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# Where Were the Counselors - Reflections on Advice Not Given and the Role of Attorneys in the Accounting Crisis

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# Where Were the Counselors? Reflections on Advice Not Given and the Role of Attorneys in the Accounting Crisis

William O. Fisher\*

## TABLE OF CONTENTS

I. SCENE ONE: THE LAWYER OF YESTERYEAR COUNSELS A CLIENT AGAINST SHARP PRACTICE.....	30
II. SCENE TWO: THE LAWYER OF 1999 DOES NOT COUNSEL ABOUT THE PRESSURES FOR AND THE MANNER OF AVOIDING MANIPULATIVE ACCOUNTING .....	32
III. THE SPEECH NOT GIVEN.....	35
IV. A FIRST CONTRAST: THE CLIENT IN SCENE ONE ASKS FOR ADVICE, WHILE THE CLIENT IN SCENE TWO DOES NOT .....	44
A. <i>Press Reports and Commentary Had Highlighted Overly Aggressive Accounting</i> .....	44
B. <i>Publicly Expressed SEC Views Suggested that the Accounting Counseling Was in Order</i> .....	55
C. <i>The Limited Explanatory Power of the First Contrast in Light of Press Articles and SEC Speeches About Corporate Accounting</i> .....	70
V. A SECOND CONTRAST: THE LAWYER IN SCENE ONE HAS NO ECONOMIC FEAR OF LOSING HIS CLIENT BY PROVIDING THE ADVICE, WHILE THE LAWYER IN SCENE TWO MAY FEAR THAT THE COUNSEL WILL HARM BOTH THE ATTORNEY’S INCOME AND MOBILITY .....	71
VI. A THIRD CONTRAST: THE ADVICE IN SCENE ONE DOVETAILS WITH THE PREVAILING COMMUNITY VALUES OF OLD, WHILE THE ADVICE IN SCENE TWO MAY CHALLENGE THE DIFFERENT VALUES OF 1999 .....	74
VII. A FOURTH CONTRAST: THE FIRST ATTORNEY’S SOCIAL POSITION AND SELF-IMAGE AFFIRMATIVELY PROMPT THE ADVICE, WHILE THE SECOND LAWYER’S STATUS AND SENSE OF SELF ARE UNAFFECTED BY HIS FAILURE TO SPEAK .....	76

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VIII. A FIFTH CONTRAST: THE LAWYER IN SCENE ONE IS THE SOLE ADVISOR, WHILE THE ATTORNEY IN SCENE TWO IS BUT ONE OF MANY AND, INDEED, IN THE “SPEECH NOT GIVEN,” WOULD HAVE COUNSELED ON MATTERS THAT WERE THE PRIMARY RESPONSIBILITY OF ANOTHER PROFESSION .....	77
IX. CONCLUDING THOUGHTS AND THE SCENE TODAY .....	80
A. <i>Why Attorneys Did Not Deliver the “Speech Not Given”</i> .....	80
B. <i>Was it a Mistake to Forego the Speech and, if so, How Serious a Mistake?</i> .....	81
1. First Contrast (No Request for the Advice) .....	81
2. Second and Third Contrasts (Advice Might Drive Clients Away or Conflict with Commercial Culture) .....	82
3. Fourth Contrast (No Social or Moral Stake for the Lawyer in Client Accounting).....	82
4. Fifth Contrast (Accounting Professionals Had Primary Responsibility for Complicated Matters that Attorneys Did Not Fully Understand) .....	83
5. Normative Conclusion .....	84
C. <i>What this Analysis Suggests for Today’s and Tomorrow’s Counseling</i> .....	86

Today’s reports of corporate villainy invite these questions: Restricting ourselves to what the profession knew in the last days of the late 1990s soaring stock market, what advice might attorneys have given—about the temptations of deceptive accounting and the defenses to erect against it—to young executives who were taking their companies public then? And, if attorneys did not always give that counsel in fulsome form, why was that so? What forces worked on lawyers to deter that advice? What does all this suggest for counseling today?

To help us answer these questions, we begin with two scenes. We return to them later for contrasts.

#### I. SCENE ONE: THE LAWYER OF YESTERYEAR COUNSELS A CLIENT AGAINST SHARP PRACTICE

A lawyer, deep in middle age, sits at an old table that we suspect has been in the attorney’s family for at least a generation. Behind the lawyer’s revolving office chair stands a rolltop desk. Though the room swelters from the remains of a summer day’s heat, the lawyer still wears his tie over a white shirt. He wears suspenders and glasses too. Although the year is indeterminate, it is before we were born or at least before we practiced law.

It is night. A rangy man, a rough contemporary of the lawyer, paces back and forth before the table. He is agitated and sprinkles salty phrases in his monologue. He speaks of a business setback and of a plan to hold the bankers at bay.

There is a customer with whom this client has dealt for years. The client and the customer have operated on trust, relying on the kind of handshake honesty that we associate with the times in which we did not ourselves live. The rangy man tells the lawyer that, shortly before the market turned, he agreed to sell a large stock of goods to his customer. If he can avoid the deal, he can sell out his inventory at the now much higher price and, without mortgaging his home, repay the local bank the money that he borrowed for a modest expansion of his company.

The lawyer asks about the terms of the deal, past practice in documenting such agreements, part performance, the customer's reliance, and so forth. But before the lawyer proffers an opinion, he leans back in his chair, takes up the pipe on his table, fills it with tobacco, and lights it with a match. After a comfortable puff or two and with an expression both kindly and concerned, the attorney says something like this:

Take a seat, Jack.

You and I go back a long way. I opened this office at about the same time that you took over your company from your dad. Back then people told me that, if I was lucky, good, and honest, I might be fortunate enough to work for you some day. I aimed for that. Not just because your business was big enough to have some real legal issues worth sending to a lawyer, but because simply being associated with your business, and with you Jack, was something of an honor. You were known to be a hell of a businessman. You were also known always—and I mean always—to play fair and square.

You talk to me tonight like the person I sought to represent never walked the earth. You come here asking that I help you to cheat a man who has done nothing but right by you for more than a decade.

Oh, I'm not telling you that you cannot do what you propose. If you did, and it went to court, you might win because there is no written contract, not even a purchase order yet. We could even sit here tonight and go over the facts again and maybe I could give you a legal opinion saying that the law, when examined closely, is unclear on whether you are required to deliver that inventory to your longtime customer or not.

But I'm not going to do that, Jack, because both you and I know that what you are considering is wrong. You know it's wrong, otherwise you would not be here at ten o'clock at night when there is no one else to see you and no one else to hear you.

Now, you go on home. You hug your wife, Sally. You kiss those two young children of yours good night. You get up tomorrow and do the right thing. We'll deal with the bank if and when we need to.

Warring emotions play across the client's face. He is used to command, in the autocratic fashion of a small businessman. At least momentarily, he resents the dressing down. As the silence lengthens, however, and as the client and lawyer look eye to eye, we see the anger fade. A kind of relief washes across the client's face. He shakes his head, forms a rueful smile, and says, "Hell, Tom, I don't know what I was thinking." The rangy man then rises from the chair, shakes his head again, and walks out of the office with a lighter step that suggests he is glad to have been talked out of his plan.

The lawyer prepares to close the office. We know that he will walk home because he lives within walking distance of his office in this small community in which he, his client, and their reputations live. As he walks, we know that he will reflect. We know that he will be deeply satisfied that he has helped Jack tonight. We know that, as he grows old and looks back over a lifetime in the law, he will savor this night's work.

## II. SCENE TWO: THE LAWYER OF 1999 DOES NOT COUNSEL ABOUT THE PRESSURES FOR AND THE MANNER OF AVOIDING MANIPULATIVE ACCOUNTING

We are in a law office again, but this office is very different. It has many conference rooms and we are in one of them. It is broad daylight in Silicon Valley, but ample air-conditioning shelters the room's occupants from the California heat. There are three lawyers, one partner and two associates. All appear young, with their youthful appearance enhanced by their casual dress, adopted in part to cater to their started-it-in-a-garage-then-made-it-big clientele. The conference table is cluttered not only with pens and legal pads, but notebook computers and PDAs, for the lawyers know that their clients value technological prowess. Modern art adorns the walls.

It is late 1999. The NASDAQ is a rocket.<sup>1</sup> IPOs hit the market by the hundreds.<sup>2</sup> Silicon Valley mints new millionaires in dozens.<sup>3</sup>

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1. Most of the tech stocks going public out of Silicon Valley traded on the NASDAQ. The NASDAQ Composite Index provides the most familiar measure of technology stock performance. The Composite is a capitalization-weighted index of stocks traded through the National Association of Securities Dealers Automated Quotation system. Nasdaq, *How the Nasdaq Composite Index Works*, at <http://www.nasdaqnews.com/stats/comp.html> (last visited Feb. 4, 2004). To place our reflections in perspective, the NASDAQ Composite Index reached 500 in April 1991, topped 1,000 in July 1995, and found the 2,000 mark in July 1998. The Index hit 2,200 on January 4, 1999 and, with ups and downs, climbed to more than 2,800 by July 14. Though it stumbled a bit thereafter, the fourth quarter of 1999 really sang. The Composite moved through 2,900 on October 11 and, after a brief decline, continued pretty much straight up to close at 4,041 on December 29. It would race to an astonishing 5,046.86 on March 9, 2000. Nasdaq, *Statistical Milestones*, at <http://www.nasdaqnews.com/dynamic/stats.asp> (last visited Feb. 4, 2004) (listing the dates on which the Index hit the referenced marks).

2. By one count, 486 companies went public in 1999, including 124 from the San Francisco Bay Area. Kathleen Pender, *IPO Quantity Down, But Quality Up*, S.F. CHRON., Jan. 8, 2002, at B1.

The clients in our conference room are even younger than the lawyers. They are brash, expectant entrepreneurs. They, too, disdain suits and ties. While they do not pace, as did our long-ago client, they walk at times to a whiteboard, in order to draw a diagram to illustrate a technical concept or explain their business model. They speak excitedly of going public, selling at a dear price the founder's stock that they acquired for next to nothing or exercising options at well below the market price and selling the underlying shares for an immediate profit. They will candidly acknowledge that their goal is, by such stock sales, to amass a fortune in their comparatively early years.

At this meeting and others like it, the lawyers bend to their tasks, which include drafting the transaction documents that will advance the company through its infancy, initial financing, second or third-round financing, and eventually that anticipated IPO. Along the way, the attorneys may also introduce the young executives to venture capitalists, investment bankers, and accountants at Big Five firms. Indeed, the clients may have chosen the law firm in part because it is able to make these introductions.

As the golden day of the IPO approaches, the lawyers describe the public offering process, emphasizing the preparation of the registration statement and the prospectus, the need for accuracy in those documents and the liabilities for material misstatements and omissions. They advise on multiple aspects of public company status, including the requirement to file quarterly and annual reports with the Securities and Exchange Commission ("SEC" or "Commission"); the prohibition against insiders trading when in possession of material, nonpublic information (and related matters such as insider trading policies and trading windows); reports of beneficial ownership that certain shareholders must file; timing and volume restrictions on insider sales (and related matters such as Rule 144 and standard lockup agreements); the disclosures that will go into proxy statements (including the publication of executive compensation); and the prohibition against short-swing profits and short selling.<sup>4</sup> Turning to current developments, the attorneys describe the

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3. One famous estimate claimed that, in 1996, sixty-two individuals became new millionaires every twenty-four hours in the Silicon Valley. Andy Reinhardt et al., *What Matters Is How Smart You Are*, BUS.WK., Aug. 25, 1997, at 68.

