of expenses as part of selling, general, and administrative expenses. See Vanessa O'Connell, *R.J. Reynolds Faces SEC Probe Related to Expense Accounting*, WALL ST. J., Aug. 11, 2003, at B3. Manipulation of percentage of completion accounting has also resulted in the distortion of financial results. Long-term contracts are accounted for by one of two methods. The first, the completed contract method, requires that income from a long-term contract be recognized upon completion of the contract. Alternatively, the percentage of completion method allows income to be recognized over the life of the contract in proportion to the percentage of the contract completed. This method requires that contract costs and profits be estimated. See generally LONG-TERM CONSTRUCTION TYPE CONTRACTS, ACCOUNTING RESEARCH BULLETIN NO. 45 (Am. Inst. of Certified Pub. Accountants 1955). It is relatively easy for companies to overestimate the percentage of the contract completed and thus overstate revenue and income. See Simon Romero & Barnaby J. Feder, *In a Low Key, New E.D.S. Chief Hopes to Regain Skeptics' Trust*, N.Y. TIMES, May 20, 2003, at C1 (discussing the aggressive accounting employed by Electronic Data Systems on several large contracts).

tion rests on a very simple, yet judgmental foundation. As new types of arrangements proliferated, additional guidance was provided that, in most cases, was based on broad principles. More specific guidance appeared only after the accounting profession proved inept at satisfactorily applying the broad guidance.

Accounting for liability reserves is, like revenue recognition, based on broad conceptual standards and has similarly been prone to manipulative and abusive practices. "Reserves" is the term generally used for liabilities that have, in an accounting sense, been incurred but are not yet fixed in a transactional sense.¹²⁴ Common types of reserves are those established for estimated warranty costs on products sold, settlement costs for ongoing litigation, expected environmental cleanup costs, and severance and other costs associated with downsizing a business operation.¹²⁵

Authoritative guidance for accounting for contingencies is provided by *Statement of Accounting Standards No. 5, Accounting for Contingencies*.¹²⁶ A loss contingency is defined as a situation where a possible loss is subject to "an existing condition, situation, or set of circumstances involving uncertainty . . . that will ultimately be resolved when one or more future events occur or fail to occur."¹²⁷ Accounting for such contingencies is dependent upon the likelihood of the loss occurring. A loss contingency must be accrued as a charge to income if it is both probable that the loss will occur and the amount can be reasonably estimated.¹²⁸ In the event the contingency is probable but the amount may not be reasonably estimated, or in cases in which loss is reasonably possible but not probable, footnote disclosure is required. Remote contingencies need not be disclosed.¹²⁹

124. In this respect, financial accounting standards differ markedly from tax accounting rules. For tax accounting purposes, a liability may not be accrued until all the events occur that establish the fact that a liability has been incurred; the amount of such liability must be determinable with reasonable accuracy. Moreover, economic performance must occur, which, for certain types of expenses, precludes any accrual at all. See generally Treas. Reg. §§ 1.461-1(a)(2) (1999); 1.461-4 (1999). With few exceptions, reserves are not properly accrued for tax purposes.

125. Reserves for bad debts are similar, but technically they are treated as a reduction of accounts receivable and not as liabilities. These reserves are established to estimate the amounts that are deemed uncollectible from accounts receivable. These reserves are also susceptible to manipulation. Excessive reserves against accounts receivables may be established in an effort to smooth earnings. Alternatively, reserves for uncollectible accounts receivable may be understated in an effort to improve earnings. See, e.g., Jonathan D. Glater, *HealthSouth Looks Deeper Into Its Books*, N.Y. TIMES, July 12, 2003, at C1, (reporting that an internal investigation uncovered evidence that reserves for uncollectible accounts were understated).

126. STATEMENT OF ACCOUNTING STANDARDS NO. 5, ACCOUNTING FOR CONTINGENCIES (Fin. Accounting Standards Bd. 1975).

127. *Id.* § 1.

128. *Id.* § 8.

129. Probable is defined as likely to occur. Remote contingencies are those with a slight

The determination of whether a loss is probable, as opposed to merely reasonably possible, is subject to managerial discretion and judgment. Similarly, estimates of the amount of loss with respect to the contingency in question are often based on subjective factors. In an effort to purge the balance sheet, management often took “big bath” charges. These charges, major one-time items that create reserves related to layoffs, restructurings, obsolete inventory, and other such items, were often used to inflate earnings in future periods by eliminating large cost components from future periods. Because these charges were classified as nonrecurring, the impact of such charges on the companies stock was muted.¹³⁰ Consequently, such reserves were often excessive.

Excessive reserves also served another purpose as a source of future earnings. So-called “cookie-jar” reserves allowed companies to reverse such reserves in future periods if needed to bolster earnings. Predictable and sustained earnings growth was an attribute highly valued by Wall Street. In periods of excess earnings, the establishment of excessive reserves reduces earnings and places liabilities on the balance sheet that, if needed, can be reversed to bolster income in a future year.¹³¹

Close cousins to contingency reserves are write-offs — used to reflect the impairment of long-lived assets to be held and used. Impair-

chance of occurring. Reasonably possible contingencies are those whose likelihood of occurrence is between probable and remote. See *id.* § 3. Guarantee agreements, obligations under letters of credit, and standby agreements must be disclosed in all cases, regardless of the possibility of performance under such arrangements. See *id.* § 12.

130. Such nonrecurring or one-time charges were usually excluded in the determination of pro forma earnings. See *supra* note 108 and accompanying text. Classification of such charges as nonrecurring for pro forma purposes does not affect the reporting of such items under generally accepted accounting principles. Under such principles, earnings are generally reported from continuing operations, discontinued operations, and extraordinary items. See REPORTING THE RESULTS OF OPERATIONS — REPORTING THE EFFECTS OF DISPOSAL OF A SEGMENT OF A BUSINESS, AND EXTRAORDINARY, UNUSUAL AND INFREQUENTLY OCCURRING EVENTS AND TRANSACTIONS, ACCOUNTING PRINCIPLES BOARD OPINION NO. 30 (Am. Inst. of Certified Pub. Accountants 1973). The FASB is considering proposals to overhaul the presentation of the income statement. One such proposal would require companies to report “comprehensive income” instead of net income. Such a change would result in more items flowing through the income statement instead of shareholders equity. See Cassell Bryan-Low, *Deals & Deal Makers: Accounting Changes Are in Store*, WALL ST. J., Sept. 10, 2003, at C4 (reporting on the comments by Robert Herz, chairman of the FASB, at a New York State Society of Certified Public Accountants conference).

131. W.R. Grace’s National Medical Unit was particularly aggressive in this regard. Management allegedly ordered earnings above a cap amount to be placed in reserve. In subsequent periods, such reserves were reversed when needed to bolster earnings. See Ann Davis, *SEC Case Claims Profit Management by Grace*, WALL ST. J., Apr. 7, 1999, at C1. See also Dawn Kopecki, *Freddie Mac’s Use of Reserve Accounts Falls Under Scrutiny*, WALL ST. J., July 8, 2003, at C1 (reporting that the SEC is investigating Freddie Mac’s use of reserves to smooth earnings).

ment of an asset is the condition that exists when the carrying amount of the asset exceeds its fair value.¹³² A loss must be recognized for such impairment if the asset's carrying amount is not recoverable.¹³³ The subjectivity inherent in this standard was often exploited to justify the creation of "big bath" restructuring charges and "cookie jar" reserves, particularly in the case of corporate acquisitions.¹³⁴

The accounting maneuvers employed by Enron have become paradigmatic of the ills that have befallen accounting standards. Particular focus was placed on Enron's use of off-balance sheet partnerships and the seeming failure of existing accounting standards in preventing the

132. ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 144, § 7 (Fin. Accounting Standards Bd. 2001) (superceding ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 121 (Fin. Accounting Standards Bd. 1995)). This standard also sets forth rules for accounting for impairment of assets to be abandoned or to be sold. The standard does not apply to certain specialized industries for which separate accounting guidance exists, nor to certain financial instruments. *See id.* § 5. Under generally accepted accounting principles, the carrying amount of an asset is generally historical cost less accumulated depreciation.

133. *Id.* The recoverability of an asset's carrying value is determined by comparing such carrying amount to the undiscounted cash flows expected to result from the use and eventual disposition of such asset. Certain factors are mentioned that indicate that an asset should be tested for impairment. Such factors include a significant decrease in the market price of such asset, a significant adverse change in the extent or manner in which the asset is used, and significant adverse legal changes. *See id.* § 7-8.

134. An acquiring corporation may, for example, assign a significant portion of the purchase price of an acquired business to research in process only to write off such research during one period. In so doing, the acquiring corporation incurs one bad quarter, but future periods are purged of additional earnings charges. Generally, assets acquired should be assigned a cost, or carrying amount, based on the relative fair market values of the assets acquired. A discussion of purchase accounting is beyond the scope of this work. Prior to 2001, two general methods of accounting were in use for business combinations: the purchase method, under which the assets of the acquired enterprise were assigned the cost of acquisition; and the pooling of interest method, under which the carrying value of the assets of the acquired enterprise were not adjusted. *See generally* BUSINESS COMBINATIONS, ACCOUNTING PRINCIPLES BD. OPINION NO. 16 (Am. Inst. of Certified Pub. Accountants 1970). The pooling of interest method was severely criticized and, in an effort to harmonize U.S. acquisition accounting standards with international standards, the pooling of interest method is no longer permissible. *See generally* BUSINESS COMBINATIONS, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 141 (Fin. Accounting Standards Bd. 2001) (superceding ACCOUNTING PRINCIPLES BOARD OPINION NO. 16). Assigning a significant portion of such costs to research in-process instead of tangible assets or less ephemeral intangible assets, such as goodwill or workforce in place, results in less periodic charges to future periods. *See* Justin Gillis, *Firm's Profits Survive Scrutiny of SEC Microscope*, WASH. POST, Apr. 27, 1999, at E1 (describing WorldCom's accounting for its merger with MCI and AOL's accounting for its acquisition of Mirabilis, Ltd.). Lynn Turner, the former Chief Accountant of the SEC, asserted that during the past decade at least 140 acquiring companies wrote off, or attempted to write off, in-process research of the acquired target. Darin Bartholomew, *Is Silence Golden When It Comes to Auditing?*, 36 J. MARSHALL L. REV. 57, 66 n.39 (2002). It strains credibility that an acquiring corporation could assign significant value to research in process in justifying the price it is willing to pay for the target, yet then write off such research in the near future as worthless.

resulting distortions in Enron's reported financial position.¹³⁵ The financial accounting standards that have come under criticism are, admittedly, complex, but they are so because the underlying transactions to which they apply are complex. The standards do, however, provide ample room for the exercise of professional judgment, and, more so than on the standards themselves, blame should be laid on the failure of various professionals to responsibly exercise sound judgment.

An "off-balance sheet" entity is an investee entity whose assets and liabilities are not included in the balance sheet of the investor entity. Such treatment is common in accounting for investments in special purpose vehicles (SPVs). SPVs are used in asset securitization transactions and structured financings. Asset securitization transactions can take several forms, but the broad structure of the transactions follows a similar pattern. Assets representing financial claims, such as auto loans receivable, credit card receivables and the like, are transferred to an SPV. The SPV is funded by investors who lend funds to the SPV or are issued equity stakes in the entity. The transferor usually retains a residual interest in the SPV.¹³⁶ The legal form that the SPV takes varies. Partnerships, limited liability companies, corporations, and trusts are commonly used. The particular form used depends on the peculiarities of the transaction in question, but the two principal concerns in selecting the form are avoidance of an entity level tax¹³⁷ and bankruptcy remoteness.¹³⁸ Structured financings make use of SPVs to finance investments

135. Section 401(c) of the Sarbanes-Oxley Act mandates that the SEC "... complete a study of filings by issuers and their disclosures to determine — (A) the extent of off-balance sheet transactions . . . and the use of special purpose entities; and (B) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions."

136. The assets transferred to the SPV are typically in excess of the amount necessary to collateralize the investors' stake in the entity. The retention of a residual interest allows the transferor of the assets to remain over-collateralized.

137. The federal income taxation of such entities was greatly simplified in 1996 by the issuance of final regulations that, in general, allow most noncorporate forms to escape entity level taxation. These so-called "check-the-box" regulations allow such entities to elect to be taxed as partnerships for federal income tax purposes. *See generally* Treas. Reg. §§ 301.7701-2, 3 (2001). For federal income tax purposes, partnership income is not taxed at the entity level. Instead, the income is passed through to the partners and, assuming the partner is a taxable entity or individual, is subject to tax at the partner level. *See generally* I.R.C. §§ 701-04 (2002). Corporations, in contrast, are subject to tax with certain exceptions. Most of the exceptions have little applicability to securitization transactions. *See e.g.*, I.R.C. §§ 1361-75; 856-59 (2002) (providing the rules for S Corporations and Real Estate Investment Trusts, respectively). However, a corporation may qualify as a Financial Asset Securitization Investment Trust (FASIT) and thereby avoid entity level taxation. *See* I.R.C. § 860H-L (2002).

138. The retention of a residual interest in the assets raises issues as to whether the assets of the trust may be subject to the claims of the transferor's creditors in bankruptcy proceedings. The use of the SPV is designed to insulate the assets transferred from such claims. Generally, the corporate form is preferred in terms of bankruptcy remoteness from the transferor of the assets.

in real estate, equipment, or other property. Typically, an SPV is formed to construct or purchase such assets and lease them to the company. All or a portion of the construction costs or purchase price is borrowed, and the lease payments service the debt. The SPV is designed to avoid entity-level taxation and to create bankruptcy remoteness from the lessee.

Off-balance sheet entities can be favorable from the standpoint of an investee because the investee's share of the debt of the entity does not appear on the investee's balance sheet, thus improving certain financial ratios that stock analysts and credit rating agencies examine.¹³⁹ The accounting for investments in other entities takes one of three forms, two of which achieve off-balance sheet treatment for the investee entity's assets and liabilities.

The cost method of accounting for investments requires that an investment be carried at cost and is adjusted only for subsequent investments, dispositions, and impairments in value.¹⁴⁰ Dividends received are recorded as income.¹⁴¹ Distributions received reduce the carrying value of the investment.¹⁴² Under this method, the composition of the investee's underlying assets and liabilities are ignored.

The second method, the equity method of accounting, likewise results in the exclusion of the investee entity's assets and liabilities from the investor's balance sheet. However, in the case of a corporate investee, the investor records its share of investee's income and loss and concomitantly adjusts the carrying value of the investment.¹⁴³ The equity method is required for situations in which the investor's financial interest in the investee is not a controlling financial interest in the investee, yet nonetheless enables the investor to exercise significant influence over operating and financial policies of the investee.¹⁴⁴ It is presumed that ownership of twenty percent or more of the voting interests in the

The trust form, however, provides greater protection for the senior security holders. For an analysis of the relative merits of the various forms of entities used for SPVs, see Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 *BUS. LAW.* 559 (2003).

139. The net equity position of the investor is generally unaffected by whether the investee entity's assets and liabilities are included in the investor's balance sheet. However, by reporting only the net investment in the entity in contrast to "grossing-up" the balance sheet by including both assets and liabilities, an investor's debt-equity ratio is generally improved.

140. THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, ACCOUNTING PRINCIPLES BOARD OPINION NO. 18, § 6a (Am. Inst. of Certified Pub. Accountants 1971).

141. *Id.*

142. *Id.* § 10.

143. *Id.* For partnerships and other pass-through entity investments, the investor recognizes its share of the entity's income and loss and adjusts the carrying value of its investment accordingly.

144. *Id.* § 17. A controlling financial interest is generally present if the investee owns more

investee provides the investor with the ability to exercise significant influence over operating and financial policies of the investee.¹⁴⁵ Conversely, ownership of less than twenty percent of the voting interests in the investee presumptively signifies the lack of such ability.¹⁴⁶ Both presumptions, however, may be rebutted by facts and circumstances.¹⁴⁷

The third method, consolidation, essentially treats the investor and investee as one entity, thereby requiring the investor to include the assets, liabilities, revenues, and expenses of the investee in consolidated financial statements.¹⁴⁸ When an investor, directly or indirectly, has a controlling financial interest in another entity, it is presumed that consolidated financial statements are more meaningful than separate financial statements.¹⁴⁹ A controlling financial interest is generally evidenced by ownership of a majority voting interest in the investee entity.¹⁵⁰

These three methods provide the basic framework for accounting for investments but they were promulgated in a different era. The complexity of transactions and the proliferation of SPVs of various forms overwhelmed professionals' ability to fit such transactions and entities into a standard that envisioned plain vanilla corporate investments. With some prompting from the SEC, the FASB's Emerging Issues Task Force reached consensus on several issues.¹⁵¹ One such consensus, dealing with lease transactions through SPVs, required that unrelated investors provide at least three percent of the capital of the SPV in order for the SPV to remain unconsolidated.¹⁵² This requirement was not meant as a safe harbor nor was it meant to replace a more nuanced facts

than fifty percent of the voting interests of the investee. *See infra* note 150 and accompanying text.

145. *Id.*

146. *Id.*

147. *See* CRITERIA FOR APPLYING THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, INTERPRETATION NO. 35 (Fin. Accounting Standards Bd. 1981) (describing several circumstances in which the presumption of the ability of an investor to exercise influence is rebutted). The FASB's Emerging Issues Task Force has on its agenda Issue No. 02-14, *Whether the Equity Method of Accounting Applied When an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means*, available at <http://www.fasb.org/eitf/eitfissu.shtml>.

148. Rules are provided to account for minority interests and for the elimination of intercompany transactions. *See generally* CONSOLIDATED FINANCIAL STATEMENTS, ACCOUNTING RESEARCH BULLETIN NO. 51 §§ 7-15 (Am. Inst. of Certified Pub. Accountants 1959).

149. *Id.* § 1.

150. *Id.* § 2.

151. *See* Luppino, *supra* note 50, at 64-67. *See also id.* at 65 n.63 (describing the various Emerging Issue Task Force Issues).

152. *Id.* at 66 (discussing IMPACT OF NONSUBSTANTIVE LESSOR'S, RESIDUAL VALUE AND GUARANTEES, AND OTHER PROVISIONS IN LEASING TRANSACTIONS I, EMERGING ISSUES TASK FORCE ISSUE NO. 90-15 (Fin. Accounting Standards Bd. 1990)).

and circumstances analysis.¹⁵³

Enron aggressively employed off-balance sheet partnerships to present the company in a more favorable light than might otherwise be warranted. The company exploited the three percent capital rule discussed above.¹⁵⁴ Moreover, the off-balance sheet entity was managed by a general partner entity whose owner was an Enron employee.¹⁵⁵ Existing rules for consolidation contained adequate flexibility in forcing the substance of Enron's transactions to be reflected in its accounting. As previously mentioned, the three percent capital requirement was not meant to be a bright-line test.¹⁵⁶ Moreover, the definition of a "controlling financial interest" necessary to trigger consolidation accounting is vague enough to have allowed the totality of circumstances surrounding the transactions to be considered in the decision of whether consolidation accounting was appropriate.¹⁵⁷

The FASB, in the wake of Enron scandal and the enactment of the Sarbanes-Oxley Act,¹⁵⁸ issued an Interpretation that more clearly mandates a substance over form approach to the consolidation issue.¹⁵⁹ However, the standards that existed prior to the issuance of this Interpretation provided ample opportunity for substance to prevail over form.¹⁶⁰

153. *Id.*

154. *See id.* at 68-73 (describing various transactions that Enron entered into with off-balance sheet partnerships and citing from the Powers Report, a study commissioned by the Enron Board of Directors).

155. *Id.* at 70-71.

156. *See supra* notes 152-53 and accompanying text.

157. *See supra* note 153 and accompanying text.

158. The Sarbanes-Oxley Act mandated that the SEC undertake a study of off-balance sheet transactions and entities. *See supra* note 135 and accompanying text.

159. *See* CONSOLIDATION OF VARIABLE INTEREST ENTITIES, INTERPRETATION NO. 46 (Fin. Accounting Standards Bd. 2003). This interpretation requires that the "primary beneficiary" of a variable interest entity consolidate such entity's assets, liabilities, revenues, and expenses if such "primary beneficiary" absorbs a majority of the entity's expected losses, receives a majority of expected residual returns, or both. In most cases, however, the determination of the apportionment of risks and rewards among the owners of the entity will require the exercise of judgment and a discerning analysis of the substance of the arrangements among the entity and its owners. One study estimated that the aforementioned Interpretation could add as much as \$ 379 billion and \$ 377 billion to the assets and liabilities, respectively, of the companies that make up the Standard & Poor's 500-stock index. *See* Cassell Bryan-Low, *Off-Balance-Sheet Operations Are Focus of New Regulations*, WALL ST. J., July 15, 2003, at C5 (citing a report by Credit Suisse First Boston).

160. After the facts surrounding the Enron transactions became known, the company restated its earnings and stated that previously filed financial statements could not be relied upon. *See infra* note 208. Some of the most egregious practices involving off-balance sheet entities have occurred in the structured finance area through the use of synthetic leases. Off-balance sheet entities are formed to purchase or construct property that, in turn, is leased to the corporation. In substance, the leases essentially ensure that the lessor will attain an adequate return on investment, and they place the residual risk on the lessee. The lease is structured so that the corporate lessee is deemed the owner of the property for federal income tax purposes but not for financial accounting

A manifest failure of various professionals to exercise judgment is more to blame than a failure of accounting standards to reflect reality.

C. *The Efficacy of a Principles-Based System*

The premise that principles-based standards are more likely than rules-based standards to capture the substance of a transaction is based on two assumptions. First, a more searching analysis of the facts is possible under principles-based standards. Second, the substance of a transaction is transparent and consensus on such substance is readily attainable. Both assumptions are subject to challenge. Moreover, proponents of a principles-based system of standards misunderstand the fundamental distinction between rules-based and principles-based standards. Principles-based standards will not solve the accounting problems that rules-based standards allegedly spawned.

1. FACT-FINDING

A common criticism of rules-based standards, and formalism in general, is that they tend to ignore facts. The application of detailed rules assumes a homogeneity of circumstances outside of the readily ascertainable facts necessary to apply the detailed rules.¹⁶¹ Principles-based standards permit the assessment of more facts and, consequently, will allow the substance of a transaction to become apparent — or at least will prevent absurd results. However, the fact that principles-based standards permit the assessment of more facts does not mean such assessments will actually take place. Arguably, the facts that are deemed important by rule-makers will be the facts that are examined most closely in the application of principles. Certain facts will weigh more heavily than others. Analogously to juries, the fact-finders may focus on relatively few facts because those facts are the ones that “they can readily understand or that appear most salient.”¹⁶²

2. SUBSTANCE: THE SEARCH FOR CONSENSUS

Proponents of principles-based standards also assume that consensus can be easily reached on the substance of a transaction or on the

purposes. The duality of ownership allows the corporation to deduct interest on debt and depreciate the property for tax purposes, yet present its financial position to the public without the attendant debt on its balance sheet. Enron employed a synthetic lease transaction to finance its corporate headquarters. See Luppino, *supra* note 50, at 68.

161. See Paul N. Cox, *An Interpretation and (Partial) Defense of Legal Formalism*, 36 IND. L. REV. 57, 75-76 (2003).

162. Louis Kaplow, *Rules vs. Standards: An Economic Analysis*, 42 DUKE L.J. 557, 566 n.14 (1992) (citing JOHN DICKINSON, *ADMINISTRATIVE JUSTICE AND THE SUPREMACY OF LAW IN THE UNITED STATES* 143 (1927)).

absurdity of a particular result. Accounting standards, like legislation, both reflect reality and create their own reality. In most respects, accounting standards attempt to accurately portray myriad business transactions on which there is consensus as to what has occurred. Debtors pay interest to creditors, employers pay wages to employees, and retailers sell goods to customers. Most of us have little difficulty in categorizing such transactions and explaining how they should be accounted for. For example, common experience informs accountants that a particular transaction is a sale. A transaction whereby the seller of services is obligated to reciprocate with a like amount of expenditures to the buyer for similar services — a round-trip transaction — is not a sale.¹⁶³ We know what a sale is and, call this transaction what you will, it is not a sale.

However, in other cases, the standards “impose their own form on the world.”¹⁶⁴ A thing, transaction, or event is such because a rule or statute says it is. On close examination, much of the fundamental underpinnings of generally accepted accounting principles may be so categorized. Historical cost accounting is a case in point. Is it evident that depreciation and the carrying value of assets should be based on their historical cost? One can certainly make a case that fair market value accounting is a better reflection of reality.¹⁶⁵ Likewise, it is arguable that the cash basis method of accounting is less prone to manipulation and is more understandable to the average reader of financial statements.¹⁶⁶ After all, most of us run our personal affairs on such a basis. There is no natural law of accounting that mandates that income is

163. See *supra* note 115 and accompanying text.

164. Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 865 (1982).

165. See, e.g., Alex Berenson, *Fannie Mae's Accounting Finds Critics Of Its Own*, N.Y. TIMES, June 23, 2003, at C1 (describing criticism aimed at Fannie Mae's accounting for derivatives used to hedge its mortgage portfolio and positing that full fair market value accounting of such instruments would present a truer picture of the firm's financial health); Peter J. Wallison, *Give Us Disclosure, Not Audits*, WALL ST. J., June 2, 2003 (opining that the historical cost model of accounting fails to capture the value of personnel in a knowledge-based economy). In fact, attempts have been made to capture the value of intangible assets for management's use. See, e.g., R. Lee Brummet et. al., *Human Resource Measurement — A Challenge for Accountants*, 43 ACCT. REV. 217 (1968); James S. Hekimian & Curtis H. Jones, *Put People on Your Balance Sheet*, HARV. BUS. REV., Jan.-Feb. 1967, at 105; Robert S. Kaplan & David P. Norton, *The Balanced Scorecard — Measures That Drive Performance*, HARV. BUS. REV., Jan. 1992, at 71. Fair market value accounting has its critics. The insurance industry is adamantly against fair market value accounting because, insurers assert, it would produce meaningless volatility in reported results. See Christopher Oster, *Insurers Cry Foul to Fair-Value Accounting*, WALL ST. J., June 19, 2003, at C1.

166. Accrual based income has also been criticized for its failure to reflect economic profit because, under generally accepted accounting principles, a rate of return on equity is not imputed. The true economic profit earned by a firm is the return earned in excess of risk-free rate of return. See Robert L. Bartley, *Economic Profit vs. Accounting Profit*, WALL ST. J., June 2, 2003, at A17;

earned prior to receipt or that probable, but future losses, should be accrued.