IPOs in 1999 suggested the possibility of great wealth for founders who held stock that they acquired before the public offerings, in part because of the amazing way that stocks went up after they started to trade. VA Linux Systems produced the showcase example: Its stock price shot up more than 700 percent on its first trading day. Cecilia Kang, *Linux Firm's IPO Soars 700%*, SAN JOSE MERCURY NEWS, Dec. 10, 1999, at C1. Whether a paper millionaire realized his or her gains depended on many factors, including the length of any lockup agreement, the willingness of the insider to sell, timing and volume restrictions imposed by the securities laws, and the length of time over which a company's stock price remained high. Insiders had an incentive to keep the stock price up long enough to cash out.

4. As examples of then-contemporary pieces describing the advice to provide to companies before they launched a public offering, see John K. Hoyns & Stacy J. Kanter, *Deciding Whether to Go Public: Certain Basic Considerations*, 1135 PLI/CORP 9, 9 (1999); John F. Olson & Daniel W. Nelson, *What Makes a Company a Good Candidate for Going Public? Criteria, Advantages, and*

new requirements for board of director audit committees that NASDAQ and the exchanges are about to impose, as well as the new SEC rule for audit committee disclosures.<sup>5</sup> There is even some talk about the Commission's recent emphasis on the

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*Disadvantages Related to Going Public*, SE10 ALI-ABA 591, 591 (1999); Robert B. Robbins & William L. Horton, *Preparation of the Registration Statement*, SE13 ALI-ABA 131, 131 (1999).

5. In September, 1998, the Securities and Exchange Commission, the New York Stock Exchange ("NYSE"), and the National Association of Securities Dealers ("NASD") announced the formation of a "Blue Ribbon Panel" to make recommendations to strengthen corporate audit committees. That panel issued its report in February 1999. Press Release (Sept. 28, 1998), *contained in BLUE RIBBON COMMITTEE, REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES* 46 (1999), *available at* <http://www.sec.gov/edgar.shtml> (last visited Feb. 18, 2004) [hereinafter BLUE RIBBON REPORT] (announcing the formation of the panel reproduced at 40). Among other things, the panel recommended that the NYSE and NASD require that: (1) each listed company with a market capitalization above \$200 million have an audit committee comprised of at least three members; (2) all members of such audit committees be independent directors, with the listing standards defining "independent" directors in a way to exclude those having certain specified relationships with their corporations; (3) all audit committee members be financially literate, with one member of each committee having accounting or related financial management expertise; and (4) each board formally adopt a written charter for its audit committee, with each charter expressly stating that (a) the outside auditor is responsible to the board and the audit committee and (b) the audit committee is responsible for receiving a statement from the independent auditor identifying the various relationships between the auditor and the company (including nonaudit consulting work) and engaging the auditor in a dialogue regarding whether those relationships impact the objectivity and independence of the audit work. *Id.* at 10–14 (recommendations 1–4, 6–7). The panel also recommended that the SEC require each "34 Act" reporting company to disclose in its proxy statements whether its audit committee had a formal written charter; to include any charter in the proxy statement or annual report at least once every three years; and to include in its 10-K a statement from its audit committee saying whether or not the audit committee had discussed a number of matters with management and the outside auditors and whether, based on its review, the audit committee believed that the company's financial statements were fairly presented in conformity with generally accepted accounting principles ("GAAP"). *Id.* at 13, 15–16 (recommendations 5 and 9).

With some modifications to specifics, such as parts of the definition of "independent" directors, but with all substantial components listed above included, the NYSE, the American Stock Exchange ("AMEX"), and NASD (for NASDAQ) all adopted the listing requirements that the Blue Ribbon Panel recommended. They proposed these listing rule changes to the SEC in September 1999. Together with minor amendments that the SROs had submitted, the SEC approved the rules in December. Self-Regulatory Organizations; Order Approving Proposed Rule Change by the American Stock Exchange, LLC Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, 64 Fed. Reg. 71518 (Dec. 21, 1999) [hereinafter AMEX 1999 Audit Committee Listing Rules]; Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Amending Its Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, 64 Fed. Reg. 71523 (Dec. 21, 1999) [hereinafter NASDAQ 1999 Audit Committee Listing Rules]; Self-Regulatory Organizations; Order Approving Proposed Rule Change by the New York Stock Exchange, Inc. Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto, 64 Fed. Reg. 71529 (Dec. 21, 1999)

integrity of public companies' financial reports. But at no point does the partner draw the leader of the young, dream-seeking executives aside and say something like this:

### III. THE SPEECH NOT GIVEN

Jonathan, you are about to enter a new world. It is one that holds the possibility of great and early wealth, but it also holds temptation and danger and I want to talk to you about that now.

In the most general terms, you and your top executives will be tempted to do things that are either at the edge of accounting rules or flat illegal in order to keep the price of your company's stock high after you go public. But let me be more precise because it is the mechanics of this new environment that will create the pressures that could drive you to wrongdoing.

The investment bankers who will lead your underwriting will tell you that they have in their firms "analysts" who will "follow" or "cover" your company. Now these analysts may never have run a company like yours or any company at all. The analysts may not even fully understand your technology or your markets, particularly as your company grows and you expand to foreign sales or sales to distributors instead of end users. If your company is as hot as we hope it will be, other analysts at other investment banks and brokerages will also cover your company. They also may be uninformed about the details of your business.

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[hereinafter NYSE 1999 Audit Committee Listing Rules].

The SEC also initiated its own action on the Blue Ribbon Panel's recommendations by proposing, in October 1999, new rules requiring each reporting company to disclose in its proxy statement whether its audit committee had a written charter approved by the full board; include a copy of the charter in the proxy statement at least once every three years; disclose whether its audit committee members met the independence tests in the applicable listing requirements; and say whether the audit committee had reviewed and discussed the audited financials with management and the outside auditor and whether the committee had obtained certain information from the auditor relevant to the auditor's independence and discussed independence issues with that auditor. Audit Committee Disclosure, 64 Fed. Reg. 55648 (Oct. 14, 1999). However, instead of proposing, as the Blue Ribbon Panel suggested, that audit committees state whether they believed company financials were fairly presented in conformity with GAAP, the SEC proposed that each audit committee state whether, based on its review and discussions with management and the auditor, "anything has come to the attention of the members of the audit committee that caused the . . . committee to believe that the audited financial statements included in [the 10-K] . . . contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading." *Id.* at 55649. The SEC then adopted its proposed rules in December 1999. Audit Committee Disclosure, 64 Fed. Reg. 73389 (Dec. 30, 1999). In doing so, the SEC modified the language by which the committees would vouch for financials, deleting the just quoted words and substituting the requirement that each audit committee simply say in proxy statements whether, based on its discussions and review, the committee "recommended to the Board of Directors that the audited financial[s] . . . be included" in the company's 10-K. *Id.* at 73390.



The analysts will estimate your revenues and your earnings on a quarter-by-quarter basis. These estimates will take on an importance that may be completely out of proportion to their source.

The estimates will become “Wall Street’s” targets. If you report revenues or earnings below those forecasts, the Street may punish your stock price. Indeed, even missing consensus forecasts by as much as a penny may produce a dramatic decline in the price of your company’s stock.

Such a stock drop, of course, will hurt your shareholders. It may also crimp your business plans, as you may be hoping to use stock to buy other companies or their technology. If your stock price falls, you will have to part with larger percentages of ownership to make such acquisitions.

A stock price decline could also cost you, and your fellow executives, real money in a very personal way. Your company may have tied cash bonuses to revenue, earnings, or stock price targets. Poor financial numbers may lose you and other senior managers those bonuses.

Far more importantly, if the stock price falls, you and they will not be able to convert your founders stock into as large a profit as you would enjoy if the stock stayed high. Also, the options that the company issues will not have the value that you and other executives had hoped.

All of these circumstances will combine to put tremendous pressure on you, your chief financial officer, your top sales staff, and your operational leaders to produce the financial numbers that meet or beat the analysts’ estimates. In turn, you and your fellow executives may put pressure on others farther down the organizational chart to make the sales and shipments needed to clear the hurdles that the analysts set.

And so, you may find yourself, as an accounting quarter draws to a close or even after the three months have run, but before you must report the quarter’s numbers, facing the possibility of missing the Street forecasts. You may, at that time, be tempted in the sorest way. Your sales staff may have negotiated—before the quarter concluded—a contract with a customer that has not yet been signed, perhaps because the customer’s purchasing personnel have not obtained all the required corporate approvals. You may be certain in your mind that those approvals will be forthcoming. You may heartily believe that the deal was “done” before the quarter’s last day. You may, therefore, be tempted to look the other way if told that your sales staff dates the contract and all signature lines before the quarter’s end, even if the customer’s signature is in fact not added to the document until the customer completes its internal corporate approval process after the quarter closes.

With the final days or even hours of a quarter upon your company and with sales not yet sufficient to generate the numbers that equal or exceed Street estimates, you or your staff may be tempted to fudge the numbers in other ways. You might, for example, stop the clock and record as shipped before midnight on the last day of the quarter product that was not shipped until after that hour, perhaps even the next day or the day after that. At the time, this might seem fair to you, perhaps because the product would have been shipped by the midnight cutoff had some operational glitch not intervened.

As another example, you might consider counting as sold within the quarter product that your company ships with rights of return. Again, this might seem justified. You might feel certain that your customers will not use the return rights to send back the exceptional product that your company has created.

All of these are examples, however, of improper revenue recognition, and there are many other ways in which companies yield to the temptation to violate the accounting protocols that govern when companies can book dollars from their sales. These other abuses include recording revenue on consignment deals, aggressive “bill and hold” arrangements in which your company sells product to a customer who does not want it delivered at the time of the sale, but held at your warehouse until a date into the next quarter, and sales on credit to customers that do not yet have real economic substance and do not meet your company’s standards for credit approval.

*The SEC calls the recording of revenue in each of these examples fraud. Improper revenue recognition is the most common cause of serious SEC enforcement actions against companies and individual executives. It can even lead to criminal prosecution.*

Let me be clear. I am not suggesting that you are the type of person who is likely to commit a fraud, that your fellow founders are inclined to commit fraud, or that you would hire anyone who was. I am only warning that the pressures on executives of public companies to make analysts’ forecasts are tremendous and that even good-hearted people can succumb.

I also want to caution that revenue recognition fraud can creep up on you. It might occur in one quarter in a small amount. You might find out after-the-fact. But then, in the next quarter, with some of the sales that should have been counted in that period already recorded in the earlier three months, the pressure may increase to repeat the errors—maybe even in larger amounts.

Let me counsel you on another aspect of public company accounting. As you know, your financial statements will have to be reported in accordance with generally accepted accounting principles: “GAAP.” Far from being a precise instrument always yielding the same, single set of reported numbers from a

given set of business events, GAAP permits myriad judgment calls. Indeed, two companies in the same industry can undergo virtually the same economic experience in a quarter, yet report GAAP numbers that differ dramatically.

This is because GAAP not only permits, but requires that companies make estimates and judgments. As an example, some customers may return your products because of production defects. If this happens in significant quantity, you will need to create a “reserve” for returns, which is simply a number that estimates the revenue or profit that will be lost when the returns come back. As you can readily imagine, such an estimate is a judgment call and may vary over time as, for example, your products go through their life cycles. Additions to and reductions of that reserve in a particular quarter or at year’s end directly affect your company’s revenue or income. The same is true of other reserves for warranty work, bad debts, and other contingencies.