Despite the consternation over the perceived abuses of off-balance sheet entities that prominently figured in Enron's demise, disagreements exist about whether consolidation accounting accurately portrays reality. This is ironic in that criticisms directed at Enron's accounting for its SPVs were based on the fact that the standards somehow permitted the entities to avoid consolidation. A study of corporate failures in Australia had this to say about consolidation accounting:

[C]onsolidation accounting has another, less obvious yet insidious result, it purposely conceals and buries subsidiary information within the group's consolidation, hiding both the enlightening and damaging aspects of subsidiary performance within the whole . . . Consolidation techniques are the product of relying on economic form over legal form and financial substance. They obfuscate, confuse, and conceal data that might normally be available to users of financial statements, and may serve to hide data from shareholders and creditors that is damaging or otherwise disparaging. . . . Consolidation accounting purports to represent a fictional legal structure which by its very nature "lacks legal capacity generally to exercise property rights, sue or be sued, incur physical or financial damage or impose it upon others; the statements contradict the legal, social and financial essence which their constituent corporations enjoy."¹⁶⁷

Critics of rules-based standards believe that "bad results" arising from the application of such rules are readily ascertainable and that the "right results" are discoverable through a more judicious examination of the facts. This presumes too much. Tax practitioners have had considerable experience with substance versus form issues and their experiences should make accountants reticent about inviting liberal use of such a doctrine into their world.

Courts have longed applied a substance versus form analysis in interpreting and applying the tax law.¹⁶⁸ The Supreme Court, in *Greg-*

G. Bennett Stewart III, *Why Smart Managers Do Dumb Things*, WALL ST. J., June 2, 2003, at A16.

167. Rodriquez, *supra* note 107, at 470 (citing to, and quoting from, F.L. CLARKE ET AL., *CORPORATE COLLAPSE, REGULATORY, ACCOUNTING, AND ETHICAL FAILURE* (1997)).

168. Issues of economic substance are not exclusively raised in litigation. For example, the regulations that govern the registration of tax shelters define a transaction that has as a significant purpose of its structure the avoidance or evasion of federal income taxes to include transactions that lack economic substance. See Temp. Treas. Reg. § 301.6111-2T(b)(1) (2000). The regulations describe a transaction that lacks economic purpose as a transaction with reasonably expected pre-tax profit, determined on a present value basis, that is insignificant relative to the expected present value of net federal income savings from the transaction. Temp. Treas. Reg. § 301.6111-2T(b)(3) (2000).

ory v. *Helvering*,¹⁶⁹ created the doctrine when it affirmed the Second Circuit's decision that the taxpayer was not entitled to a statutory benefit because while the taxpayer, in form, met the statutory requirements at issue, the substance of the transaction was altogether different and not within the purpose of the statute.¹⁷⁰ In 1978, the Court stated that it "has never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary."¹⁷¹

The doctrine has spawned numerous tests and ancillary doctrines, such as the economic substance doctrine and the step-transaction doctrine.¹⁷² Application of the doctrines has caused the courts to inquire into various attributes of particular transactions, including whether the expected returns on an investment, exclusive of tax benefits, are sufficient, and the subjective motivation for the transaction.¹⁷³ Two commentators have discerned four general principles that have emerged from the case law. First, the courts will respect the form of a transaction if its substance agrees with its form.¹⁷⁴ Second, if the substance of transaction cannot be reconciled with its form, the courts will not respect the form of the transaction.¹⁷⁵ Third, if the substance of the transaction agrees with its form, and the substance of the transaction can be recharacterized, the courts will respect the form of the transaction if none of the plausible recharacterizations better represents the transaction's substance.¹⁷⁶ Finally, if the transaction's form arguably agrees with its substance but more reasonably does not, the courts will not respect the form of the transaction unless a business purpose exists for the form chosen.¹⁷⁷

These common law doctrines, all attempting to ascertain the sub-

169. 293 U.S. 465 (1935), *aff'g* *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934).

170. *Id.* The Court made earlier statements regarding the primacy of substance over form, but *Gregory* remains the landmark case in the area. See, e.g., *Weiss v. Stearn*, 265 U.S. 242, 242 (1924); *United States v. Phellis*, 257 U.S. 156, 168 (1921).

171. *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978). In this case, the Court did not disturb the taxpayer's treatment of a sale-leaseback transaction and acknowledged that it is often difficult to peel away the form of a transaction to reveal its substance.

172. The economic substance doctrine requires that a transaction have a reasonable expectation of some substantial pre-tax economic profit and have a business purpose. See generally Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000). The step transaction doctrine is used to treat a series of transactions as a single transaction if the separate transactions are integrated, interdependent, and focused toward a single result. See Ray A. Knight & Lee G. Knight, *Substance over Form: The Cornerstone of Our Tax System or a Lethal Weapon in the IRS's Arsenal?*, 8 AKRON TAX J. 91, 100-01 (1991).

173. See Bankman, *supra* note 171, at 13-29.

174. See Knight & Knight, *supra* note 171, at 106.

175. *Id.*

176. *Id.*

177. *Id.* at 106-07.

stance of a transaction or series of transactions, have been subject to harsh criticism on several grounds. Ascertainment of the substance of a transaction is possible in situations where the statutory strictures apply to facts or terms with a clear extra-statutory meaning — what one commentator refers to as “the Code following life.”¹⁷⁸ In such cases, the basic terms of the transaction are imported into the statute. Examples would include the definitions of a sale, compensation, and a fine. However, statutes are also “creatures of art” that create their own reality.¹⁷⁹ If the Internal Revenue Code defines a transaction in a certain fashion, then the statutory rules have created the substance to which the transaction’s form supposedly adheres.

Courts, in order to go beyond the statutory text, have resorted to the legislative purpose of the statute in question. However, as one noted commentator stated, a legislature’s purpose “is largely a fiction in hard cases” and risks ambiguity, overinclusiveness, and underinclusiveness.¹⁸⁰ The application of the four general principles set forth by Knight and Knight supports this criticism. Assuming *arguendo* that courts should diligently inquire about the substance of a transaction, in order to do so they must delve into a taxpayer’s subjective motivation for a transaction and determine how much of pre-tax return is enough to lend economic substance to a transaction.¹⁸¹ Moreover, courts have had to grapple with whether legislatively intentioned benefits should be exempted from the reach of the doctrines. For example, the choice of entity in which business is conducted can have dramatic tax consequences. The partnership form of business offers certain advantages not available to the corporate form.¹⁸² Choosing such a form for tax reasons

178. See Isenbergh, *supra* note 164, at 864-65.

179. *Id.* at 865.

180. Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 433 (1989).

181. Inquiry into a taxpayer’s subjective motivation could result in different treatment for identical transactions if, on the one hand, a transaction is closely related to routine business operations and, by happenstance, exploits a so-called “loophole” is respected and an identical transaction, entered into purposefully to exploit such “loophole,” is not. In a high profile case, the IRS is seeking \$75 million from the former partners of Long-Term Capital Management. The IRS alleges that the firm, with the aid of three Nobel Prize winning economists, entered into a series of complex transactions for the sole purpose of creating tax deductions. See Kara Scannell, *As LTCM Trial Begins, It Offers an Inside Peek at Executives and Their Taxes*, WALL ST. J., June 24, 2003, at C1. The tax shelter registration regulations make similar exceptions. A transaction that is structured to produce federal income tax benefits as an important part of its intended results is exempted from the registration if (1) the transaction occurs in the ordinary course of business in a form consistent with customary commercial practice; and (2) there is a long-standing and generally accepted understanding that the expected tax benefits are allowable under the Internal Revenue Code for substantially similar transactions. See Temp. Treas. Reg. § 301.6111-2T(b)(4)(i)-(ii) (2000).

182. Federal income taxes are not imposed on partnerships. Instead, the income or loss

alone will not subject the taxpayer to challenge.¹⁸³ In fact, the proliferation of limited liability companies is due in great part to recent favorable tax developments concerning choice of entity.¹⁸⁴

Of course, there are significant differences between enforcement of tax accounting rules and generally accepted accounting principles. However, those differences do little to engender much confidence that the accounting profession will have any more success than the tax bar and the courts in ascertaining the economic substance of transaction. Attaining consensus on the substance of a transaction for tax purposes has proved enormously vexing despite the fact that tax disputes have certain amenable characteristics: The parties' objectives are transparent; they are placed in adversarial relationship; and an impartial arbiter renders decisions. These characteristics are absent from accounting disputes, and to assume that the accounting profession would have better success than the tax bar is fanciful.

In matters of taxation, a "bad" result, from the taxing jurisdiction's standpoint, is obvious — reduction of tax liabilities. Such is not the

generated by the partnership is reported by the partners in accordance with their interests in the partnership. In contrast, corporations, with certain exceptions, are taxed at the entity level. Corporations meeting certain statutory requirements could elect to be taxed as S corporations. These corporations are not subject to tax at the entity level. However, the partnership form offers many advantages over S corporations. Partnerships offer, *inter alia*, more flexibility in capital structure and income allocation. Moreover, partnerships offer a new entrant the ability to step up the basis of the assets to reflect the purchase price for the acquired interest. For an overview of the advantages of the partnership form, see Matthew A. Melone, *Corporate Partnering: The Applicability of Subchapter K in a Subchapter C World*, 15 J. PARTNERSHIP TAX 229 (1998).

183. For state tax purposes, the form in which business is transacted is often subject to challenge. Presently, significant state tax dollars are at issue with respect to the use of Delaware holding companies to hold intangible assets. Many corporations have transferred valuable intangible assets to Delaware subsidiaries. Such subsidiaries, in turn, charge other operating subsidiaries royalties for the use of such intangibles. Thus income, for state income tax purposes, is shifted to Delaware where it is exempt from tax. See Carrick Mollenkamp & Glenn R. Simpson, *WorldCom Tax Strategy May Have Helped It Save Millions*, WALL ST. J., Aug. 14, 2003, at C1. It is doubtful that such a structure would be subject to challenge if the intangibles were originally held in Delaware corporate solution and operational activities were later incorporated in other states. It is not so clear that transferring the intangibles to a Delaware corporation changes the substance of the transaction.

184. Limited liability companies are entities formed under state law that, depending on state law, provides significant liability insulation for the owners of the entity. The business community was slow in adopting this form of business for several reasons, not the least of which was that the federal income tax status of these entities was uncertain. Final regulations — the "check-the-box regulations" — were issued in 1996 and provide assurance that these entities would be taxed as partnerships. See generally Treas. Reg. §§ 301.7701-1 (1996); 301.7701-2 (1999); 301.7701-3 (1999). Prior to the issuance of these regulations, a four-factor test was applied to determine whether the entity in question should be taxed as a corporation. See generally Larry E. Ribstein & Mark A. Sargent, *Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. LAW. 605 (1997). The corporate form offers similar, if not better, liability protection and administrative costs are usually a minor factor. Arguably, the determining factor in the decision to form a limited liability company is the tax status of such entity.

case with generally accepted accounting principles. In certain cases, companies wish to report increased earnings, but in other circumstances reduced earnings are preferred.¹⁸⁵ Companies' reporting goals are not homogeneous and are often driven by analysts' expectations, compensation targets, and other forces that defy generalization for what the skeptical eye should be on the lookout.

The relationship between the taxpayer and the taxing authority is adversarial. The relationship between a company and its auditor is, instead, client and professional. This is a significant difference about which more will be said later in this work.¹⁸⁶ Finally, tax disputes have an objective arbiter at the ready — the courts — that is lacking in the accounting realm. Even if the SEC were ready, willing, and able to take on such a function, it would prove unworkable.¹⁸⁷ Accounting disputes, unlike tax disputes, cannot be resolved over extended periods of time. Restatement of earnings, as a regular occurrence, will wreak havoc on the securities markets.

3. THE FUNDAMENTAL DISTINCTION BETWEEN RULES AND PRINCIPLES: *EX ANTE* OR *EX POST*?

Critics of rules-based standards reserve special vitriol for “bright-line” tests, “on-off switches,” and frequent scope and transition exceptions.¹⁸⁸ Principles-based standards, assert such critics, would eliminate, or at least mitigate, the elevation of form over substance that is too common under the present system. However, the focus on whether rules are complex, contain threshold tests, and are subject to numerous exceptions misses the fundamental distinction between rules and principles. Rules are merely an attempt to provide *ex ante* guidance, whereby principles require *ex post* determinations of what is or is not permissible. The application of rules requires that the facts be determined, but otherwise the task of determining what is or is not permissible has been performed in advance. On the other hand, principles require the determination of facts, and a separate and contemporaneous inquiry into what is or is not permissible is also required.

This distinction between rules-based and principles-based standards lays bare several weaknesses in the proposals for less of the former and more of the latter. First, rules are not necessarily more complex than principles. The costs of compliance in a rules-based system are overestimated and the costs of compliance in a principles-based system are

185. See *supra* notes 130-31 and accompanying text for a discussion of earnings smoothing.

186. See *infra* notes 222-51 and accompanying text.

187. See *infra* notes 220-21 and accompanying text.

188. See *supra* note 7 and accompanying text.

underestimated. Second, whether guidance should take the form of rules or principles depends on several factors. One is not inherently superior or inferior to the other and, on balance, the present system is not bad. Third, proponents ignore the role of precedent in a principles-based system. The present regulatory and audit model is inadequate in this respect.

a. Complexity: A Chimera

A common criticism of the current system is that complex rules, laden with numerous thresholds and exceptions, have contributed to standards overload and have unduly increased the expense of accounting and reporting for many transactions.¹⁸⁹ However, replacing such rules with principles-based standards will not necessarily reduce complexity. Broad, principles-based standards will, *ex ante*, obviously appear to be less complex. In application, however, such principles-based standards may be as complex, or in many cases, more complex.¹⁹⁰

Statement of Financial Accounting Standard No. 13, Accounting for Leases, provides a good example of an often-criticized rules-based standard.¹⁹¹ Four bright-line tests exist for the classification of a lease as either an operating lease or a capital lease. A lease is treated as a capital lease if the lease transfers ownership to the lessee at the end of the lease term; contains a bargain purchase option; its term equals or exceeds seventy-five percent of the economic life of the property; or the present value of the minimum lease payments equals or exceeds ninety percent of the fair value of the lease property.¹⁹² The FASB has decided, *ex ante*, that these four factors are relevant in making the distinction between operating and capital leases. Assume that a lessor and lessee purposefully structure a lease to barely fail one of the tests so that the lease is classified as an operating lease. For example, assume that

189. See *supra* notes 4-5 and accompanying text.

190. Alan Greenspan, chairman of the Federal Reserve, famously opposes the application of detailed rules in setting monetary policy. He believes that “[r]ules by their nature are simple. They cannot substitute for risk-management paradigms.” Edmund L. Andrews, *Greenspan Argues Against Strict Rules for Fed*, N.Y. TIMES, Aug. 30, 2003, at C1. Greenspan’s position is based on the premise that the economy is too complex to be managed by adherence to detailed rules. Given the stakes involved, this position may be justified when dealing with monetary policy but not accounting standards.

191. This standard was specifically mentioned in the SEC report mandated by the Sarbanes-Oxley Act. See *supra* note 86 and accompanying text. Moreover, much of the consternation over special purpose entities and off-balance sheet accounting treatment has arisen with respect to lease transactions, and more specifically, “synthetic leases.” See *supra* note 160.

192. ACCOUNTING FOR LEASES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13 § 7 (Fin. Accounting Standards Bd. 1976). Additional rules are provided for leases of real estate. See *id.* § 26.

the present value of the future lease payments amount to eighty-eight percent of the fair market value of the asset.

A principles-based standard for classifying leases would avoid such hard and fast thresholds and direct the parties to examine whether, under all the facts and circumstances, the lessor or lessee retains the benefits and burdens of ownership. The argument that this broad standard will yield a more informed result than that arising from the application of the detailed rules in *Statement of Accounting Standards No. 13* must be based on the premise that the rule either places undue focus on the percentage of fair market value test, ignores other factors that should be considered, or both. Application of such a principles-based standard will be more complex than the application of the rules-based standard because it will either have to assign varying weights to the factors and come up with an individualized assessment of what percentage of fair market value is tolerable, or it must look to other factors not presently considered. Most likely, both will be necessary. The problem of standards overload is not caused by rules. This problem will exist whether a standard is rules-based or principles-based.¹⁹³ The crux of the matter is whether one prefers to navigate the terrain *ex ante* or *ex post*.¹⁹⁴

In comparison with principles-based standards, rules-based standards are costly to promulgate because rules-based standards specify in advance, and with particularity, the application of a principle in various contexts. For example, it would be more costly for the FASB to issue a standard addressing off-balance sheet accounting treatment that attempted to consider all foreseeable permutations in the structure of such arrangements than if the FASB issued a principles-based standard that required consolidation of all entities over which the investor exercises managerial control. However, the principles-based standard would generate greater costs of advice and compliance because each arrangement would be resolved individually. Moreover, principles-based standards would likely result in less predictability and comparability.¹⁹⁵ Although in a principles-based system, precedent can mitigate the loss of predictability inherent in such standards, it is unlikely to have such an effect in the application of accounting standards.¹⁹⁶

193. One scholar has developed the concept of a "rule equivalent to a standard" to support the notion that rules are not inherently more complex than principles. A rule can be written incorporating the factors that are used in the application of a principle. Consequently, the rules-based standard and the principles-based standard should yield similar results. See Kaplow, *supra* note 162, at 586-90.

194. A rules-based system will incur greater promulgation costs because the rule-makers need to examine, *ex ante*, various permutations of a transaction. Whether additional promulgation costs are justified depends on several factors. See *infra* notes 195-96 and accompanying text.

195. See *supra* note 10 and accompanying text.

196. See *infra* note 210 and accompanying text.

b. The Economic Case

Whether rules-based or principles-based standards are more cost effective depends, to a great extent, on the frequency of the transactions subject to the standards.¹⁹⁷ The issues raised by a commonplace transaction are best resolved wholesale by enacting a rule. The up-front promulgation costs may be spread over numerous transactions, thereby making it likely that such costs are less than those that would be incurred in a case-by-case determination.¹⁹⁸ Professor Kaplow refers to the case of need-based financial aid as an example.¹⁹⁹ Generally, the definition of “need” is specified in advance by detailed rules. Because the number of applicants is great, an *ex ante* determination of the factors to apply and their relative weight is efficient despite the fact that a more nuanced, *ex-post* analysis may, on occasion, result in substantially different awards.²⁰⁰

Rules-based standards, therefore, should not be deemed deficient *per se*. In many cases they are an efficient way of dealing with frequently recurring issues. *Statement of Financial Accounting Standard No. 13* is a case in point. Lease transactions are ubiquitous. In the vast majority of cases, whether a lease is, in substance, what it purports to be will turn on four factors deemed relevant by the standard. If the existing standards yield anomalous results in too many cases, then the rules should be fixed, not scrapped. If, however, the rules yield the “wrong” result with respect to the occasional transaction, then other mechanisms should be considered, which, for the most part, are available.²⁰¹

Is it possible that the benefits of elevating substance over form, through the use of broad, principles-based standards, exceed any conceivable increase in application costs? Such a possibility is highly unlikely for two reasons. First, the added value of alternatively characterizing most transactions in accordance with their so-called substance is dubious. Second, the value placed on the existence of this benefit

197. See Kaplow, *supra* note 162, at 563-64.

198. In the event previous applications of principles-based standards have established precedent for future application, the costs of knowing the rules should not exceed the costs of applying a principles-based standard.

199. See Kaplow, *supra* note 162, at 594 n.100.

200. Professor Kaplow actually uses the financial aid example to make the point that there is no certainty that a case-by-case application of broad principles will consider all the subtleties of a particular case. However, even assuming that individual cases are examined thoroughly, the variation in most awards will not differ significantly from the result derived from applying the rules. If such were the case, the response should be to revise the rules, not scrap them.

201. See *supra* notes 90-97 and accompanying text. If certain factors, ignored by the rule in question, are highly particularized, there is no reason that the rules should be scrapped. The rules may work well, and an *ex post* analysis of those particularized factors may provide the fix. A standard need not be exclusively rules- or principles-based.

falsely presupposes that a principles-based system has immunity from opportunistic behavior.

As discussed earlier in this Article, a standard may incorporate commonly understood concepts in which case it attempts to reflect a reality that is defined by constituencies other than the standard setters.²⁰² Alternatively, a standard may create its own reality by defining terms for its own purposes.²⁰³ In the latter case, attempts at discerning the “true” substance are of dubious benefit — and perhaps dubious validity. Again, lease transactions offer a good example.

Leases are a legal construct. Well-established notions of property law set forth the rights and burdens of the holder of the residual property rights and the holder of the possessory interest. Most businesspersons, and many consumers, can easily distinguish between a sale and a lease. However, it is also possible to structure a transaction as a lease that contains certain attributes that would make one question whether the transaction is what it purports to be. For example, a lease may automatically transfer ownership to the lessee at the end of the lease term. How much time and effort are expended in quieting one’s unease should depend on the stakes involved and how much better an alternative classification purports to capture reality.

Whether a transaction is a lease or sale has significant legal consequences. For federal income tax purposes, the characterization of the transaction will determine whether the lessor or lessee may depreciate the asset, whether the lessor has a gain or loss on a sale of the asset, and whether the lease obligation is a debt that generates interest income and expense to the parties. Likewise, the characterization of the transaction will have implication for other lenders, particularly in the event of bankruptcy. If the transaction is recast as a sale, then the putative lessor is a creditor whose position *vis-à-vis* other claimants to the collateral will depend upon whether steps were taken to perfect a security interest.²⁰⁴ In such circumstances, the time and effort expended to ascertain the substance of the transaction arguably yield some tangible benefit.

The purpose of accounting is to provide timely and relevant information to management, investors, creditors, and other interested third parties. Assume in a given “hard case,” reasonable auditors come to the conclusion that, given all the facts and circumstances, a lease transaction in question should be treated as a sale by the lessor and a purchase by the lessee despite the fact that the transaction fails all four “bright-line”

202. See *supra* note 163 and accompanying text.

203. See *supra* note 164 and accompanying text.

204. See generally U.C.C. §§ 9-201, 9-301 (2002).

tests set forth in *Statement of Accounting Standards No. 13*.²⁰⁵ It is difficult to see how reality is better reflected by an *ex post* determination that sets the threshold for capital lease treatment at seventy-two percent of the economic life of the asset or eighty-seven percent of the fair market value of the asset, or some other such threshold that the particular facts of this case seemingly yields.²⁰⁶ A capital lease is what the standards say it is.²⁰⁷ The accounting standards are — or should be — known by readers of the financial statements. They can draw their own conclusions.

Bear in mind that differences in results between the application of principles-based standards and rule-based standards will come in the “hard cases.” In the vast majority of cases, a transaction will fit comfortably within or without a reasonably drafted rule. If not, then the rule’s content is more the problem than the existence of the rule itself. In egregious cases, the accounting and auditing professions already possess the tools to recast the transactions.²⁰⁸ In fact, many of the so-called “hard cases” would have fit nicely within existing rules had not management committed outright fraud or failed to disclose all relevant information.²⁰⁹ The “hard cases” are such because different, yet reasonable, conclusions may be drawn about the transactions.

c. Precedent

Complex rules are sometimes overinclusive or underinclusive. As such, they tolerate opportunistic exploitation of their complexity to cause transactions that, in spirit, should fall within the rules’ ambit to escape their reach, and vice-versa. However, replacing such rules with principles-based standards will not necessarily reduce the opportunities for those so inclined to “game” the system. Arguments to the contrary underestimate the effect of precedent in a principles-based system. Precedents established under such a system create thresholds that, like rules, are subject to exploitation. Moreover, under the present audit model, such precedent will be established without the benefit of a credible arbiter.

205. See *supra* note 191.

206. Kaplow questions whether *ex post* decision makers consider all relevant factors or rather focus only on certain factors that they deem critical. See Kaplow, *supra* note 162, at 565-66.

207. Arguably, to better reflect reality, the accounting treatment should mirror the characterization given to a transaction by a court or regulator for other purposes. This would cause the accounting standards to reflect “life” as opposed to creating their own reality.

208. See *supra* notes 90-97 and accompanying text.

209. For example, once all the circumstances came to light concerning Enron’s off-balance sheet transactions, Arthur Andersen required the company to restate its results with such entities consolidated. See Richard A. Oppel, Jr. & Floyd Norris, *In New Filing, Enron Reports Debt Squeeze*, N.Y. TIMES, Nov. 20, 2001, at C1.

1. OPPORTUNISTIC BEHAVIOR

The assertion that a rule is prone to overinclusivity or underinclusivity implies that certain factors necessary in the application of the rule are either not relevant, not accorded appropriate weight, or are ignored. In the cases where the factor or factors in question are not relevant or not appropriately weighted, the easy solution is to fix the rule. However, many substance versus form disputes are based on the assertion that certain factors germane to the resolution of the issue at hand are ignored under a rules-based system.

In a principles-based system, once the additional factors that are deemed relevant are considered, a precedent is created. Such precedent, in effect, becomes a new rule just as susceptible to exploitation as an *ex ante* promulgation. With respect to legal issues, "an accumulation of precedents dealing with the same question may create a rule of law having the same force as an explicit statutory rule."²¹⁰ Although the precedential value of previous applications of accounting rules does not approach the value of legal precedent, it is inconceivable that prior decisions dealing with similar issues will not carry substantial weight.²¹¹ Large accounting firms expend enormous effort to create "knowledge databases," the purpose of which is to provide the firms' professionals with the benefit of the firms' past experience in resolving an issue.

Consequently, a principles-based standard does not eliminate the ability to structure transactions to obtain desirable accounting results. If the application of a principles-based standard is justified by reference to certain factors deemed relevant, then those factors become susceptible to manipulation. For example, assume that an accounting standard dealing with consolidation of investee entities by the investor states that the exercise of control over the investee by the investor mandates consolidation.²¹² Control is not defined but is instead to be determined by all the facts and circumstances.

Assume further that in a particularly difficult case, one of the facts considered important is that the investor is a significant customer of the investee. This fact favored the decision to consolidate despite the fact that investor owned a significant, but not a majority, stake of the equity of the investee entity. Once the basis for the decision is known, someone inclined to avoid consolidation will make the effort to structure a

210. Kaplow, *supra* note 167, at 577 n.46 (quoting RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 20.1, at 539 (4th ed. 1992)).

211. Confidentiality rules limit the dissemination of client information. See *CODE OF PROFESSIONAL CONDUCT*, *supra* note 65, § 301, Rule 301. Moreover, competitive pressures will, in all likelihood, limit the sharing of information among accounting firms.

212. See *supra* notes 140-150 and accompanying text for a discussion of consolidation accounting.

transaction to differentiate it from the prior transaction. The transaction may be structured so that the investor owns less equity outright or does less business with the investee. The roadmap is there — whether by rule or past applications.