These and many other estimates that your company will have to make as you comply with GAAP may—like close-of-quarter revenue recognition—tempt you and your CFO. In quarters when the company is otherwise flourishing, you may be inclined to be more conservative in estimating reserves, putting too much into them then so that, when times are leaner, you can adjust those reserves downward and increase income as a result. Both the original and the later, adjusted reserve figures might be within the range of what is reasonable and satisfy GAAP, although you might have to vary some of your assumptions in order to get the lower figure the second time.

By adjusting your reserves in this way (building them when times are easy and reducing them when times are harder, in order to boost income), you may accommodate the analysts. Many of them would rather see a steady march of increasing revenue and income rather than growth by fits and starts. They would rather see your company increase earnings per share by five cents each quarter than see no growth for four quarters and a twenty-five-cent jump at the end of the fifth. You may be tempted to use accounting reserves to “smooth” or “manage” your reported earnings in order to cater to this analyst preference.

Aside from manipulating reserves in this manner, you may be tempted to “manage” earnings by taking large, one-time charges. For example, if you decide at some point to discontinue a particular line of business, you may take a “restructuring” charge to record, at the time the line is discontinued, the costs that you anticipate the discontinuation will create. This, too, is an estimate.

When you take that one-time charge, you may again find an opportunity to calculate the numbers to your advantage, again while remaining within the confines of GAAP. Deciding which future costs are allocable to the discontinuation may involve discretionary decisions, and estimating those costs will necessarily involve judgment. You may see the allure of including as many

types of costs as possible and stretching assumptions in order to estimate each cost as generously as possible. In this way, you could increase the restructuring charge to as large a number as you can. This would give you a “cushion” on which you could draw to reverse a portion of the reserve when needed to improve poor results in a later quarter and thereby avoid a drop in stock price.

Outsized, one-time restructuring charges can affect stock prices in another way. The analysts may attribute little importance to a “one-time” charge, so loading it up with all sorts of costs—including costs that you would normally accrue in later quarters and that will generate revenue in those later periods—may not hurt your stock price when you take the charge. But loading that charge with such future costs will improve your results down the line. As you go through subsequent accounting periods, some of the costs that you would ordinarily have subtracted from revenue to compute earnings in those quarters will not be taken then because they were already included in the earlier restructuring charge. So your earnings will be higher because you will have avoided appropriately matching costs with revenues.

To be sure, if you abuse reserves or one-time charges too much, you will run afoul of the accounting rules and commit fraud. But long before you reach that point, and while you still remain within the ambit of acceptable though aggressive practice, you may have created a reserve or taken a charge that serves more to obscure later results rather than to provide for expenses that your current actions will create in the future.

In these and other ways, you or your CFO may find it possible to deliberately exploit estimates and judgments in order to produce numbers that satisfy analysts’ predictions. Your reported results, however, may then fail to reflect the real ebb and flow of your business.

*Any such manipulation of your numbers to please the analysts is wrong. It is wrong, even if your accountants will give you a “clean opinion,” because you remain within the literal reading of complicated GAAP rules.*

*Reported financial statements for a public company should tell the investment community your company’s real economic condition and performance. If you massage the numbers so that they do not reflect the reality of your business, those numbers fail to serve that fundamental purpose. In that event, you have hurt your investors and potential investors and done something that you should not do, even if your accountants will still sign the opinion that you want from them for your annual report.*

Now that you see the problem, let me talk about the solution. How can you avoid reporting misleading numbers? How can you effectively fight the pressures to do so?

In part, you must depend on your own integrity. You must establish a “tone at the top” that values ethical, straightforward financial reporting and will not countenance either false figures or figures that misdirect instead of inform. You must never suggest to your CFO that he or she should rework the numbers in order to meet Street estimates.

But, in this new environment, it will not be enough to simply rely on your own commitment to business morality. It is essential to establish and preserve strong organizational counterweights to the influences that could push you towards wrongdoing. One such counterweight is your CFO and your CFO’s staff. They must be strong enough, savvy enough, and sufficiently supported to collect true financial information and report it with the goal of representing your company’s real business condition in its balance sheets and its real economic history in its income and cash flow statements.

I appreciate that spending on accounting infrastructure will be painful and will take money from the bottom line. But a fully staffed, professional accounting team that has your respect and the respect of other top executives can establish and enforce sound revenue recognition practices and make consistent, well-supported accounting estimates and judgments for reserves and one-time charges.

As soon as possible, you must also spend the money to create a serious internal audit group that will report not to your CFO, but to you directly and that can also report directly to the audit committee of your board of directors. This direct access is essential to ensure that your internal auditors can bring financial reporting problems to you without going through the accounting hierarchy that may have contributed to those problems and can even bring a questionable practice to the audit committee without going through any part of the executive cadre that may have condoned that practice.

Speaking of the audit committee, I have already mentioned the new requirements for such committees that NASDAQ and the two principal exchanges are now introducing. But you will want to do more than simply comply with those requirements in a technical sense. Just as you have sought outside directors who can provide sage counsel on product development, marketing, and financing, so you will want to seek outside directors who will be good audit committee members.

You do not want any weak personalities on your audit committee who will not rock the boat, who will not ask questions, or who, if they do interrogate, will do so without the inclination or ability to follow up. You want directors who will ask the hard questions, even the embarrassing ones, and who will probe into the answers that they receive. Such questions may now seem an unpleasant

prospect. When asked, they may seem an unwarranted intrusion. But remember that the audit committee is in the end a part of your own defense, counterbalancing the forces that may push you and others in the company to fiddle or distort the numbers you report.

You should also seek, for your audit committee, directors who know how to read and penetrate corporate reports. You do not want those who barely satisfy the minimal level of financial literacy required by NASDAQ. You want the ones who can ask your CFO and the outside auditor about the quality—not just the acceptability—of your accounting and who can evaluate the answers that they receive. You want directors who will be able to tell whether your company's reports really represent the true economic state of affairs and who have the gumption to insist that those reports do just that.

And now, to the last of your organizational counterweights—your outside auditor. As you know, you will be required, as a reporting company, to file annual financial statements with the SEC. You will have to distribute those financial statements to your shareholders. Those statements must be audited by an outside accounting firm. Your outside auditor is, in a real sense, your last line of defense against bad numbers.

You must remember two things: First, it is essential that your auditor be independent. Without independence, the auditor cannot be objective. Without objectivity, the auditor cannot do its job.

Oddly enough, your auditor may make propositions to you that threaten its own independence. The firm that does your audit is not just an accounting outfit. It offers management as well as information consulting and such consulting may generate the majority of that firm's revenue. The firm may even attempt to "cross-sell" consulting to you. You may buy some of those services because they appear to be quite valuable. And they may indeed be valuable. But you must never use the possibility that you might buy those services, or continue to buy them, as a lever to influence your outside accountants' views on issues that arise in an audit.

Here, the audit committee of your board of directors can help. The new NASDAQ listing standards will require that that committee receive information from the auditor on such matters as the management and information consulting work that the audit firm performs for your company. The listing standards will further require the committee to expressly discuss with the outside accountants whether any of that work compromises audit independence. You want audit committee members who will make that a serious conversation, not a perfunctory exercise. You want directors on that committee who are strong enough to come to you and say, if they believe it to be true, that the firm performing the audit simply will not be sufficiently objective and independent

unless it does not undertake, or does not continue, consulting work for your company.

Now to the second point about auditors—they are supposed to be skeptical. They are supposed to ask the hard questions. They are being paid to push back when the company tries to employ overly aggressive accounting treatments. It is not their job to simply bless manipulated numbers that meet analyst expectations or to provide a “clean opinion” for financial statements that obscure rather than enlighten. It is certainly not their function to help your company find a way to reach an analyst’s target or to cloak an unpleasant business reality.

You never want to find yourself in a meeting in which you or your CFO asks, in exasperation, where the accounting rules say that you cannot treat an accounting event in a manner that will allow you to publish a number that the analysts want to see or avoid publishing one that will disappoint them. The auditor is there to critically examine the figures that you have assembled and to make sure that the reports that you file with the SEC, mail to shareholders, and publish to the investment community fairly and accurately reflect your company’s financial condition and performance. The auditor is not there to facilitate the numbers that you want to report.

Today, all of this counsel may seem mighty strange. But, believe me, after you go public, you will feel the tidal force of Wall Street forecasts. You, and others at your fine and promising young company, will need all the help you can get to resist the temptation to meet or beat those numbers in any way you can, even ways that legally or illegally mislead investors. So please keep all this in mind, build and assiduously maintain the organizational bulwarks that we have discussed, and, at the end of each quarter, think back on our conversation today.

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We cannot know how often lawyers in late 1999 delivered this imagined speech to entrepreneurs about to take their companies public. The attorney-client privilege prevents lawyers from disclosing, for any named client, just what is said along these lines. Unfortunately, no survey provides the percentage of instances in which attorneys did or did not counsel clients in such extensive and explicit terms. Intuitively, we suspect that most attorneys gave at least a portion of this advice. They probably provided some of this counsel when a company went public and more, in pieces and at different times, as the client progressed through later accounting periods.<sup>6</sup>

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6. For example, in drafting the Management Discussion and Analysis for the Registration Statement and for later 10-Qs and 10-Ks, the lawyers may have discussed revenue recognition issues with the company. In addition, at some point, the attorneys would have counseled the company on how to deal with analysts. Much of that advice, however, would have centered on how to avoid

However, we also suspect that there were many cases in which the lawyers did not give this caution, at least not in the detail and at the length set out above. The rest of this piece considers why that likely happened and investigates this question by contrasting the second scene with the first in five ways:

- The client in the first scene asks the lawyer's advice on a plan that the client proposes. The client in the second scene does not seek the advice that the "speech not given" provides and is not planning any of the actions against which the lawyer warns. It is not immediately clear that the lawyer needs to speak at all.
- The lawyer in the first scene is a sole practitioner whom we assume to be economically secure. The partner in the second scene is a member of a modern law firm, concerned about the "bottom line." The attorney's tongue might have been stilled in 1999 by concern that his or her own compensation might suffer if the monologue offended the client and the client left for another lawyer at another firm.
- The lawyer in the first scene provides advice that is a near-perfect fit with the commercial culture of the time and place. The lawyer in the second scene may have hesitated to speak words that were out of tune with Silicon Valley values.
- The first attorney inhabits a world in which the honesty of clients affects the attorney's self-image and the attorney's standing in the community. These considerations affirmatively prompt the lawyer to speak. The second counselor is more a technician with neither social

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selective disclosure to analysts and how to avoid liability for the reports that analysts write. See Steven E. Bochner & Ignacio E. Salceda, *Over the Wall: Handling Securities Analysts' Conference Calls, Earnings Forecasts, and Reports Effectively*, 1134 PLI/CORP 229, 229 (1999); Karl A. Groskaufmanis, *The Crucible: "Real-Time" Disclosure to Securities Analysts, Investors and the Financial Press*, 1134 PLI/CORP 271, 271 (1999); Gary G. Lynch, *Disclosure Obligations and the Risk of Selective Disclosure*, 1149 PLI/CORP 45, 62-63 (1999); William R. McLucas et al., *Selective Disclosure and Analysts: A Problem Better Solved by Issuers Than Law Enforcement*, 1108 PLI/CORP 77, 77 (1999); Kevin P. Roddy, "When the Truth Is Found to Be Lies": *Liability of Securities Issuers and Their Officers and Directors for Statements Made by Securities Analysts*, 1149 PLI/CORP 245, 245 (1999).