The hard cases will be structured transactions. Transactions that accidentally happen to have favorable but seemingly unintended consequences are few. Past decisions rarely pronounce clear-cut thresholds or bright-lines, as rules often do. Therefore, it is arguable that the benefits of structured transactions are less certain than under a system of rules-based standards. Firms, less certain of the outcome, will be less inclined to incur the costs of structured transactions. The evidence, however, does not support such optimism. In fact, firms may become emboldened by the existence of principles-based standards.

Studies of aggressive reporting practices have shown that even precise standards are less effective in constraining aggressive reporting if managers have wide latitude in interpreting the evidence related to the standard.²¹³ Imprecision in the standards has been shown to increase the aggressiveness of reporting. Auditors tended to allow their clients to make more aggressive reporting choices when the precedents for doing so were mixed.²¹⁴ Only in situations where the precedents unanimously favored one choice did auditors tend to require the client to report in a particular manner.²¹⁵ Moreover, poor choice of precedent was exhibited in cases where the choice supported the client's position.²¹⁶ The recent spate of accounting scandals supports these findings. As discussed earlier, most of the scandals did not result from exploitation of rules but from misapplication of broad, well-established, principles.²¹⁷ Finally, even a casual observer of the federal income tax landscape cannot help but notice that tax shelters continue to proliferate. Despite the arsenal of common law doctrines employed by the courts,²¹⁸ the possibility of substantial penalties,²¹⁹ and an adversarial setting, the attempts to find so-called loopholes go on unabated. So long as the incentives are in place, neither rules nor principles will stem such attempts.

213. See Nelson, *supra* note 78, at 94-97.

214. *Id.* at 95-98.

215. *Id.*

216. *Id.*

217. See *supra* notes 99-100 and accompanying text.

218. See *supra* note 171 and accompanying text.

219. See generally I.R.C. § 6662 (2002) (imposing a twenty percent penalty for actions including negligence and substantial understatement of income tax); I.R.C. § 6663 (2002) (imposing a seventy-five percent penalty for the portion of the underpayment of tax attributable to fraud).

2. THE ARBITER

Two fundamental distinctions may be made between the application of broad principles-based standards and rules-based standards. The first concerns when decisions are made, and the second addresses the individual decision-makers. As discussed above, the application of broad principles entails *ex post* decision-making in contrast to the *ex ante* nature of rules-based systems.²²⁰ Moreover, a rules-based system relies heavily on a regulatory-type body to promulgate such rules. A principles-based system requires an arbiter to develop a body of rules as particular situations arise. The arbiter, in effect, puts “flesh on the bones” through an ever-expanding body of precedent. Perhaps the most significant weakness in the employment of principles-based system of accounting standards is the lack of a credible arbiter.

Ex post resolution of issues that arise in the application of accounting standards will, under the present regulatory framework, fall to the accounting profession. The SEC is not in a position to serve as a timely arbiter. The SEC received an aggregate of \$2.1 trillion in public offering filings and 13,460 annual reports in the fiscal year ended September 30, 1999.²²¹ Unlike tax disputes, accounting issues must be resolved prior to the release of the issuer’s financial statements.²²² The capital markets will not tolerate regular earnings restatements. The courts, for similar reasons, are not well situated to resolve such issues.

Auditors are legally and ethically required to be independent. However, under the present audit model, auditors cannot achieve a level of independence in fact or appearance that ensures that they will exercise the proper judgment and discretion in the application of broad principles-based accounting standards. There are two reasons for this conclusion. First, the present relationship between auditors and the reporting firm is a client relationship. Recent regulatory and legislative developments in this area have not changed that fact. Second, so long as incentives for aggressive accounting exist, auditors will be pressured to agree with their clients’ management. It is too early to predict whether the provisions of the Sarbanes-Oxley Act will materially alter management’s incentives, but pessimism in this respect would not be misplaced.

220. See *supra* note 193 and accompanying text.

221. See Mark Allan Wordan, *Securities Regulation: Protecting Auditor Independence from Non-Audit Services — An Evolving Standard*, 55 OKLA. L. REV. 513, 515 (2002).

222. Tax disputes often take years to work their way through the system. After exhausting administrative procedures, disputes are often tied up in the courts for years. Although the resolution of a tax dispute often impacts the financial statements, liability reserves are established, and disclosure is provided for significant disputes. Consequently, the resolution of the dispute does not require restatement of prior years’ financial statements. In effect, the tax dispute is accounted for as a contingent liability.

(a) Independence

Congress, in enacting the Securities Act of 1933 and the Securities Exchange Act of 1934, placed the responsibility of auditing the financial statements of registrant companies on the accounting profession.²²³ In order to carry out their function, accounting firms that audit such financial statements must be independent.²²⁴ Thus, as recognized by the Supreme Court and the accounting profession itself, auditors hold a position of public trust.²²⁵ In theory, the accounting profession is well placed to perform the role of independent arbiter with respect to the application of accounting standards. Critical to the accounting profession's ability to exercise the impartial judgment necessary to effectively fulfill this role is the independence requirement. Unfortunately, with respect to independence, practice departs too far from theory.

The AICPA Code of Professional Conduct states that members "should maintain objectivity and be free of conflicts of interests in discharging professional responsibilities" and should be "independent in fact and appearance when providing auditing and other attestation services."²²⁶ Independence requirements, until the issuance of new SEC regulations in 2000, were enforced by various SEC and professional rules.

Prior to the 2000 amendments, the SEC last amended the auditor independence rules in 1983, despite the fact that the accounting profession had dramatically changed.²²⁷ The major accounting firms today barely resemble those of twenty years ago. From 1993 to 1999, as their audit revenues grew at an annual rate of nine percent, accounting firms' revenues from non-audit services increased at an annual rate of twenty-

223. Consideration was given to the creation of a group of government auditors and to federal licensing of auditors. See 65 Fed. Reg. 43,148, 43,150 (July 12, 2000).

224. 15 U.S.C. §§ 77-78 (2000). The Second Circuit Court of Appeals stated that the accounting profession, due to the SEC's inability to review the vast number of filings it receives, is primarily responsible for the integrity of the financial information companies submit to the SEC. *Touche Ross & Co. v. SEC*, 609 F.2d 570, 580-81 (2d Cir. 1979).

225. In *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), the Supreme Court stated that "[b]y certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a position of public responsibility." This responsibility "demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust." *Id.* at 817-18. The Court, moreover, distinguished the role of auditor from that of an attorney, stating that the auditor should be disinterested. *Id.* at 818.

226. CODE OF PROFESSIONAL CONDUCT, *supra* note 65, § 55, Art. IV, para. 3.

227. In 1997, the SEC and the AICPA jointly formed the Independence Standard Board. Composed of four members from the accounting profession and four from business and finance, the Independence Standard Board was charged with developing a conceptual framework for independence regulation. See William T. Allen & Arthur Siegel, *Conflicts of Interest in Corporate and Securities Law: Threats and Safeguards in the Determination of Auditor Independence*, 80 WASH. U. L.Q. 519, 525 (2002). The SEC abandoned its commitment to the Independence Standard Board, and it was dissolved in July 2001. *Id.*

six percent.²²⁸ By the end of the decade, approximately fifty percent of the Big Five public accounting firms' revenues were generated from non-audit services.²²⁹ In comparison, such revenues accounted for approximately thirteen percent of the firms' revenues in the early 1980s.²³⁰ Management of the major accounting firms recognized the limits to the growth of the auditing business while, at the same time, acknowledged the vast potential in consulting services, particularly information technology.²³¹ The AICPA itself encouraged such trends.²³²

The accounting profession and the SEC have taken a pragmatic, rather than dogmatic, approach to auditor independence and non-audit services.²³³ One school of thought posits that all non-audit services should be banned by the independence requirement. Supporters of an exclusionary ban believe that by providing such services, the audit firm serves both management and the investing public, thereby creating a conflict in appearance and, possibly, in fact. A second school of thought believes that many non-audit services provide a service to the public.²³⁴

228. See Worden, *supra* note 220, at 516-17.

229. *Id.* at 517. Arthur Andersen, Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche, and KPMG were the Big Five public accounting firms. After the demise of Arthur Andersen as a result of its role in the Enron scandal, the remaining firms are known as the Big Four — or derisively as The Final Four.

230. A report prepared by Wilmer, Cutler & Pickering on the WorldCom fraud highlights the severe pricing pressure on the audit profession and the concomitant impetus to sell more lucrative services. Moreover, the report also asserts that such pricing pressures have led to less rigorous audits. See Cassell Bryan-Low, *WorldCom's Auditors Took Shortcuts*, WALL ST. J., July 23, 2003, at C9.

231. The push into consulting services caused much turmoil within some of the firms with respect to compensation and governance. Arthur Andersen and its consulting practice parted ways amid much acrimony. See Reed Abelson, *After Andersen War, Accountants Think Hard About Consulting*, N.Y. TIMES, Aug., 9, 2000, at C1. See also Cassell Bryan-Low, *Deloitte Chief Wrestles to Get Consultants Back in Firms*, WALL ST. J., Aug. 14, 2003, at C1.

232. See MAKE AUDITS PAY: LEVERAGING THE AUDIT INTO CONSULTING SERVICES (Am. Inst. of Certified Pub. Accountants 1999).

233. The provision of non-audit services are but one of many factors that determine whether an auditor is independent in fact and appearance. Financial and employment relationships between the auditors and client are two significant factors. These factors, however, have proven relatively uncontroversial in comparison to the issues raised by the provision of non-audit services. Occasionally, however, certain business relationships have led to controversy. See Jonathan Weil, *Freddie Mac's Charity Case*, WALL ST. J., July 21, 2003, at C1 (reporting that the lead partner on the audit of Freddie Mac served on the board of a charity to which the company made significant contributions).

234. In recent years, the major public accounting firms have embroiled themselves in disputes as a result of services or arrangements that seemingly bear little relation to audit efficiency. Some of the more questionable practices have involved marketing or client referral arrangements whereby the audit client referred business to the audit firm or vice versa. Others involved the marketing of tax shelters to audit client or, in some cases, to the executives of the audit clients. See, e.g., Cassell Bryan-Low & Carrick Mollenkamp, *Wachovia, KPMG Face SEC Probe over Referrals*, WALL ST. J., Aug. 15, 2003, at A3; Cassell Bryan-Low, *KPMG's E-Mails Pointed to Concerns over Tax Shelters*, WALL ST. J., June 25, 2003; Cassell Bryan-Low, *Did Ties That Bind*

Such services enable the auditor to obtain a deeper knowledge of the client's operations and controls, thereby leading to improved audit efficiency. Moreover, such services allow the audit firm to suggest improvements in client operations. The SEC subscribes, in great part, to this school of thought.

The SEC adopted a final rule in 2000 that limited, rather than banned, non-audit services. The rule specifically set forth several prohibited situations and relationships. Circumstances not specifically addressed are tested under the existing general standard for independence based on all the facts and circumstances.²³⁵ With certain exceptions, the final rule prohibits auditors from providing bookkeeping services, operating, supervising, or designing client financial information systems, appraisal and valuation opinions, internal audit services exceeding certain thresholds, management functions, human resource services, broker-dealer services, and legal services.²³⁶ Moreover, the rules require the client to disclose audit and non-audit fees billed by the auditor.²³⁷ A recent dispute about the fee disclosure rule, however, causes one to doubt the efficacy of this requirement.²³⁸

The Sarbanes-Oxley Act enumerated several services that auditors may not provide to audit clients.²³⁹ The list of services prohibited by the Act mirror those listed in the SEC rule. However, the legislation eliminated the numerous exceptions that exist in the final rule.²⁴⁰ Moreover, the Act also requires that any non-audit service that is not prohibited, including tax services, must be approved in advance by the client's audit

Also Blind KPMG, WALL ST. J., June 18, 2003, at C1; Patrick McGeehan, *Sprint's Holders Rumbling over Conflicts by Auditor*, N.Y. TIMES, May 14, 2003, at C1.

235. The general standard of auditor independence states that an accountant is not independent "if the accountant . . . or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not . . . capable of exercising objective and impartial judgment on all issues . . ." 17 C.F.R. § 210.2-01(b) (2001).

236. 17 C.F.R. § 210.2-01(c)(4)(i)-(ix) (2001).

237. 17 C.F.R. § 240.14a-101 (2001).

238. HealthSouth Corp. classified \$2.39 million in payments to Ernst & Young as "audit-related fees." The company later acknowledged that approximately \$1.3 million included in the "audit-related" figure was for janitorial service — basically operational inspections to determine the cleanliness of company's facilities and the like. The company relied on Ernst & Young for the classification. A spokesperson for Ernst & Young stated that "[t]he audit-related category is not limited to services related to the financial statement audit per se." See Jonathan Weil, *HealthSouth and Ernst Renew Flap over Fee Disclosures*, WALL ST. J., July 1, 2003, at C1.

239. Sarbanes-Oxley Act, § 201(a) (amending 15 U.S.C. § 78j-1).

240. Under the final rule, for example, auditors could provide certain system design and implementation work, perform certain tax valuation, and provide internal audit work for smaller clients. See, e.g., 17 C.F.R. §§ 210.2-01(c)(4)(ii)(B)(1)-(4); 210.2-01(c)(4)(iii)(B)(1)-(4); 210.2-01(c)(4)(iv)(A)(1)-(3) (2001). The Public Company Accounting Oversight Board, described at *supra* note 54 and accompanying text, may exempt any person, issuer, public accounting firm, or transaction from the prohibition on the provision of non-audit services. Such exemptions are to be made on a case-by-case basis. See Sarbanes-Oxley Act, § 201(b).

committee.²⁴¹ Finally, the Act added a conflict of interest provision that prohibits a firm from conducting an audit if the chief executive officer, controller, or chief financial officer of the issuer was employed by the audit firm and participated in the audit of the issuer, in any capacity, during the one year period preceding the date of the initiation of the audit.²⁴²

In addition to strengthening the independence requirement, the Sarbanes-Oxley Act contains several other provisions that directly affect the audit function. The Act establishes a Public Company Accounting Oversight Board, which is an independent nonprofit corporation.²⁴³ The Board is empowered with regulatory authority over private audit firms and is to register and inspect such firms, and establish or adopt auditing, quality control, ethics, and independence standards related to the conduct of audits.²⁴⁴ The Board consists of five members, no more than two of which shall be or have been certified public accountants.²⁴⁵ Membership on the Board is full-time with five-year terms.²⁴⁶ As a consequence, the audit profession will no longer be self-policing, and the promulgation of auditing standards is no longer within the exclusive purview of the AICPA.

In addition, the Act attempts to strengthen the role of issuers' audit committees.²⁴⁷ All audit committee members must be independent and are precluded from accepting any consulting, advisory, or other compensatory fee from the issuer. Committee members also must not be an affiliated person of the issuer or any subsidiary.²⁴⁸ Moreover, auditors must timely disclose to the audit committee all critical accounting policies and practices, all alternative accounting treatments that have been discussed with management, the ramifications of the use of such alterna-

241. Sarbanes-Oxley Act, § 201(b). The SEC recently issued final regulations implementing the statutory rules. See 17 C.F.R. § 210.2-01(c)(4) (2003).

242. Sarbanes-Oxley Act, § 206. It was very common for issuers to hire, as chief financial officers and controllers, employees of the audit firm who were assigned to the engagement. The rationale for this practice is that such persons were familiar with the issuer's accounting practices, procedures, and personnel and would, therefore, have less of a learning curve than other candidates for the position.

243. The Board is not agency of the U.S. government nor shall any member or employee of the Board be considered an officer, employee, or agent of the federal government. *Id.* § 101(b). The SEC has oversight and enforcement authority over the Board. *Id.* § 107. The Act also established funding sources for the Board, primarily from the collection of monetary penalties and annual assessments of issuers. *Id.* § 109.

244. *Id.* §§ 101-105.

245. *Id.* § 101(e).

246. *Id.* §§ 101(e)(3), 101(e)(5). A member may be removed by the SEC but only for cause. *Id.* § 101(e)(6).

247. The SEC and the stock exchanges have also addressed the composition and role of issuers' audit committees. See generally Bartholomew, *supra* note 134, at 88-89.

248. Sarbanes-Oxley Act, §301.

tive treatments, and the treatment preferred by the audit firm.²⁴⁹ Material written communication between the audit firm and management, such as management letters and schedule of unadjusted differences, must also be provided.²⁵⁰

The Act mandates that the lead audit partner or the partner responsible for reviewing the audit be rotated off the engagement within five years.²⁵¹ The Act did not mandate rotation of audit firms, but it does require the Comptroller General of the United States to conduct a study of mandatory audit firm rotation.²⁵²

It remains to be seen what effect the Sarbanes-Oxley Act will have on the quality of the audit function. Certainly, more rigorous audit committee oversight, tightened independence rules, and the existence of an independent watchdog are welcome. However, the Act did not disturb the fundamental cause of auditor conflicts of interest. The issuer remains the client. Although reducing, and perhaps eliminating, the non-audit services the accounting firm is able to provide may mitigate the conflict of interest, it will not eliminate it. The audit fee in and of itself creates the conflict. Despite the fact that a single audit fee is immaterial to firms of the magnitude of the Big Four accounting firms, such a loss could be material for smaller firms. Moreover, loss of a major audit client can be devastating to a partner's career in any firm and substantially affect the operations of local offices or practice specialties.

This Article does not suggest that the audit model should be revised. Perhaps mandatory audit firm rotation, government paid auditors, or some other such arrangement may be more effective. However, the present model is inherently deficient if the accounting firms are to determine, *ex post*, the application of accounting standards. That is precisely what they would be called upon to do in a principles-based system. Most of the "bubble era" accounting irregularities that have come to light in the past several years resulted in part from auditors' failures to exercise independent judgment and take a firm stand against management. Auditor independence, to have any substance, requires that auditors be capable of acting as counterweights to the incentives management has to make the numbers look favorable. The present

249. *Id.* § 204.

250. *Id.* A management letter is a written communication between the audit firm and the client's management that describes operational or internal control weaknesses discovered during the course of audit and offers suggestions for improvements. A schedule of unadjusted differences is a summary of all accounting adjustments proposed by the audit firm but not made because such adjustments are deemed not material.

251. Sarbanes-Oxley Act, § 203.

252. *Id.* § 207.

model provides little assurance that, in the face of management pressure, auditors will behave differently than they have in recent years.

(b) Managerial Incentives

The auditor-client relationship places the accounting firm in a compromised position. The client, after all, pays the bills, and the client, in recent years, has had every incentive to exploit this relationship. Ironically, much of the incentive can be attributed to one particular accounting standard. The accounting standard for stock option compensation has contributed to the creation of a “stock market” culture that has pervaded the executive suite. This culture adopts, as the ultimate objective of management, shareholder wealth maximization as measured by the firm’s stock price. Such a culture placed tremendous pressure on public accounting firms to comply with client wishes.

During the period 1992-2000, the median pay of chief executive officers, in constant 2001 dollars, nearly tripled. During this period, stock option compensation,²⁵³ as a component of overall chief executive compensation, increased from twenty-seven percent to fifty-one percent and nearly quintupled in dollar terms.²⁵⁴ More than sixteen percent of the shares of large firms are reserved for option exercises.²⁵⁵

Stock option based compensation plans are justified by the notion that such plans align managerial incentives with shareholder objectives, thereby reducing the agency costs inherent in an employment relationship.²⁵⁶ Whether such plans are effective has been subject to much

253. A stock option is a contract that gives the holder the right, but not the obligation, to purchase a certain number of shares of stock at a predetermined price for specified period of time. A stock option may also grant the holder the right to sell a certain number of shares at a predetermined price. These “put” options are not, for obvious reasons, used in compensatory settings. The predetermined price, or strike price, can be set below, at, or above the market price of the stock at the time of grant — in-the-money, at-the-money, and out-of-the-money, respectively. Moreover, the option contract can be structured so that the holder captures all of a stock’s appreciation or only that appreciation over and above an established benchmark.

254. See Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002).

255. David Henry, *An Overdose of Options: Depressed Stock Prices Are Prompting Companies to Issue More Options Than Ever*, BUS. WEEK, July 15, 2002, at 112. In 1980, the average annual compensation of chief executive officers in the United States was slightly less than \$1,000,000 and virtually all of this amount consisted of traditional salary and cash bonuses. In 1998, the average annual compensation of chief executive officers ballooned to approximately \$5.5 million, almost sixty percent of which was generated by some form of equity-based pay. Daniel Altman, *How to Tie Pay to Goals, Instead of the Stock Price*, N.Y. TIMES, Sept. 8, 2002, § 3, at 4 (citing several sources including Towers Perrin and Standard & Poor’s ExeCucomp).

256. See Michael W. Melton, *The Alchemy of Incentive Stock Options — Turning Employee Income into Gold*, 68 CORNELL L. REV. 488, 495, 501-02 (1983). Other compensation arrangements can also be used to align management’s goals with those of shareholders. For example, cash bonuses determined on some profitability metric or phantom stock plans are quite common.

debate, and certain attributes of stock options, as compensation vehicles, have attracted much criticism. Critics have asserted that stock options are valued less than optimally by their recipients and thus impose a deadweight cost on the issuer.²⁵⁷ Moreover, stock options reward their recipients for general stock market rises and punish them for general market declines.²⁵⁸

Stock option based compensation arrangements proliferated for several reasons. Federal tax law limits a publicly traded corporation's compensation deduction for salaries paid to the chief executive officer and the four highest paid officers other than the chief executive to \$1,000,000 per officer.²⁵⁹ Excluded from this limitation is performance-based compensation.²⁶⁰ Most stock option plans are deemed performance-based.²⁶¹ Moreover, the recipient of stock options is generally entitled to defer the income from the receipt of options until the options are exercised.²⁶² Another factor contributing to the proliferation of stock options is the ease with which these instruments allow management to camouflage rent-seeking behavior.²⁶³ Ineffective board of directors and inadequate shareholder protections were also contributing factors.²⁶⁴

257. See Lisa K. Meulbroek, *The Efficiency of Equity-Linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options*, 30 FIN. MGMT. 5 (2001), available at 2001 WL 23057973; Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. ECON. 3, 12, 15-17 (2002). The principal reason for this phenomenon is that the recipients of the stock options are typically nondiversified.

258. See Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 797 (2002).

259. I.R.C. § 162(m)(1)-(3) (2002).

260. *Id.* § 162(m)(4)(A)-(B).

261. See generally Treas. Reg. § 1.162-27(e)(2)(iii)(C) (1995).

262. The federal income tax treatment of stock options depends on whether the options qualify as incentive stock options and whether the recipient is subject to the alternative minimum tax. Incentive stock options are not taxed as income to the recipient upon receipt or exercise. Instead, the incidence of taxation is postponed until the holder sells or exchanges the underlying stock. Gains from such sales or exchanges are taxed as capital gains. Because of several statutory limitations, incentive stock options are not used, to any significant extent, in compensating executives. See generally I.R.C. § 421 (2002). Nonqualified stock options are generally subject to tax upon the exercise of the options. The income subject to tax is determined by the difference between the option's exercise price and the fair market value of the underlying stock. See generally *Id.* § 83; Treas. Reg. § 1.83-7 (1978). The alternative minimum tax may accelerate the incidence of taxation. A fuller discussion of this tax is beyond the scope of this work. See generally I.R.C. §§ 55-56 (2002). Whether the tax deferral on the income for the recipient of the income provides a competitive advantage for stock option based compensation is not clear because the corporation's compensation deduction is concomitantly deferred. See Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, 14 TAX POL'Y & ECON. 1, 8 (2000).

263. See generally Bebchuk et al., *supra* note 257, at 786-90.

264. The ability of a corporation to deduct performance-based compensation requires that such performance-based plans be put to a shareholder vote. I.R.C. § 162(m)(4)(C) (2002). Moreover,

Many of the accounting irregularities that have taken place may be laid at the feet of stock options because they fostered a corporate culture in which accounting irregularities were tolerated, if not encouraged. Ironically, the accounting treatment of compensatory stock options has contributed most to their proliferation. The standards governing compensatory stock options are not particularly complex and, with a few exceptions, criticisms have not been directed at the exploitation of “bright-line rules.” The problem is that the standards are conceptually flawed — a plain and simple example of bad accounting.

Until the mid-1990s, generally accepted accounting principles, with respect to compensatory stock options, required that issuing corporations recognize compensation expense determined under the so-called “intrinsic value” method.²⁶⁵ This method determines compensation expense as the difference between the fair market value of the stock and the exercise price at the measurement date.²⁶⁶ For most stock option compensation plans, the measurement date is the date the options are granted.²⁶⁷

many state corporation statutes subject stock option plans to a shareholder vote as do the major stock exchanges. *See, e.g.*, N.Y. BUS. CORP § 505(d) (McKinney Supp. 1999). However, shareholder approval is typically required only with respect to the broad parameters of the compensation plan and not detailed design features. The threat of shareholder litigation is also an ineffective mechanism for checking managerial excesses. Directors’ actions are generally protected by the business judgment rule. The business judgment rule provides legal cover for actions undertaken in good faith and made with due care. This doctrine has found statutory expression in Delaware with respect to stock options. “In the absence of actual fraud . . . the judgment of the directors as to consideration for the issuance of . . . options and the sufficiency thereof shall be conclusive.” DEL. CODE ANN. tit. 8, § 157 (1998). Shareholders also encounter procedural challenges. Shareholder challenges to executive compensation would come in the form of derivative litigation. Generally, the shareholders must first make a demand on the directors to investigate the claim and consider whether further action is appropriate. *See Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984). In almost all cases, the directors, perhaps through a special litigation committee, will seek to have the action terminated. *See Randall S. Thomas & Kenneth J. Martin, Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 576 (2001).

265. The compensation expense is recognized at the earliest date that both the number of shares and the exercise price with respect to those shares are known with certainty. ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, ACCOUNTING PRINCIPLES Bd. OPINION NO. 25 § 10(b) (Am. Inst. of Certified Pub. Accountants 1972). Prior to the issuance of A.P.B. Opinion No. 25, authoritative rules for the accounting of compensatory stock options were issued in 1953. *See generally* RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, ACCOUNTING RESEARCH BULLETIN No. 43, ch. 13, § B. (Am. Inst. of Certified Pub. Accountants 1953). A.P.B. Opinion No. 25 amended this pronouncement in part and superceded it in parts. Earlier guidance (ACCOUNTING FOR COMPENSATION IN THE FORM OF STOCK OPTIONS, ACCOUNTING RESEARCH BULLETIN No. 37 (Am. Inst. of Certified Pub. Accountants 1948)) was superceded by the rules issued in 1953.

266. ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, *supra* note 264, § 10a.