There is some evidence that attorneys counseled clients that analyst coverage would put pressure on a public company to achieve immediate results. Robbins & Horton, *supra* note 4, at 134. But lawyers may have presented analyst interest more as a factor that would divert a company's focus from a business strategy developed for the far horizon or that would magnify the effect of informational errors in public documents, rather than as a force that might move a company to report bad numbers. *Id.* at 134 (suggesting that lawyers tell companies considering a public offering that "Market pressures by investors in public securities tend to increase the focus on short-term results rather than long-term goals" and that "Management is subject to the constant pressures of securities analysts, which increases short-term performance pressure and creates additional risks from incomplete or incorrect disclosures").



position nor self-definition so much at risk if a client publishes misleading financials.

- The lawyer in scene one was the only professional advisor that the client will consult. The attorney in scene two is only one of many advisors to the budding company. Indeed, the speech is geared towards issues that are largely the province of a different set of professionals—the accountants.

#### IV. A FIRST CONTRAST: THE CLIENT IN SCENE ONE ASKS FOR ADVICE, WHILE THE CLIENT IN SCENE TWO DOES NOT

In our first case, the client comes to the attorney to propose a very specific action—stiffing a customer on an oral agreement. The lawyer is on the spot with the client expressly requesting counsel on his proposal.

In our second scene, the client has not requested the counseling at all. The client has not proposed any of the actions against which the lawyer warns—recording phony revenue, creating and then manipulating oversized reserves, taking restructuring charges that include costs more properly recorded in later quarters, or jawboning auditors into giving a clean opinion for financial statements that pass minimum GAAP standards, but nevertheless mislead. Nothing in our example suggests that the client even has a propensity to such mischief. Indeed, the lawyer says that such actions would be out of character.

Whether, under these conditions, the lawyer should have delivered the long monologue depends, in large part, on the risks that the client realistically faced and whether those risks were well-known to the legal community. One theoretical explanation for second-scene silence (or delivery of our supposed counsel in a significantly truncated form) is that lawyers did not have data suggesting that this counsel need be given at all.

This view has considerable force. Scene two played out in 1999. The stock market bubble was still expanding. Enron's implosion and the dramatic WorldCom arrests all lay in the future.

These circumstances, however, cannot supply a complete explanation for two reasons. First, by the end of 1999, recent news and commentary suggested that there was a crisis in corporate accounting. Second, the SEC leadership had, by that time, publicly identified bad accounting as a major regulatory issue and called for the very remedial actions that our second-scene speech recommends.

##### A. *Press Reports and Commentary Had Highlighted Overly Aggressive Accounting*

Financial scandals that were fresh in the mind of our second-scene attorney suggested the need for the counsel that the lawyer did not deliver. Waste Management, Cendant, and McKesson HBOC had all, in the then-recent past,

reported spectacular accounting meltdowns. A host of other companies had disclosed smaller scandals. The financial press grieved over the fallen state of public company bookkeeping. What follows is just a sample of what our scene-two attorney had probably read or heard about in 1998 and 1999.

In February 1998, Waste Management announced an accounting restatement, changing the financial numbers it had reported for the past five years.<sup>7</sup> The company also took a special charge and expense adjustment, stating, in the press release disclosing all this, that the “special charge, adjustments to expenses and restatements . . . cumulatively total \$2.9 billion after-tax and \$3.5 billion pre-tax.”<sup>8</sup>

A month later, the SEC charged Sensormatic with stopping its computer clock to record, in quarters that had just ended, revenue from sales of products that were in fact shipped after the quarters closed.<sup>9</sup> By this and other accounting gymnastics,

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7. Press Release (Feb. 24, 1998), *contained in* Waste Management Inc. Form 8-K filed Mar. 2, 1998, *available at* [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004) (emphasis added). The company said that “certain items of expense were incorrectly reported. These principally relate to the calculation of vehicle, equipment, and container depreciation expense and capitalized interest. In the depreciation area, the Company employed incorrect vehicle and container salvage value assumptions, and made mistakes in the corporate financial reporting process.” *Id.* A little over two years after our second scene, the SEC filed a complaint against senior Waste Management executives, alleging financial fraud and saying that: “Defendants’ scheme was simple. They improperly eliminated or deferred current period expenses in order to inflate earnings. For example, they avoided depreciation expenses by extending the estimated useful lives of the Company’s garbage trucks while, at the same time, making unsupported increases to the trucks’ salvage values.” Complaint at ¶ 2, *S.E.C. v. Buntrock*, No. 02C 2180, (N.D. Ill. Mar. 26, 2002), *available at* <http://www.sec.gov/litigation/complaints/complr17435.htm> (last visited Feb. 4, 2004).

8. *Id.* (emphasis added).

9. In the Sensormatic administrative proceeding, which was settled without any company admission of wrongdoing, the SEC found that:

On or shortly before the last day of a quarter, employees from the sales, manufacturing, and shipping departments . . . met to determine what purchase orders were expected to be received and processed and how long it would take to ship the related product. During the relevant period, purchase orders were accepted through the last day of the quarter and processed late into the night on that day. On at least one occasion, orders were accepted throughout the first day of the next quarter but were recorded as having been received in the previous quarter. If these last minute orders could not be shipped by midnight on the last day of the quarter, the decision was made, usually by Sensormatic’s VP of Finance or its CFO, as to how much product to ship after the end of the quarter.

Sensormatic then shipped goods for a number of days past the end of the quarter by going through a complicated and costly process to backdate computer-generated records of these shipments. Shortly before midnight on the last day of the quarter, the computer system that recorded and dated shipments was “brought down” so that the computer clock date would reflect the last day of the prior quarter. The computer system then falsely recorded shipments as having occurred on the last day of the prior quarter.

Order Instituting Pub. Admin. Proceedings, Making Findings, & Issuing Cease-and-Desist Order, *In re Sensormatic Electronics Corp.*, File No. 3-9563, 1998 WL 130864, at \*3 (S.E.C. Mar. 25, 1998) [hereinafter Sensormatic Order]. One pundit put it that, “In the old days, time literally stood still at

Sensormatic padded its revenue “in order to reach its budgeted earnings goals and thereby meet analysts’ quarterly earnings projections.”<sup>10</sup> The SEC concluded that senior management, including the CFO and the COO, not only knew about “the methods used to effectuate the scheme, but also condoned and directed them.”<sup>11</sup>

In June, Sunbeam fired Albert Dunlap, an irascible turnaround artist who had earned the sobriquet “Chainsaw Al” for laying off employees in order to bring companies back into the black.<sup>12</sup> In November, Sunbeam restated results reaching from 1996 through the first quarter of 1998, acknowledging that it had improperly recognized revenue on “bill and hold” sales and made improper charges to a restructuring reserve it had created when Dunlap arrived to save the company.<sup>13</sup>

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Sensormatic Electronics.” Thor Valdmnis, *Accounting Abracadabra*, USA TODAY, Aug. 11, 1998, at 1B.

10. Sensormatic Order, *supra* note 9, at \*1.

11. *Id.* at \*2.

12. A June 15, 1998 article in *The Wall Street Journal* reviewed the history that earned Mr. Dunlap his moniker. Martha Brannigan & James R. Hagerty, *Chain-Sawed: Sunbeam, Its Prospects Looking Ever Worse, Fires CEO Dunlap*, WALL ST. J., June 15, 1998, at A1. It also reported that Sunbeam had discharged him. *Id.*

13. The Sunbeam story began when *Barron's* published an article in its June 8, 1998 issue questioning Sunbeam's accounting. Jonathan R. Laing, *Dangerous Games: Did "Chainsaw Al" Dunlap manufacture Sunbeam's earnings last year?*, BARRON'S, June 8, 1998, at 17. The article said that Dunlap had created a huge restructuring reserve in 1996 when he arrived, including, for example, a one hundred percent write-down of discontinued products in inventory. *Id.* In later accounting periods, the company sold these products without charging any costs against those sales. *Id.* The restructuring reserve also included advertising and packaging costs, which—because they were charged at the time that Sunbeam created the reserve—were not incurred in later quarters when they benefited sales. *Id.* The *Barron's* article also contended that warranty and bad debt reserves had been manipulated to improve 1997 results. *Id.* Further, “as 1997 dragged on and the pressure to perform for Wall Street intensified,” Sunbeam's revenue included \$35 million from “bill and hold” transactions. *Id.* Sunbeam had not shipped the products in these deals by the end of the quarter in which the company recognized the revenue from the sales. *Id.* Instead, Sunbeam continued to store those products itself. *Id.* at 19. *Barron's* said that Sunbeam was “now holding so many grills in various warehouses around its Neosho, Missouri, grill plant that it has had to lease warehouse space in nearby Oklahoma.” *Id.* The author added that some sources said Sunbeam had made sales to distributors with absolute rights of return. *Id.*

On June 15 and 18, 1998, respectively, Sunbeam announced the terminations of its CEO (Dunlap) and its CFO. Sunbeam Form 10-K/A filed Nov. 12, 1998, at 3, *available at* [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004). On June 25, it stated that its auditor would not consent to the inclusion of the auditor's opinion on the 1997 financials in a registration statement. *Id.* On June 30, the company announced that its Audit Committee would conduct a review of Sunbeam's prior financial statements and that investors should not rely on those statements. *Id.* On August 6, Sunbeam said that it would restate numbers for 1997 and the first quarter of 1998 and, on October 20, it advised that the restatement would go back to the fourth quarter of 1996. *Id.* When the company filed the restated 1996 and 1997 numbers with the SEC in November 1998, Sunbeam disclosed that:

Upon examination, it was determined certain revenue was improperly recognized

Cendant Corporation, the company formed by the merger of HFS Incorporated and CUC International Inc., provided the year's most spectacular accounting disaster. On April 15, 1998, the company announced that it had "discovered potential accounting irregularities in certain former CUC business units" and that it "expect[ed] to restate annual and quarterly net income and earnings" for 1997 and might "restate certain other previous periods."<sup>14</sup> It said that the Audit Committee of its Board of Directors had engaged special counsel and was conducting an investigation.<sup>15</sup>

On May 18, Cendant reported that it had dismissed the independent accountants who had audited CUC's 1997 numbers.<sup>16</sup> On July 14, the company acknowledged that "accounting irregularities at the former CUC International . . . were greater than those initially discovered."<sup>17</sup> The press release quoted the Cendant CFO's reference to "evidence that for at least the last three years the [CUC] financial results . . . reflected a continuing program of false entries."<sup>18</sup>

On August 28, 1998, Cendant filed an extraordinary 8-K containing a 258-page report to its Audit Committee by special counsel Willkie, Farr & Gallagher.<sup>19</sup> Stating that accounting missteps at CUC "were pervasive" and labeling them "irregularities,"<sup>20</sup> the report defined that latter term in the patois of accountants as "*intentional* misstatements or omissions of amounts or disclosures in financial statements."<sup>21</sup> Quantifying the false numbers, the special counsel said that "During the Restatement Period, operating income was improperly inflated by an aggregate of

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(principally "bill and hold" and guaranteed sales transactions), certain costs and allowances were not accrued or were improperly recorded (principally allowances for returns, cooperative advertising, and customer charge-backs as well as deductions and reserves for product liability and warranty expense) and certain costs were inappropriately included in, and subsequently charged to, restructuring, asset impairment and other costs . . .

*Id.* at F-31; *see also* Sunbeam Form 10-Q/A filed Nov. 25, 1998, *available at* [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004) (showing the revised figures for the first quarter of 1998).

14. Press Release (Apr. 15, 1998), *contained in* Cendant Form 8-K filed Apr. 17, 1998, *available at* [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004).

15. *Id.*

16. Press Release (May 18, 1995), *contained in* Cendant Form 8-K filed May 18, 1998, *available at* [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004).