267. For fixed share plans, the measurement date is the date of grant regardless of whether the options were subject to a vesting schedule based on length of service or attainment of pre-established performance goals. Fixed share plans are plans under which both the number of shares subject to option and the strike price are established at the date of grant. The existence of a

Consequently, at-the-money or out-of-the money stock options will, in contrast to other forms of equity-based compensation, generate no compensation expense for the issuing corporation.²⁶⁸

The growth of stock option based compensation led the FASB to issue an exposure draft in 1993 that recommended that stock options be recorded as compensation using fair market value models.²⁶⁹ The exposure draft generated tremendous controversy, and industry, particularly technology companies, mobilized political opposition against the proposal.²⁷⁰ In 1995, the FASB issued its final statement but the new standard

vesting period serves only to spread the resulting compensation expense over the vesting period but does not affect the initial measurement of the expense. *Id.* §§ 12-14.

268. In contrast to tax accounting rules, the exercise date is largely irrelevant in the determination of compensation expense under generally accepted accounting principles. In general, compensatory stock options are taxable to the recipient upon their exercise, or if later, when vested, resulting in a concomitant compensation deduction to the issuer. *See* I.R.C. § 83(b) (2002); *Treas. Reg.* § 1.83-7 (1978). The tax benefits generated from compensatory options can be quite significant. *See* Michelle Shevlin, *Accounting for Tax Benefits of Employee Stock Options and Implications for Research*, 16 *ACCT. HORIZONS* 16 (2002) (reporting that Cisco Systems received a tax benefit of approximately \$2.5 billion in its fiscal year ended July 2000 as a result of compensation deductions generated from the exercise of employee stock options).

269. The most prevalent valuation methods are the Black-Scholes and binomial valuation methods. Under the Black-Scholes model, five principal variables influence the price of an option: the current stock price; the exercise price of the option; the volatility of the stock price; the option's time to maturity; and the risk-free interest rate. The model was developed by Fischer Black and Myron Scholes, who published a paper in 1973 that presented the model. *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 *J. POLITICAL ECON.* 637 (1973). An analysis of this model is beyond the scope of this work. A binomial option pricing model establishes a portfolio of stock and options so that there is no uncertainty about the value of the portfolio at the end of the option period and assumes a risk-free portfolio earning a risk-free rate of return. The model also factors in the option's delta — the ratio of the change in the price of the option to the change in the price of the underlying stock — by periodically rebalancing the stock holdings. *See generally* JOHN C. TULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES* 194-207 (3d ed. 1997).

270. For example, Senator Lieberman introduced the Equity Expansion Act of 1993, which would have mandated the SEC to prohibit the recognition of compensation expense from the issuance of stock options. *See* Equity Expansion Act of 1993, S. 1175, 103d Cong. (1993). Moreover, the proposed valuation methods stood to significantly affect the earnings of technology companies because their stocks tend to be volatile. Oft-repeated criticisms include the assertion that options are too problematic to value as non-cash outlays, that they do not represent an expense, that options represent transactions with stockholders rather than expenses, and that their issuance is reflected in the calculation of earnings per share and, consequently, are adequately reflected in income. *See, e.g.*, Harvey Golub, *The Real Value of Options*, *WALL ST. J.*, Aug. 8, 2002, at A12.

The medium of exchange is not relevant in the determination of whether an expense is incurred. If an employee is compensated with a car, a house, or theater tickets, an expense will be recognized. If such forms of non-cash compensation are appropriately recognized solely because they can be otherwise sold for cash, while compensatory options are not recognized due to their vesting restrictions, then such options could be used to compensate nonemployees without recognition of expense. However, issuance of such options in consideration for the purchase of supplies would clearly generate an expense. Moreover, premising the argument on options' nonmarketability underestimates Wall Street's market making prowess. In fact, convertible bonds

only encourages, but does not require, corporations to recognize compensation expense using a fair market value model.²⁷¹ Issuing corporations may continue to account for stock options under *Accounting Principles Board Opinion No. 25* provided a footnote disclosure is made that presents the amount of compensation that would have been charged had the options been valued under a fair value model.²⁷² Alternatively, corporations may recognize compensation expense upon the issuance of compensatory stock options using an appropriate valuation model such as Black-Scholes.²⁷³

In one respect, the accounting rules for stock options did provide a bright-line standard that could be exploited. Corporations, under the theory that deeply out-of-the-money options offered no incentives to employees, often reduced the strike price of options or cancelled existing options and reissued replacement options with a lower stock price. The FASB recently issued an Interpretation that in general requires corporations to recognize compensation expense upon the exercise of repriced options.²⁷⁴ However, this rule does not apply if the replacement options are issued more than six months after cancellation of the options they were meant to replace.²⁷⁵ Therefore, corporations can avoid the potential earnings charge by waiting six months to issue new options — a practice that creates perverse incentives.²⁷⁶

are commonplace, and they may be viewed as a debt interest with an embedded call option. The value of the option can be reasonably estimated by the interest foregone by the bondholder. *See, e.g.,* Floyd Norris, *Legal but Absurd: They Borrow a Billion and Report a Profit*, N.Y. TIMES, Aug. 8, 2003, at C1 (discussing a convertible bond issuance by STMicroelectronics that requires the holder to pay the issuer one-half of one percentage point). The second point, that transactions with stockholders do not generate expense, is accurate but only if the transaction is with a stockholder acting in such capacity. A stockholder may act in various capacities — including as an employee. Finally, although option shares are reflected in the earnings per share denominator, their value should also be reflected in the numerator as a reduction of earnings. If stock is issued to employees, the value of the stock enters into the denominator and also reduces the denominator. No principled reason exists for treating options differently.

271. ACCOUNTING FOR STOCK-BASED COMPENSATION, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123 (Fin. Accounting Standards Bd. 1995).

272. *Id.* § 11.

273. *See supra* note 268.

274. ACCOUNTING FOR CERTAIN TRANSACTIONS INVOLVING STOCK COMPENSATION, INTERPRETATION NO. 44 (Fin. Accounting Standards Bd. 2000). An option whose exercise price is reduced is treated as a variable plan option. As such, the appropriate compensatory measurement point is not the date of grant but the date of exercise and, therefore, any stock appreciation that accrues to the time of exercise will cause the corporation to recognize compensation expense. *Id.* § 39. Indirect reductions of the exercise price are also subject to this rule. For example, if a cash bonus arrangement is instituted that is tied to the exercise of options, then the option is deemed repriced downward to reflect the cash bonus. *Id.* Moreover, the cancellation of existing options, coupled with the issuance of replacement options, is deemed to be an indirect repricing and subject to the same rule. *Id.* §§ 43-45.

275. *Id.* § 45.

276. Because most options are issued at-the-money, executives anticipating the receipt of

Public pressure has led many corporations to heed the FASB's encouragement and adopt the fair value method of accounting for options.²⁷⁷ Many other corporations, however, continue to resist the pressure and echo the arguments put forth a decade ago in opposition to the 1993 Exposure Draft.²⁷⁸ Moreover, those opposed to the fair value model assert that the disclosure requirement in the 1995 standard obviates the need for expensing.²⁷⁹

In certain cases, companies that have opted to expense the grant of compensatory stock options have taken steps to mitigate the charge to earnings by employing aggressive assumptions for use in the mathematical models.²⁸⁰ Ironically, it is precisely at the point where a certain amount of flexibility is provided by the standard that the manipulation is made possible and consequently exploited. One compensation expert succinctly captured the essence of these practices when he said, "They're working within the system. Part of the problem is the system probably allows them too much flexibility."²⁸¹ The FASB has undertaken a major project with respect to stock based compensation and, given the sea change in public opinion, perhaps it can resist pressures to maintain the status quo.²⁸²

options in the near future will be inclined to favor a decline in the stock price during the interregnum between cancellation and re-issuance.

277. In February 2002, the Ending the Double Standard for Stock Options Act was introduced by Senators McCain and Levin, whose provisions would prohibit the tax deductibility of option related expense if the taxpayer does not account for option-based compensation as an expense. See S. 1940, 107th Cong. (2002). Proponents of expensing stock option based compensation were encouraged by the requirement in international accounting standards to expense such options by 2005. See Int'l Accounting Standards Bd., IASB Update, July 2002, available at <http://www.iasc.org.uk/docs/update/upd0207.pdf>.

278. Boeing Corp. and the Washington Post Corp. have accounted for options as expenses for years. Among the prominent corporations that have decided to join them are General Electric and Coca-Cola. Intel, a bellwether technology company, has decided not to change its accounting for options, however. See Don Clark, *Contrary Intel Won't Expense Options*, WALL ST. J., Aug. 8, 2002, at B1; Rachel E. Silverman, *GE to Expense Stock Options Held by 12% of its Employees*, WALL ST. J., Aug. 1, 2002, at A3.

279. This argument relies on the efficient market theory. The efficient market theory asserts that the market processes all available information and, therefore, the use of options as compensation is priced into the stock regardless of whether the cost is reflected on the income statement or in the footnotes.

280. One of the variables in the Black-Scholes model is the volatility of the stock underlying the option. The greater the volatility in the stock, the greater the value the model places on the options. Some companies have, in applying this model, reduced their estimates of stock volatility, thereby reducing the value of the options granted. See Gary Williams, *Dell Joins Wave of Companies Seeking to Soften Options Hit*, WALL ST. J., June 27, 2003, at C3 (describing such practices at Dell Computer, Genentech, Oracle, eBay, Apache, Hilton Hotels, and Stanley Works).

281. *Id.* (quoting Mark M. Reilly, a partner at 3C LLC, a compensation consulting firm).

282. Among the proposals that the FASB is considering is one that would allow corporations to choose one of three methods to implement a requirement to expense stock option compensation. Corporations could choose to expense options prospectively, whereby options granted prior to the

Microsoft Corp. recently announced that it will no longer issue its employees stock options and, instead, will issue employees restricted stock.²⁸³ The decision, based in part on employees' dissatisfaction with stock option based compensation, is likely to prompt other corporations to consider similar changes in their compensation strategies.²⁸⁴ Moreover, corporations that continue to issue stock options are reducing the amount of shares granted to employees.²⁸⁵ Some technology companies, however, continue to buck this trend.²⁸⁶

Stock option based compensation has contributed to the "stock market culture" that has pervaded corporate executive suites. A recent study by researchers from the University of Maryland's Robert H. Smith School of Business concluded that "[a]n environment of excessive stock options, deteriorating financial conditions preceded by a history of growth through acquisitions provides conditions for accounting fraud."²⁸⁷ The study examined seventy-one companies that the SEC

change in accounting method are ignored, including those not vested at the date of change. Alternatively, corporations may elect to include in expense any options granted, but not vested, prior to the date of change. Finally, all options could be included and prior results restated. See FASB, *Project Updates and Technical Plan*, available at <http://www.fasb.org/project/index.shtml> (last visited June 26, 2003). See also Robin Sidel, *Three Choices Are Two Too Many for Expensing Options*, WALL ST. J., Sept. 6, 2002, at C1. The FASB has been provided independent funding, thereby reducing the perception that the major accounting firms exercise undue influence in the standard setting process. See Sarbanes-Oxley Act, § 109(e).

283. See Robert A. Guth & Joann S. Lublin, *Tarnished Gold: Microsoft Ushers Out Era of Options*, WALL ST. J., July 9, 2003, at A1; John Markoff & David Leonhardt, *Microsoft Will Award Stock, Not Options, to Employees*, N.Y. TIMES, July 9, 2003, at A1. Restricted stock is stock issued to employees that vests either with the lapse of time, upon the attainment of certain performance benchmarks, or both. Unlike stock options, the value of restricted stock issued to employees requires the issuer to charge earnings for the fair market value of the shares issued. In addition to replacing stock options with restricted stock, Microsoft has also decided to restate prior earnings to expense stock option based compensation. See Jonathan Weil, *Microsoft's Reboot: Decision to Restate Earnings Is Unusual*, WALL ST. J., July 10, 2003, at C1. However, some corporations are choosing to exclude the expenses associated with grants of restricted stock in the presentation of pro forma earnings.

284. See Guth & Lublin, *supra* note 282, at A10; Matt Richtel & Laurie J. Flynn, *In Silicon Valley, Pressure for Stock Grants in Lieu of Options*, N.Y. TIMES, July 11, 2003, at C6. Stock options have been criticized on efficiency grounds. It has been asserted that, due to most executives' lack of diversification, stock options impose a deadweight cost on the issuer. That is, the recipient of the stock options values such options at an amount less than the value placed on them by the issuer. See generally Hall & Murphy, *supra* note 256; Meulbrook, *supra* note 256.

285. A sluggish job market is a significant reason for such cutbacks. See Ruth Simon, *Companies Get Stingy with Stock Options*, WALL ST. J., July 30, 2003, at D1 (citing surveys by Mercer Human Resource Consulting and Sibson Consulting that found most companies surveyed are reducing the number of stock options granted to employees).

286. See Gregory Zuckerman, *Tech Companies Find Options Hard to Kick*, WALL ST. J., Aug. 11, 2003, at C1 (reporting that Apple Computer, Adobe Systems, Electronic Data Systems, and Ciena Systems, among other technology companies, recently have enabled employees to trade in underwater options for new options exercisable at lower prices).

287. See Joann S. Lublin, *Study Blames Accounting Fraud on Takeover Fever, Age of Officers*, WALL ST. J., July 3, 2003, at C4.

prosecuted for alleged accounting irregularities between 1992 and 1999 and compared those companies with seventy-one companies in the same industry of similar size against which no such allegations were made. The study found that, on average, the chief executive officer of a violator company owned options valued at more than three times his salary or bonus.²⁸⁸ In comparison, the chief executives of non-violator companies owned options approximately equal to their annual cash compensation.²⁸⁹

The primacy that the shareholder wealth maximization principle, as measured by short-term gains in the stock price, has achieved is startling.²⁹⁰ Investment banks and brokerage houses serve, in part, as a bridge between shareholders and management. The almost two-decade long bull market that began in 1982 brought unprecedented influence and celebrity to stock market analysts. The incentive infrastructure under which Wall Street operates is underpinned by a rising stock market, and intense pressure is exerted on management to maintain an ever-increasing stock price.²⁹¹ Management, in collusion with Wall Street, learned to manipulate the system. The incessant focus on earnings estimates led companies to manage earnings. Between 1992 and 1999, the number of companies beating earnings estimates by exactly one-cent per share quadrupled.²⁹² Practices of dubious validity were accepted, encouraged, and standardized, and Wall Street analysts, far from providing a check on these practices, had every incentive to encourage them.

288. *Id.*

289. *Id.*

290. The single-minded focus on stock prices has been challenged. Various constituencies of the firm have their own purposes, including government, consumers, labor, and suppliers. The selection of one goal as final or ultimate requires, for legitimacy, a consensus by all constituencies. *A fortiori*, such a goal will be one that is useful to all members of the firm and the public. See Peter Koslowski, *The Limits of Shareholder Value*, 27 J. BUS. ETHICS 137, 138 (2000). Because all members of the firm and society are consumers, the ultimate purpose of a corporation is, arguably, to optimally produce goods or services that satisfy the needs or desires of its customers. *Id.* Shareholder wealth may also be viewed as the evidentiary proof of the extent to which the firm is achieving its goal. If shareholder wealth correlated perfectly with the firm's principal goal, then it could be substituted, or used as a proxy, for the firm's ultimate goal. Koslowski, however, asserts that "the price of shares in the stock market does not just reflect the real value of the firm's productivity and performance but is also subject to mere speculation." *Id.* at 141. As discussed at *supra* note 282, Microsoft Corp. has decided to issue restricted stock instead of stock options. Less noticed, however, was the fact that Microsoft will determine incentive compensation in large part based on customer satisfaction surveys. See Steve Lohr & John Markoff, *You Call This a Midlife Crisis?*, N.Y. TIMES, Aug. 31, 2003, at C1.

291. Commission-based compensation is pervasive, whether at the retail level or at the wholesale level. Fees for investment banking services are typically determined by a percentage of the transaction amount. Rising markets are associated with increased trading, public offerings, and merger and acquisition activity.

292. See Jerry Useem, *In Corporate America It's Cleanup Time*, FORTUNE, Sept. 16, 2002, at 63, 64.

Investment banks, aware of management's discretion to award lucrative projects among competing firms, exerted pressure on analysts to refrain from issuing negative reports on current or potential banking clients.²⁹³ Moreover, the merging of commercial and investment banking functions brought pressure to bear on analysts by management whose firms had extended loans to the companies covered by the analysts.²⁹⁴ "Friends and Family" initial public offering programs placed sought-after stocks in the accounts of friendly executives.²⁹⁵

Boards of directors did relatively little to break management's infatuation with short-term share prices. Chief executive officers often serve on the board's nominating committee, many board members are executives themselves and may exhibit a reticence to challenge one of their own, and information asymmetries may also lead to board reluctance to challenge management.²⁹⁶

293. Citigroup's Salomon Smith Barney Unit is under investigation by the New York State Attorney General, and the investigation is primarily focused on the practices of Jack Grubman, the unit's telecommunications analyst. Mr. Grubman maintained positive public positions on numerous companies and, allegedly, those positions were compromised by his close ties to the executives of firms in question or by pressure from his superiors. See Charles Gasparino, *NASD Is Preparing Civil Charges Against Salomon and Ex-Analyst*, WALL ST. J., Sept. 20, 2002, at A1; Gretchen Morgenson, *In Broker's Notes, Trouble for Salomon*, N.Y. TIMES, Sept. 22, 2002, at C1; see also Gretchen Morgenson, *Analyze This: What Those Analysts Said in Private*, N.Y. TIMES, Sept. 15, 2002, at 1. The NASD, formerly the National Association of Securities Dealers, has also sued Mr. Grubman and an assistant for issuing misleading research reports on Winstar Communication, a company that eventually filed for bankruptcy. See Gretchen Morgenson, *NASD Sues Star Analyst over Research*, N.Y. TIMES, Sept. 24, 2002, at C1.

294. See Gasparino, *supra* note 299, at A1; see also Randall Smith & Susan Pulliam, *Buddy System: How a Technology-Banking Star Doled Out Shares of Hot IPOs*, WALL ST. J., Sept. 23, 2002, at A1 (describing the practices employed by Credit Suisse First Boston and its telecommunication analyst, Frank Quattrone). Another potential source of conflict is the fact that many firms have exclusive contracts with a particular investment firm to manage their stock option programs. As a consequence, the investment bank will obtain information on the amount of shares that will be purchased or sold during a vesting period. Significant amounts of vesting options may result in increased buy or sell volume, thereby affecting the stock price. The investment bank's trading desk, if it traded on such information, could profit handsomely. Such trading would be a form of illegal "front-running."

295. Underwriters of an initial public offering typically reserve a small portion of the offering for select customers (friends) and employees of the firm offering the shares (family). During the height of the bull market, it was not unusual in initial public offerings for the stock to close well in excess of the offering price. In many cases, friends included executives of customers or potential customers of the offering corporation. Allocating shares to such executives created another set of conflicts in the sense that persons in a position to award business held stock in the companies bidding for the business. The expectation that the share price would close well in excess of the offering price raises the issue of whether the offering price was set too low. If so, the offering resulted in a transfer of wealth from the corporation to the shareholders who purchased at the offering price. The investment banks, which also serve as the offering managers, justify the initial offering price as the optimal price with which to launch a successful offering and obtain widespread coverage of the stock post-offering.

296. See Bebchuk et al., *supra* note 257, at 767-72. A noted corporate governance authority noted:

The Sarbanes-Oxley Act mandates enhanced audit committee independence.²⁹⁷ The Act provides a bonus-disgorgement provision, imposes stock trading bans during pension blackout period, and requires timelier reporting of insider transactions.²⁹⁸ The Act also includes a financial statement certification requirement and provides enhanced penalties for misleading auditors.²⁹⁹ Otherwise, however, the Act does nothing to address corporate governance in general or executive compensation issues in particular.³⁰⁰ Likewise, the distribution of power between management and shareholders has remained largely undisturbed.³⁰¹ The SEC and the stock exchanges have taken several steps in

Even if the independent directors are not actually biased in favor of insiders, the former often are predisposed to favor the latter. Most of the learning on this phenomenon, known as structural bias, arises out of the use of special litigation committees to terminate shareholder derivative litigation against officers and directors. *Independent directors tend to be corporate officers or retirees who share the same views and values as the insiders.* A sense of "there but for the grace of God go I" is the likely response to litigation against fellow directors.

See Amanda K. Esquibel, *A Guide to Challenging Option Repricing*, 37 SAN DIEGO L. REV. 1117, 1155 n.204 (2000) (quoting Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1059-60 (1993)) (emphasis added).

297. See *supra* notes 246-49 and accompanying text. The increased ownership of shares by institutional shareholders over the past two decades and the shareholders' willingness to agitate for more effective corporate governance practices have led to an increase in the number and the influence of independent directors both at the board and committee levels. The tenure of chief executive officers has declined, indicating an increased assertiveness by directors. See Bebhuk et al., *supra* note 257, at 773 (citing studies that report the median tenure of chief executive officers declined from seven to five years during the period 1980 to 2000 and that the percentage of chief executive officers with less than five years on the job has increased from forty-six to fifty-eight percent between 1980 and 1998).

298. Sarbanes-Oxley Act, §§ 304, 306, 403.

299. The principal executive officer or officers and the principal financial officer or officers must certify in each annual or quarterly report filed with the SEC that the signing officer has reviewed the report and that, based on the officer's knowledge, the report does not contain any untrue statement of material fact or omission of a material fact. Moreover, the officers certify that, based on their knowledge, the financial statements fairly present the financial condition and results of operations of the issuer. The certification also encompasses internal control procedures. See *id.* § 302. The Act also provides criminal penalties for altering and destroying documents, makes certain debts nondischargeable in bankruptcy, lengthens the statute of limitations period for certain actions, enhances sentences for fraud and obstruction of justice, and provides whistleblower protections. See *id.* §§ 801-806. These provisions should make fraudulent behavior more costly but probably will have little effect on less odious practices such as aggressive accounting. Several states have also enacted, or are considering enacting, their own version of these and other provisions of the Sarbanes-Oxley Act. See Deborah Solomon, *Zealous States Shake Up Legal Status Quo*, WALL ST. J., Aug. 28, 2003, at A4.

300. Significant corporate governance reforms have been put in place by, ironically, WorldCom. As part of a settlement with the SEC, the company agreed to institute sweeping reforms, among the most significant of which is the requirement that an outside director serve as board chairman, and to provide mechanisms for increased shareholder participation in certain corporate matters, including dividend policy. See *WorldCom's Revenge — Radical New Ideas on Corporate Governance*, THE ECONOMIST, Aug. 30, 2003, at 44-45.

301. But see Gretchen Morgenson, *Shareholders Win in Effort To Alter Pay*, N.Y. TIMES, Aug.

an effort to provide shareholders with a more effective voice in certain matters, but the effects of these steps will, in all likelihood, prove to be marginal.³⁰²

CONCLUSION

U.S. accounting standards are not without imperfections. However, the notion that the nature of current accounting standards paved the way for the recent round of high-profile accounting improprieties is misguided. In most cases, the improprieties took place within the confines of broad-based standards and, contrary to popular criticism, did not involve the exploitation of rules-based, loophole-ridden standards. Moreover, neither rules-based nor principles-based standards are inherently superior or inferior to the other. The appropriateness of a particular form of standard depends on many factors. Wholesale adoption of principles-based standards will not eliminate aggressive accounting. A body of precedent will develop under such standards that, in all likelihood, will prove at least as complex as rules-based standards and equally

27, 2003, at C1 (reporting that Siebel Systems and the Teachers Retirement System of Louisiana, a shareholder in the company, settled a lawsuit, and under the terms of the settlement, the company agreed to alter its executive compensation practices and provide more information to shareholders with respect to such compensation).

302. Individual shareholders often hold shares in street name and the brokerage firm votes their shares by proxy. The New York Stock Exchange has recently amended NYSE Rule 452, subject to SEC approval, to prohibit firms from giving proxies on matters related to equity-based compensation plans unless a beneficial owner of the shares has expressly given the vote to the institution. See CORPORATE GOVERNANCE PROPOSALS REFLECTING RECOMMENDATIONS FROM THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE AS APPROVED BY THE NYSE BOARD OF DIRECTORS (Aug. 1, 2002), available at http://www.nyse.com/pdfslcorp_gov_pro_b.pdf. The SEC's Division of Corporation Finance recently announced that shareholder proposals on broad-based equity compensation plans would not be excluded from proxy statements, pursuant to Exchange Act Rule 14a-8, as "ordinary business" matters. See STAFF LEGAL BULLETIN NO. 14A (Sec. & Exch. Comm. 2002), available at <http://www.sec.gov/interp/legals/cfslb14a.htm>. Moreover, the SEC has required the New York Stock Exchange, NASDAQ, and other major markets to require that listed companies' stock-based compensation plans be approved by shareholders. See Deborah Solomon, *SEC Is Set to Require Clearance by Holders of Stock Compensation*, WALL ST. J., June 27, 2003, at C7. The SEC recently announced that it will consider proposing rules that will require the disclosure of policies and procedures used to determine voting proxies related to portfolio securities and will make voting records available to investors. SEC NEWS DIGEST ISSUE 2002-178, Sept. 13, 2002, available at <http://www.sec.gov/news/digest/09-13.txt>. Shareholder opposition to management often results in withheld votes for management's slate of directors. Unless accompanied by public statements or other public expression of dissatisfaction, the withholding of votes has little effect. Many institutional investors are reluctant to disclose their votes on individual ballot questions. In a potentially significant development, the SEC is studying proposals that would allow shareholders to place a number of alternative directors on the ballot sent to shareholders by management in limited circumstances. See Stephen Labaton, *S.E.C. May Ease Voting for Outside Directors*, N.Y. TIMES, July 16, 2003, at C1; Floyd Norris, *A Small Move to Shareholder Democracy*, N.Y. TIMES, July 16, 2003, at C1.

subject to exploitation. The present audit model places the responsibility of applying such standards — and hence the making of precedent — on the accounting profession.

It is too soon to predict whether the legislated reforms of the accounting profession will stiffen the profession's backbone. Perhaps, in time, the profession can earn back the public trust it so quickly lost. The fact that the reforms did not disturb the fundamental nature of the client-auditor relationship justifies a healthy dose of skepticism. Managerial incentives for aggressive accounting remain in place. Incentive compensation, whether in the form of stock options, restricted stock, or cash, will tempt management to employ aggressive accounting to meet whatever metric by which its performance is measured. *The Economist* recently stated that “[t]argets set as triggers for incentive payments came to suffer from what central bankers know as ‘Goodhart’s law,’ after the academic who noted the phenomenon: any target that is set quickly loses its meaning as it comes to be manipulated.”³⁰³ Fundamental changes in the audit model may warrant greater reliance on principles-based standards, and perhaps we are but a few high-profile scandals away from drastic changes in the model. Until that time, however, the investing public should take comfort in the fact that the FASB, and not the accounting firms, sets the standards.

303. *Beyond Shareholder Value*, THE ECONOMIST, June 28, 2003, at 7.