17. Press Release (July 14, 1998), *contained in* Cendant Form 8-K filed July 14, 1998, *available at* [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004).

18. *Id.*

19. WILKIE, FARR & GALLAGHER & ARTHUR ANDERSEN, LLP, REPORT TO THE AUDIT COMM. OF THE BD. OF DIR. OF CENDANT CORP. (Aug. 24, 1998) [hereinafter CENDANT AUDIT COMM. REPORT], *contained in* Cendant's Form 8-K filed Aug. 28, 1998, *available at* [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004).

20. *Id.* at 9.

21. *Id.* at 7 (emphasis added) (quoting from the Statement on Auditing Standards No. 53, which was effective for CUC's 1996 and 1997 fiscal years).

approximately \$500 million before taxes, which represents more than one-third of the total operating income reported by CUC.<sup>22</sup> CUC's deceptive techniques included improper revenue recognition and manipulation of reserves.<sup>23</sup> The "purpose of many of the irregularities was . . . to conform CUC's publicly-reported results to Wall Street's earnings expectations."<sup>24</sup>

The report said that CUC headquarters had directed the false entries, specifically:

At each of the first three fiscal quarters since 1995, CUC inflated its operating income by increasing revenues and/or decreasing expenses of its largest business unit . . . without any valid basis. . . . So-called 'topside' entries were made by accounting personnel at corporate headquarters to increase accounts receivable and revenues, or to decrease accounts payable and expenses, even though (as these personnel acknowledged) there was no actual receivable supporting the entry giving rise to the revenues, and no actual reduction of a payable obligation to justify the reduced expense. . . .

The amount of the income adjustments at each quarter closely mirrored the amount needed to bring CUC's results into line with Wall Street earnings expectations, e.g., if actual income in a particular quarter was 10[¢] per share and consensus analysts' expectations were 18[¢] per share, then adjustments of approximately 8[¢] were made, without support, to increase earnings.<sup>25</sup>

To close the gap between what the company had reported at each quarter's end after the topside adjustments and what the unadjusted books actually showed, at the end of 1997, CUC reversed portions of merger and restructuring reserves into income through unsupported bookkeeping entries.<sup>26</sup>

The report to the Audit Committee sais that the wrongdoers responsible for this debacle sat at the apex of CUC's accounting apparatus. The CFO "directed the unsupported topside adjustments to increase quarterly income;" the Controller "gave the directions that resulted in the improper reversal of a substantial amount of merger reserves into income and the recording of improper entries."<sup>27</sup>

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22. *Id.* at 9.

23. For example, CUC arbitrarily recorded the revenue from the sale of certain products, for which revenue should have been recognized over several accounting periods, as revenue from the sale of other products, for which all sale revenue could be recognized immediately. *Id.* at 12. CUC also understated its reserve for cancellations of memberships in consumer services programs and, in order to hide that understatement, delayed recording cancellation charges and created fictitious accounts receivable. *Id.* at 13.

24. CENDANT AUDIT COMM. REPORT, *supra* note 19, at 9.

25. *Id.* at 9–10.

26. *Id.* at 11–12.

27. *Id.* at 14.

As 1998 ended and 1999 commenced, more financial frauds came to light. The new year began with an SEC order against Livent, a Canadian company that had financed both “Ragtime” and a “Show Boat” revival.<sup>28</sup> The SEC found that the company’s “former senior management . . . engaged in a multi-faceted and pervasive accounting fraud spanning eight years from 1990 through the first quarter of 1998.”<sup>29</sup> They had engineered kickbacks to put money into their own pockets; shifted preproduction costs to fixed asset accounts to expense them over a longer period of time and thereby reduce current costs; simply erased some of the company’s liabilities at the end of each quarter then added them back in to the books in the next quarter; and recognized revenue on deals with side agreements that required Livent to pay back the money that it received.<sup>30</sup>

Late April 1999 brought more sensational news. McKesson HBOC reversed \$26.2 million of software sale revenue in the corporation’s fourth quarter and \$16 million in previous quarters because McKesson had recorded revenue from sales

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28. Order Instituting Public Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings and Imposing a Cease-and-Desist Order, *In re Livent, Inc.*, File No. 3-9806, 1999 WL 10265, at \*1 (S.E.C. Jan. 13, 1999) [hereinafter *Livent Order*]. For a brief background on Livent, see Lisa Gubernick, *Entertainment: Livent Officials Are Suspended In New Inquiry*, WALL ST. J., Aug. 11, 1998, at B1. The company had suspended its Chief Executive Officer in August 1998, published restated financials in November for 1996 through the first quarter of 1998, and filed for Chapter 11 protection that same month. *Id.*; *Livent Order*, *supra* at \*2; Eben Shapiro, *Livent, Inc. Sues Founder, Files for Chapter 11*, WALL ST. J., Nov. 19, 1998, at B8.

29. *Livent Order*, *supra* note 28, at \*1.

30. The SEC’s administrative order, entered without any admission by Livent or specific individuals, said that:

Preproduction costs, which include costs for advertising, sets and costumes, are incurred prior to the opening of the production. According to Livent’s accounting policy, as contained in its financial statements, preproduction costs are expensed through amortization once a production begins, for a period not to exceed five years. Fixed assets, on the other hand, are depreciated over their useful life, up to forty years for buildings. As a result, Livent significantly decreased show expenses, and inflated profits, by fraudulently amortizing preproduction costs over a much longer period of time. In 1997, for example, Livent transferred preproduction costs, and certain show operating expenses, totaling \$15 million from six different shows in thirty locations, to three different fixed asset accounts . . . . As a second part of this accounting scheme, at the end of each quarter, Livent simply removed certain expenses and the related liabilities from the general ledger, literally erasing them from the company’s books. In the succeeding quarter, the expenses and related liabilities would be re-entered . . . as original entries. . . . The amount of expenses moved from current periods to future periods was internally tracked at Livent as the “Expense Roll.”

*Id.* at \*4. The Order added: “From 1996 through 1997, [the CEO and the President] orchestrated the recognition of at least \$34 million in revenue by entering into side agreements on transactions that required Livent to pay back monies it received.” *Id.* at \*7. The SEC also found that the CEO and President had “operated a kickback scheme with two Livent vendors designed to siphon millions of dollars from the company directly into their own pockets.” *Id.* at \*3.

before they were final.<sup>31</sup> The company's market capitalization dropped \$9 billion in a single day.<sup>32</sup>

McKesson removed its Board Chairman and dismissed executives in its Health Care Information Technology business.<sup>33</sup> When it published revised figures in July, the company said it reversed some of the software sales because they were—when counted as revenue—contingent on a board approval, a legal review, or on third-party financing.<sup>34</sup> McKesson reversed other revenue because contracts were “signed subsequent to quarter end and backdated. . . .”<sup>35</sup>

More restatements followed. By the end of the first week in December, the Director of the SEC's Division of Enforcement counted fifty-three companies that had announced restatements in 1999.<sup>36</sup> That count may have been too low.<sup>37</sup>

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31. Press Release (Apr. 28, 1999), contained in McKesson HBOC, Inc. Form 8-K filed May 3, 1999, available at [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004).

32. Ralph T. King Jr., *McKesson Restates 4<sup>th</sup>-Period Results*, WALL ST. J., Apr. 29, 1999, at A3. At the same time McKesson said that it would revise its prior financial results, McKesson also reduced its estimate of earnings for the then-current fiscal year from \$3 per share to \$2.50 per share. *Id.* This revised projection may have caused some, perhaps even most, of the stock drop. On the other hand, the company may have revised the going-forward projection in part because it determined that software sales had not grown as fast in the prior fiscal year as the originally published numbers showed.

33. McKesson HBOC, Inc. Form 10-K/A filed July 16, 1999, at 4, available at [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004).

34. *Id.* at F-48.

35. *Id.*

36. Richard H. Walker, U.S. Securities and Exchange Commission Director of Division of Enforcement, Behind the Numbers of the SEC's Recent Financial Fraud Cases, Remarks Before the 27th Annual National AICPA Conference on Current SEC Developments 2 (Dec. 7, 1999), at <http://www.sec.gov/news/speech/speecharchive/1999/spch334.htm> (last visited Feb. 4, 2004) [hereinafter Walker, Behind the SEC Numbers]. For this and all other speeches, the page number for the citation or quotation is the number of the page at which the quotation or fact appears when the speech is printed out from the SEC's Web site using the smallest text size.

The two years—1998 and 1999—also saw three sets of securities lawsuits settle for huge amounts. In December 1998, Waste Management and its auditor agreed to pay \$220 million to settle shareholder class actions. James P. Miller, *Waste Management, Andersen Agree to Settle Holder Suits for \$220 Million*, WALL ST. J., Dec. 10, 1998, at B22. In May 1999, Informix announced that it and its auditor would settle stockholder lawsuits and related derivative litigation for a total of \$142 million. Press Release (May 26, 1999), contained in Informix Form 8-K filed June 18, 1999, available at [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004). In November, IKON reported that it was settling securities and derivative lawsuits for \$111 million. Press Release (Nov. 24, 1999), contained in IKON Form 8-K filed Nov. 30, 1999, available at [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004).

37. A recent study of restatements over five years counted 216 in 1999. Huron Consulting Group, *An Analysis of Restatement Matters: Rules, Errors, Ethics For the Five Years Ended Dec. 31, 2002*, at 3 (2003) [hereinafter Huron Restatement Study]. But this count apparently includes companies that said they were “revising” financial numbers as well as those that said they were “restating.” *Id.* at 4. The General Accounting Office (“GAO”) put together a database of

Beyond reports of skullduggery at particular companies, two survey works added to the evidence that, when corporations falsified their numbers, executive leadership often participated in creating the falsehoods. In March 1999, the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) published a study of financial fraud during 1987–1997.<sup>38</sup> The study analyzed 195 SEC enforcement actions over that eleven-year period.<sup>39</sup> In eighty-three percent of the enforcement actions, the Commission named either the CEO or the CFO.<sup>40</sup> The COSO Chairman concluded that the “frauds went to the very top of the organizations” and that these “results highlight the need for an effective control environment, or ‘tone at the top.’”<sup>41</sup>

*Business Week* published the second survey in its July 13, 1998 issue.<sup>42</sup> A promotional section featuring the magazine’s Seventh Annual Forum of Chief

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restatements that “were made to correct previous material misstatements of financial results.” GAO, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Challenges*, at 2 (Oct. 2002) [hereinafter GAO Study]. It counted 151 such restatements by listed companies in 1999. *Id.* at 16.

38. The report described the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) as a “private sector initiative, jointly sponsored and funded by the following organizations: American Accounting Association, American Institute of Certified Public Accountants, Financial Executives Institute, Institute of Management Accountants, and The Institute of the Internal Auditors.” COSO, *FRAUDULENT FIN. REPORTING: 1987-1997 AN ANALYSIS OF U.S. PUB. COS.*, at v. (1999) [hereinafter COSO 1999 REPORT]. The Treadway Commission had, in 1987, published its study entitled *Report of the National Commission on Fraudulent Financial Reporting*. The 1999 publication was “a comprehensive analysis of fraudulent financial reporting occurrences investigated by the SEC since the issuance” of that original Treadway report. COSO 1999 REPORT, *supra*, at iii. The three researchers who wrote the 1999 study reviewed SEC Accounting and Auditing Enforcement Releases (“AAERs”) during the eleven-year period between January 1987 and December 1997 and identified, from the AAERs, 300 companies involved in alleged fraudulent financial reporting and randomly selected approximately 200 of those companies for further investigation. *Id.* at 1.

39. *Id.*

40. *Id.* at 15. Appropriately, the authors included the caveat that “Even though these individuals were named in an AAER, there is no certain evidence that all the named participants violated the antifraud statutes. In addition, most of the named participants admitted no guilt of any kind.” *Id.*

41. Particularly relevant to our second scene, the study also found that most of the companies accused of financial fraud were small. *Id.* at iii. For the ninety-nine companies in the study whose last clean financial statements were available, total assets averaged \$533 million, with the median a much lower \$15.7 million. *Id.* Similarly, annual revenues averaged \$86 million; the median was only \$13 million. *Id.* at 11.

42. The survey results appear on the fourth page of the “Special Advertising Section” devoted to the magazine’s CFO forum. *7th Ann. Forum of Chief Fin. Officers*, *BUS. WK.*, July 13, 1999, at Special Adver. Section. While that and the other promotional pages bear no numbers, the page reporting the survey is the last page of the special section and immediately precedes numbered page 109. *Id.*



Financial Officers reported on a poll at that event.<sup>43</sup> One question inquired whether the CFOs had been asked by other executives to misrepresent financial results and, if so, what the CFOs had done.<sup>44</sup> Of those who responded, sixty-seven percent indicated that they had been asked to misrepresent.<sup>45</sup> While fifty-five percent said they had defeated this pressure, twelve percent said that they had buckled under.<sup>46</sup>

The popular financial press offered detailed explanations for top officer involvement in accounting shenanigans. Articles appeared sporting such provocative titles as: "Pick A Number, Any Number,"<sup>47</sup> "Learn to Play the Earnings Game (and Wall Street Will Love You),"<sup>48</sup> "Accounting Abracadabra,"<sup>49</sup> "The Auditors Are Always Last to Know,"<sup>50</sup> "Earnings Hocus Pocus,"<sup>51</sup> and "Lies, Damned Lies, and Managed Earnings."<sup>52</sup> The articles stressed the pressure on companies to make the

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* Although *Business Week* set out the survey responses in this promotional form, it made news. See Valdmnis, *supra* note 9, at 2B ("How often do companies flirt with disaster and cook their books? A survey at a recent *Business Week* conference of chief financial officers in Phoenix contains some alarming findings. [¶] About 12% of CFOs admitted they had 'misrepresented corporate financial results' at the request of senior company executives; 55% said that they had been asked to do so but 'fought off' the demand."). And the survey influenced the SEC. Richard Walker, the Director of the Division of Enforcement, said that SEC officials were "alarmed" by the *Business Week* poll as well as by one conducted by *CFO Magazine* in which forty-five percent of respondents said they had been asked to misstate results and thirty-eight percent of those said that they had done so. Reuters, *SEC to Press Review of Earnings Reports*, THE WASHINGTON POST, Feb. 13, 1999, at E2.

The *CFO* poll that Walker referenced provided this information:

Asked about the need for action to address accounting abuses, two-thirds of the survey respondents agreed that something should be done. This despite the finding that current problems have less to do with fraud than with aggressive accounting. A good proportion—45 percent—had been asked to misrepresent financial results. Fully 38 percent of that group did so. But a whopping 78 percent had been asked to use accounting rules to cast results in a better light. Half of that group acceded to the request. "There have been some 'creative' practices applied, but used in the parameters of GAAP, as a matter of interpretation," wrote one respondent to the *CFO* survey.

Stephen Barr, *Misreporting Results*, CFO, Dec. 1998, at 36, 40.

47. Bernard Condon, *Pick a Number, Any Number*, FORBES, Mar. 23, 1998, at 124.

48. Justin Fox & Rajiv Rao, *Learn to Play the Earnings Game (And Wall Street Will Love You)*, FORTUNE, Mar. 31, 1997, at 76.

49. Valdmnis, *supra* note 9.

50. Herb Greenberg, *The Auditors Are Always Last to Know*, FORTUNE, Aug. 17, 1998, at 228.

51. Nanette Byrnes et al., *Earnings Hocus Pocus*, BUS. WK., Oct. 5, 1998, at 134.

52. Carol J. Loomis et al., *Lies, Damned Lies, and Managed Earnings*, FORTUNE, Aug. 2, 1999, at 74.

numbers that analysts forecast.<sup>53</sup> They emphasized the heavy penalty, in stock price drops, for failing to meet those forecasts, even by as little as a few pennies per share.<sup>54</sup>

The financial press noted that when companies “made the numbers,” the top executives enjoyed personal benefits, including bonuses for reaching targets and profits from exercising options then selling stock at prices boosted by favorable reported results.<sup>55</sup> The articles also emphasized the advantage that a hefty stock price played in any corporate strategy to pay for acquisitions by issuing shares.<sup>56</sup>

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53. Byrnes et al., *supra* note 51, at 142 (“For many on Wall Street, the only number that counts is the quarterly growth of earnings per share. One measure of the intensified interest: For years, First Call compiled daily lists during weeks when companies issue earnings, of which companies made, missed or beat analysts’ estimates. Now, First Call updates those lists two or three times a day.”); Fox & Rao, *supra* note 48, at 77 (“[T]he simplest, most visible, most merciless measure of corporate success in the 1990s has become this one: Did you make your earnings last quarter? [¶] This is new. Executives of public companies have always strived to live up to investors’ expectations, and keeping earnings rising smoothly and predictably has long been seen as the surest way to do that. But it’s only in the past decade, with the rise to prominence of the consensus [analyst] earnings estimates compiled first in the early 1970s by I/B/E/S . . . and now also by competitors Zacks, First Call, and Nelson’s, that those expectations have become so explicit.”); Valdmanis, *supra* note 9, at 2B (“‘There is a greater tendency among companies to pull out all the stops to generate the kind of earnings that Wall Street demands,’ says Texas money manager and *Behind the Numbers* newsletter publisher David Tice.”).

54. Byrnes et al., *supra* note 51, at 142 (saying that a “shift in market psychology has vastly increased the pressure for managers to meet earnings projections. And those that don’t make the numbers generally get killed. ‘The penalties for missing your earnings are intense,’ says T.J. Rogers, president and CEO of Cypress Semiconductor Corp. ‘If you miss one or two quarters, you can see your net worth and market cap cut in half. . . .’ Indeed, the resulting pain is intensely personal, since more than half of CEO pay comes from stock options”); Fox & Rao, *supra* note 48, at 78 (noting that “missing by a penny” can “send your stock plummeting”).

While these authors focused on earnings, stock prices could also depend on satisfying “top line” revenue forecasts. Particularly for young companies (and most particularly for Internet companies), stock prices sometimes turned largely on revenues. In June 1999, one writer noted that: “Price targets for Internet shares went to the stratosphere in recent months, as did the stocks themselves.” Susan Pulliam, *Price Targets for Web Stocks Vex the Street*, WALL ST. J., June 17, 1999, at C1–C2. The article opined that trying “to reckon where they ought to trade in a year” was “a particularly tricky exercise, considering that few Internet companies have turned a profit yet. Many aren’t expected to be profitable for years to come.” *Id.* The author reported one analyst as saying, “We spend a lot of time building, from the ground up, *revenue projections* for the next five to 10 years and deriving income statements from those.” *Id.* (emphasis added). Commenting on AOL’s prospects, another column again emphasized revenue as the driving Internet valuation metric: “Unlike an industrial company, proceeds beyond a certain point flow directly to the bottom line.” David Alger, *Manager’s Journal: Big Profits Are in Store From the Online Revolution*, WALL ST. J., Apr. 26, 1999, at A18. Internet companies even generated a whole new set of measures that were conceivably related to company value: Click-throughs, page views, hits, visitors, and unique visitors. Edith Updike, *A Webster’s for the Web*, BUS. WK., May 24, 1999, at F4.

55. Condon, *supra* note 47, at 128 (“Chief executive compensation is usually tied to corporate results—operating income, net earnings, stock prices. A few pennies more in per-share

The press argued that the problem was not limited to out-and-out deceit. Instead, crafty accounting could obscure a company's true financial state *and* pass muster with outside auditors.<sup>57</sup> Journalists described a basket of techniques that could disguise true financial facts, yet often survive GAAP review. They criticized restructuring charges that took expenses at one time in vast amounts.<sup>58</sup> They argued that companies often overestimated those charges, then improved results down the line by taking the overestimates back into earnings.<sup>59</sup> They contended that companies included in the charges amounts that were really subsequent period operating expenses and thereby unfairly boosted earnings in later quarters when those expenses should properly have been recorded.<sup>60</sup> The articles faulted overaccrual of

earnings can translate into millions in option gains and bonuses.”); Fox & Rao, *supra* note 48, at 80 (speaking of managing earnings through accounting manipulations, the authors wrote: “What might motivate such corporate behavior? One answer is money. High-level executives like to get paid a lot, and it so happens that many bonus plans . . . are built around meeting earnings targets”).

56. *Id.* (“Not only do bonuses and stock options depend upon earnings growth, so does a company’s ability to do mergers, raise money and survive as an independent entity.”).

57. Byrnes et al., *supra* note 51, at 134–35 (“But forget about fraud for now. Regulators and investors are starting to focus on a far broader problem: companies bolstering their performance by using every legal accounting game in the book. They appear to be exploiting opportunities to jazz up their earnings like never before—all without stepping outside the loose confines of generally accepted accounting principles (GAAP).”).

58. Fox & Rao, *supra* note 48, at 78–79 (observing in the text that “One of modern accounting’s guiding principles is that of matching revenues and expenses over time” and describing, in an insert entitled “How the Pros Do It,” one way to manipulate earnings so: “Take a ‘big bath’ and charge a few hundred million in restructuring costs, and meeting future earnings targets will be easier”); Valdmanis, *supra* note 9, at 2B (“More controversial efforts to manage earnings include ‘big bath’ accounting where corporations use large, one-time write-offs to disguise operating expenses and boost earnings.”).

59. Condon, *supra* note 47, at 125 (commenting that “the Financial Accounting Standards Board (FASB) has left definitions of ‘one-time’ and ‘restructuring’ vague. Managements would be less than human if they did not exploit the ambiguities.” Also noting that charges labeled “one-time” ordinarily did not hurt a company’s stock price: “Since one-time charges don’t penalize current or future earnings and don’t hurt stock prices, it is tempting to overstate them. Why? Because you can later restore some of the write-off, running it through the P&L statement, thereby bolstering reported net income in a year when you might need it.”).

60. One of the more extensive explanations stated:

[T]he aim of today’s giant write-offs is to front-load expenses. Charge off three years of expenses all at once, and by definition future earnings will be better. . . .

Fueling the trend is the fact that stock traders tend to ignore big “one-time” charges, focusing instead on prospects. So even if the total dollars spent are the same, companies have a far greater incentive to take one large charge rather than stretch expenses out as money is actually spent. Indeed, the market’s reaction encourages executives to make charges as big as possible. And that’s got investors and the SEC worried that companies are burying all sorts of normal operating expenses into their restructuring charges.

Byrnes et al., *supra* note 51, at 135. The authors summed up that the “gray areas in GAAP are plentiful, and its terminology can be ill-defined. What constitutes a legitimate ‘one-time’ charge, and

more modest amounts in more traditional reserves—dollars salted away to be brought out into earnings when companies needed the extra cent or two per share to clear the bar that the analysts set.<sup>61</sup> The stories reported that companies debated with their outside auditors, seeking to keep questionable entries on the basis that they were immaterial or horse trading to keep them in exchange for the companies' agreement to revise other entries in the manner that the accountants requested.<sup>62</sup> The financial press surmised that a new business culture endorsed these techniques, despite the opacity they brought to corporate reports.<sup>63</sup>

*All of this means that our second-scene lawyer knew, from reading the newspapers and business magazines, that the top management of public companies experienced pressures that could, and in some instances had, caused financial fraud or produced income statements and balance sheets that obscured financial truth, even though they satisfied minimum audit standards. We cannot explain the scene-two lawyer's silence by ignorance of these facts.*

#### B. *Publicly Expressed SEC Views Suggested that the Accounting Counseling Was in Order*

Could the 1999 lawyer have dismissed the articles as disclosing nothing more than a few wayward executives whose roguery the press exaggerated for its own purpose? What were the regulators saying? And what of the preventive steps we imagine that the lawyer might have advocated? Did discussion in the legal community suggest counseling those actions?

In fact, the SEC saw the same accounting crisis and identified the same causes for it, as did the press. The Commission leadership prescribed solutions that, like those the second-scene lawyer might have advocated in the speech he did not give, depended heavily on the audit committees of boards of directors. It is virtually

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how does it differ from the normal operating costs of doing business every quarter? GAAP offers few clues." *Id.* at 138; *see also* Loomis et al., *supra* note 52, at 84.

61. Fox & Rao, *supra* note 48, at 78 (listing the ways the corporate "pros" manage earnings, the authors say: "Use your reserves: Build them up for product returns, bad loans, and insurance losses; drain them down to bolster earnings when business sags").

62. Greenberg, *supra* note 50, at 228 ("I've heard from former auditors who complain about the 'horse trading' that routinely goes on between companies and auditors over such things as the size of reserves, depreciation schedules, and other balance-sheet items."); Loomis et al., *supra* note 52, at 88 ("Unfortunately, auditors also lean on materiality when they are trying to convince themselves it's okay for managers to slip intentional misstatements into their financial reports.").

63. Byrnes et al., *supra* note 51, at 142 ("Increasingly, this culture is one of getting away with what you can," says . . . [the] founder of Pilgrim Baxter & Associates. "What we need is more integrity"—integrity in managers and integrity in their numbers."); Loomis et al., *supra* note 52, at 77 ("The fundamental problem with the earnings-management culture—especially when it leads companies to cross the line in accounting—is that it obscures facts investors ought to know, leaving them in the dark about the true value of a business.").

certain that, in 1999, the SEC Chairman and the Commission's Chief Accountant would have heartily endorsed all of the counseling that our second-scene lawyer omitted.

Beginning at least as early as the fall of 1998, the SEC made misleading corporate accounting the agency's principal target. The Commission leadership spoke often and fervently on every aspect of this issue.

On September 28, 1998, Chairman Levitt delivered a clarion call in a speech at the NYU Center for Law and Business. He titled his talk "The 'Numbers Game.'"<sup>64</sup>

Levitt condemned "earnings management" driven by the pressure to meet analyst estimates:

I'd like to talk to you about [a] . . . widespread, but too little-challenged custom: earnings management. This process has evolved over the years into what can best be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system. A game that runs counter to the very principles behind our market's strength and success.

. . . I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.

As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; Integrity may be losing out to illusion.<sup>65</sup>

The propelling force behind the decline in accounting quality was executive fear that, if a company failed by even a small margin to make the numbers that analysts forecasted, the market would batter the company's stock:

While the problem of earnings management is not new, it has swelled in a market that is unforgiving of companies that miss their estimates. I recently read of one major U.S. company, that failed to meet its so-called "numbers" by one penny, and lost more than six percent of its stock value in one day.<sup>66</sup>

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64. Arthur Levitt, U.S. Securities and Exchange Commission Chairman, The "Numbers Game," Remarks at NYU Center for Law and Business (Sept. 28, 1998), *available at* <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt> (last visited Feb. 4, 2004) [hereinafter Levitt, Numbers Game].

65. *Id.* at 1-2.

66. *Id.* at 3.

Levitt said that efforts to meet analyst estimates implicated not just fraud, but “the gray area between legitimacy and outright fraud . . . [a] gray area where the accounting is being perverted; where managers are cutting corners; and where earnings reports reflect the desires of management rather than the underlying financial performance of the company.”<sup>67</sup>

Levitt went on to address what he called “Accounting Hocus Pocus.”<sup>68</sup> He pointed to “‘Big Bath’ restructuring charges,” cautioning that:

These charges help companies “clean up” their balance sheet—giving them a so-called “big bath.”

Why are companies tempted to overstate these charges? When earnings take a major hit, the theory goes [that] Wall Street will look beyond a one-time loss and focus only on future earnings.

And if these charges are conservatively estimated with a little extra cushioning, that so-called conservative estimate is miraculously reborn as income when estimates change or future earnings fall short.<sup>69</sup>

Levitt denounced “cookie jar” reserves: “A[n] . . . illusion played by some companies is using unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs. In doing so, they stash accruals in cookie jars during the good times and reach into them when needed in the bad times.”<sup>70</sup>

67. *Id.* at 2.

68. *Id.* at 3.

69. Levitt, Numbers Game, *supra* note 64, at 3–4.

70. *Id.* at 4. Levitt challenged one other technique to improve future earnings—placing an excessive value on the in-process research and development (“IPR&D”) of an acquired company, writing all of that off in a one-time charge at the time of acquisition and thereby avoiding future amortization and depreciation expense. *Id.* at 4. Chief SEC Accountant Turner devoted almost an entire speech to this practice. Lynn E. Turner, U.S. Securities and Exchange Commission Chief Accountant, Making Financial Statements Real: Recent Problems in the Accounting for Purchased In-Process Research and Development, Remarks at the Software and Service Industry Analyst Group 3–6 (Feb. 10, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch251.htm> (last visited Feb. 4, 2004) [hereinafter Turner, Making Financial Statements Real]. This essay, however, does not refer further to IPR&D because the SEC was largely successful in jawboning companies and accountants into restraint. Enforcement Director Walker remarked that he “was encouraged to read in a September 13 [1999] *Wall Street Journal* article that certain corporate write-offs were down 24 percent from last year. Of particular note, write-offs pertaining to in-process research and development, an area we have closely scrutinized, are down 66%. These results are the product of a constructive dialogue among the Commission, the accounting profession, and corporate America and, happily, *not* the Division of Enforcement.” Walker, Behind the SEC Numbers, *supra* note 36, at 2 (emphasis in

In addition, Levitt deplored the misuse of “materiality” to hide quantitatively small, but known inaccuracies:

[S]ome companies . . . intentionally record errors within a defined percentage ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that’s the case, why do they work so hard to create these errors? Maybe because the effect can matter, especially if it picks up that last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly. . . . It doesn’t matter. It’s immaterial.<sup>71</sup>

Levitt ended with revenue recognition, although, as we shall see, the Commission saw this as much more of a fraud issue than a “gray area:”

Lastly, companies try to boost earnings by manipulating the recognition of revenue. Think about a bottle of fine wine. You wouldn’t pop the cork on that bottle before it was ready. But some companies are doing this with their revenue—recognizing it before a sale is complete, before the product is delivered to a customer, or at a time when the customer still has options to terminate, void or delay the sale.<sup>72</sup>

While the “Numbers Game” speech stands out as a call to arms, the SEC leadership returned time and again to the same themes in their 1998 and 1999 public appearances. They decried the pressure to meet published Wall Street earnings forecasts.<sup>73</sup> They recounted anecdotes of direct efforts by investment bankers and

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original); see also Huron Restatement Study, *supra* note 37, at 10 (showing forty-five restatements in 1999 involving IPR&D, but only two in 2000, one in 2001, and zero in 2002).

71. Levitt, Numbers Game, *supra* note 64, at 4–5. Levitt commented that:

In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called non-events simply don’t matter.

*Id.* at 5.

72. *Id.*

73. Arthur Levitt, U.S. Securities and Exchange Commission Chairman, Remarks at Stanford Law School Directors’ College 2 (Mar. 22, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch261.txt> (last visited Feb. 4, 2004) [hereinafter Levitt, Directors’ College] (referring to his “concern that the motivation to satisfy Wall Street earnings expectations may be overriding common sense business practices,” his “fear we are witnessing a gradual, but noticeable erosion in the quality” of published numbers, and Warren Buffet’s statement that “the attitude of disrespect toward accurate financial reporting [is] a ‘business disgrace’”); Issac C. Hunt, Jr., U.S. Securities and Exchange Commissioner, Remarks Before the 31st Annual Institute on Securities Regulation 2 (Nov. 4, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch320.htm> (last visited Feb. 4, 2004) [hereinafter Hunt, Securities Institute] (“I understand the pressures placed on a company to meet an

analysts to muscle companies into questionable accounting.<sup>74</sup> They said that the “recent increased emphasis on stock options as a key component of executive

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analyst’s projections. The pressure is intense when a projection missed by only a penny or two can send a company’s stock spiraling downward.”); Lynn E. Turner, U.S. Securities and Exchange Commission Chief Accountant, Reflections on Times Past, Times to Come, Remarks at the 10th Annual Conference on Financial Reporting 3 (Nov. 5, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch322.htm> (last visited Feb. 4, 2004) [hereinafter Turner, Reflections] (“[C]orporate managers have come under greater pressure to show earnings that meet forecasts. One way to meet forecasts is to obscure the financial results of the company.”); Lynn E. Turner, U.S. Securities and Exchange Commission Chief Accountant, 21st Century Financial Reporting—Bringing Back the Q Remarks at the 27th National AICPA Conference on Current SEC Developments 9–10 (Dec. 7, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch326.htm> (last visited Feb. 4, 2004) [hereinafter Turner, Bringing Back the Q] (“The result is a marketplace where a company that misses an earnings forecast by one penny may lose more than 15 percent of its market capitalization in a single day. This makes no sense. Companies aren’t built in a quarter, and they shouldn’t be destroyed overnight. No wonder managers who want to present high quality, transparent financial statements have trouble sleeping at night. They have to worry that, by showing the real economic ebb and flow of the business, their stock may take a beating because of analysts who just want to see a smooth earnings series.”).

One year after delivering his “Numbers Game” speech, Chairman Levitt lamented that a “gamesmanship, unfortunately, persists” that causes “companies to bend to the desires and pressure of Wall Street analysts rather than to the reality of the numbers.” Arthur Levitt, U.S. Securities and Exchange Commission Chairman, Quality Information: The Lifeblood of Our Markets, Remarks at The Economic Club of New York 3 (Oct. 18, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch304.htm> (last visited Feb. 4, 2004) [hereinafter Levitt, Quality Information]. In December 1999, speaking of the fiscal year ended September 30, 1999, Enforcement head Walker said:

We brought 18 actions last year specifically alleging that the purpose of the fraud was to engage in earnings management for the purpose of meeting projections and compensation benchmarks. Many, if not most, of the remaining actions involved schemes to manipulate earnings for similar purposes.

Walker, Behind the SEC Numbers, *supra* note 36, at 3.

74. Chief Accountant Turner recounted two such tales. He said that the staff had been told of an investment banker

who put[s] pressure on a CFO to engage in questionable accounting to make the numbers look better. Sometimes the banker tries to convince the CFO that other companies are using the same questionable accounting and, therefore it is okay, notwithstanding concerns expressed by the CFO and independent auditors of those other companies, or a lack of examples that are directly on point.

Lynn E. Turner, U.S. Securities and Exchange Commission Chief Accountant, Towards Higher Values in Financial Reporting, Remarks at the Financial Executives Institute 1998 Annual Conference 3 (Oct. 22, 1998), *available at* <http://www.sec.gov/news/speech/speecharchive/1998/spch231.htm> (last visited Feb. 4, 2004) [hereinafter Turner, Higher Values].

Turner also spoke of analysts who employed a similar technique to persuade a company to change its accounting:



compensation” placed “greater pressure on management to achieve earnings expectations” and that “pressure to meet analysts’ estimates and compensation benchmarks have both operated to increase the temptation for management to ‘fudge’ the numbers.”<sup>75</sup>

The Commission saw fraud, as well as “gray area” accounting, as reaching to the top of corporate organization charts. Chief Accountant Lynn Turner and Director of Enforcement Richard Walker both expressly referenced the COSO study, which had compiled the statistics showing that the SEC had named CEOs or CFOs in the overwhelming number of financial fraud enforcement actions during 1987 through 1997.<sup>76</sup> On a single day in September 1999, the Commission announced new actions against individuals associated with fifteen different companies. In that financial fraud “sweep,” the SEC named eleven current or former CEOs, leading Walker to state that this too confirmed that high-level executives were behind accounting misdeeds.<sup>77</sup> Walter Schuetze, the head accountant in the Enforcement Division, expressed his

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In a conversation I recently had with a Chief Executive Officer (CEO) of a public high technology company[,] [t]he CEO indicated that he and his CFO had believed that certain types of costs the company was incurring were in reality advertising costs, and should be expensed rather than reported as an asset. The company’s auditor had concurred with the company’s conclusions and issued their audit report on the annual financial statements. However, a major competitor had begun to treat these costs as assets . . . In time, analysts began to pressure the company to change its accounting, to become comparable with the accounting policies used by the competitor. The CEO noted that the analysts said that if the competitor and its auditor had “bought off” on the accounting, then it must be acceptable and that the CEO also should do it. As a result, the CEO and CFO, who to their credit were really trying to give their investors high quality information, were being subjected to business and market pressures caused by very aggressive “grey zone” accounting practices. Ultimately, the CEO and CFO “caved” in to these pressures and agreed to an accounting treatment consistent with their competitors.

Lynn E. Turner, U.S. Securities and Exchange Commission Chief Accountant, Remarks to the Panel on Audit Effectiveness 2 (Oct. 7, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch307.htm> (last visited Feb. 4, 2004) [hereinafter Turner, Comments on Audit Effectiveness].

75. Norman S. Johnson, U.S. Securities and Exchange Commissioner, “Managed Earnings” and “The Year of the Accountant,” Remarks at the Utah State Bar Mid-Year Convention 2 (Mar. 6, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch264.htm> (last visited Feb. 4, 2004) [hereinafter Johnson, Managed Earnings”].

76. Turner, Comments on Audit Effectiveness, *supra* note 74, at 4 (“One startling fact in that report, which summarizes fraud cases from 1987–1997, is that over 80% of the fraud cases involved the highest levels of management. Keep in mind that top management is the very group responsible for ensuring the adequacy of the control environment.”); *see also* Walker, Behind the SEC Numbers, *supra* note 36, at 4 (noting that “in a very high percentage of cases—83 percent in the COSO study—the frauds occurred at the direction, or with the active participation, of senior management”).

77. The SEC press release summarizing these enforcement actions is available at <http://www.sec.gov/news/press/pressarchive/1999/99-124.txt> (last visited Feb. 4, 2004); *see also* Walker, Behind the SEC Numbers, *supra* note 36, at 4.

alarm over the *Business Week* survey showing the pressure on CFOs to misrepresent<sup>78</sup> and Chief Accountant Turner advised that “CEOs need to be sure the focus is on numbers that reflect the underlying economics of the business and stop putting pressure on CFOs to move the numbers around to meet analysts’ quarterly earnings forecasts.”<sup>79</sup>

Reflecting these stated concerns, the Division of Enforcement made financial fraud its top priority.<sup>80</sup> It brought about ninety financial statement and reporting actions in its fiscal year ended September 30, 1999, which was up from seventy-nine the year before.<sup>81</sup>

As to the techniques of financial fraud, the Commission saw abusive revenue recognition as the most frequent means to misrepresent. The COSO report found that “Fifty percent of the 204 sample companies [involved in Commission enforcement actions during 1987–97] recorded revenues inappropriately, primarily by recording revenues prematurely or by creating fictitious revenue transactions.”<sup>82</sup> The SEC publicly spotlighted this finding.<sup>83</sup> The Commission’s 1998 and 1999 enforcement actions, in high proportion, continued to allege false revenues.<sup>84</sup> Because (at least as the Commission staff saw it) there was “no specific auditing standard addressing revenue recognition,”<sup>85</sup> the SEC, in early December 1999, issued its own rules in the

78. Walter P. Schuetze, U.S. Securities and Exchange Commission Chief Accountant of Division of Enforcement, Enforcement Issues: Good News, Bad News, Brillo Pads, Miracle-Gro and Roundup, Remarks at the 1998 Twenty-Sixth Annual AICPA National Conference on SEC Developments 2 (Dec. 8, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch241.htm> (last visited Feb. 4, 2004) [hereinafter Schuetze, Enforcement Issues].

79. Turner, Higher Values, *supra* note 74, at 7.

80. Walker, Behind the SEC Numbers, *supra* note 36, at 2 (“I announced last year that combating financial fraud was the Division of Enforcement’s number one priority. It remains so today.”).

81. *Id.* at 3.

82. COSO 1999 REPORT, *supra* note 38, at 23.

83. Turner, Comments on Audit Effectiveness, *supra* note 74, at 4.

84. Chief Accountant Turner reported that “a substantial majority of our accounting-related enforcement cases involve revenue recognition.” Turner, Higher Values, *supra* note 74, at 4; see also Lynn E. Turner, U.S. Securities and Exchange Commission Chief Accountant, The Year of the Accountant, Remarks at the SEC Institute 10 (June 14, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch291.htm> (last visited Feb. 4, 2004) [hereinafter Turner, SEC Institute]. Director of Enforcement Walker claimed a somewhat smaller percentage:

About one-third of the actions we brought [in the SEC’s fiscal year ended Sept. 30, 1999]—32 of the 90—involve improper revenue recognition. These actions primarily involve side letters, rights of return, consignment sales, and shipping unfinished product. Another 12 cases involve the booking of fictitious sales.

Walker, Behind the SEC Numbers, *supra* note 36, at 4.

85. Turner, Comments on Audit Effectiveness, *supra* note 74, at 7.

form of Staff Accounting Bulletin 101.<sup>86</sup> The Chief Accountant in the Enforcement Division minted the memorable remark: “Premature revenue recognition appears to be the recipe of choice for cooking the books.”<sup>87</sup>

On the other hand, the SEC leadership also stressed that accounting suffered not just from actionable deceit, but from the “gray areas” that Levitt referenced in his “Numbers Game” address. The staff expressly referred to the financial press reports describing misleading, but still legal, accounting maneuvers.<sup>88</sup> Commissioners and staff hammered away at overblown restructuring reserves,<sup>89</sup> other “cookie jar” reserves,<sup>90</sup> and the misuse of materiality.<sup>91</sup> By the end of 1999, the staff had issued

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86. Staff Accounting Bulletin (“SAB”) No. 101, 64 Fed. Reg. 68936 (Dec. 9, 1999). An SAB is not a Commission Rule. “The statements in the staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission’s official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.” *Id.* at 68936. Nevertheless, SABs can influence the law. *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 163 (2d Cir. 2000) (commenting on and following SAB No. 99 and saying that “because SEC staff accounting bulletins ‘constitute a body of experience and informed judgment,’ [citation omitted] and SAB No. 99 is thoroughly reasoned and consistent with existing law . . . we find it persuasive guidance for evaluating the materiality of an alleged misrepresentation”). *See infra* note 92.

After issuing SAB No. 101, the Commission staff received so many inquiries about it that they published a set of responses to common questions about the bulletin. U.S. Securities and Exchange Commission Office of the Chief Accountant, *Staff Accounting Bulletin No. 101: Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers* (modified Oct. 26, 2001), available at <http://www.sec.gov/info/accountants/sab101faq.htm> (last visited Feb. 4, 2004). The SEC staff modified portions of its revenue recognition rules in SAB No. 104. 68 Fed. Reg. 74436 (Dec. 23, 2003).

87. Schuetze, *Enforcement Issues*, *supra* note 78, at 4.

88. Both Turner and Schuetze listed by title most of the articles cited *supra* notes 47–52. Lynn E. Turner, U.S. Securities and Exchange Commission Chief Accountant, *A Vision for the 21st Century*, Remarks at the 1998 Twenty-Sixth Annual National Conference on Current SEC Developments 3 (Dec. 9, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch242.htm> (last visited Feb. 4, 2004) [hereinafter *Turner, A Vision for the 21st Century*]; Turner, *Making Financial Statements Real*, *supra* note 70, at 2; Schuetze, *Enforcement Issues*, *supra* note 78, at 7. The December 1999 Commission release adopting new audit committee disclosure requirements listed those articles again. *Audit Committee Disclosure*, 64 Fed. Reg. 73389, 73391 n.18 (1999).

89. *See, e.g.*, Hunt, *Securities Institute*, *supra* note 73, at 2; Turner, *Higher Values*, *supra* note 74, at 3; Walter P. Schuetze, U.S. Securities and Exchange Commission Chief Accountant of Division of Enforcement, *Cookie Jar Reserves*, Remarks at the Nineteenth Annual Ray Garret, Jr., Corporate and Securities Law Institute, at The Corporate Counsel Center of Northwestern University School of Law (Apr. 22, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch276.htm> (last visited Feb. 4, 2004) [hereinafter *Schuetze, Cookie Jar Reserves*].

90. Turner, *Making Financial Statements Real*, *supra* note 70, at 2. The Chief Accountant for the Enforcement Division offered this colorful analogy:

accounting bulletins on the first and last of these, in addition to the bulletin on revenue recognition.<sup>92</sup> Still, the Chief Accountant lamented the attitude of “companies’ accountants and their auditors who believe an accounting practice must be permitted unless there is a rule that says it cannot be done.”<sup>93</sup>

The Commissioners and top cadre did not stop with a description of accounting problems and their diagnosis of its cause. They also prescribed a cure, speaking at length on the ways that companies could fight those forces that produced misleading financial reports. In the “Numbers Game,” Chairman Levitt argued that corporate culture—particularly a commitment by top executives to forthright reporting—was key:

I believe we need to embrace nothing less than a cultural change. For corporate managers, remember, the integrity of the numbers in the financial reporting system is directly related to the long-term interests of a corporation. While the temptations are great, and the pressures strong, illusions in numbers are only that—ephemeral, and ultimately self-destructive.<sup>94</sup>

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... nowadays general reserves are like crab grass. They are everywhere. Tax liability cushions. Deferred tax asset cushions. Inventory reserves. Bad debt reserves. Merger reserves. Restructuring reserves. They are like dirt. They are everywhere. Some companies keep a 55-gallon drum of Miracle-Gro in the garage, and they irrigate their crab grass general reserve accounts with a garden hose hooked up to the 55-gallon Miracle-Gro drum. Then, along comes the Division of Corporation Finance, in its reviews of filings by issuers, and squirts Roundup from a spritzen bottle on issuers’ balance sheets, but the crab grass general reserves keep re-emerging. (For you apartment dwellers, Roundup is a herbicide that is supposed to kill weeds.) And, the reserves are being used to manipulate earnings. Need a penny a share to meet Wall Street’s expectations? Need two pennies? A nickel? A dime? Two bits? Dip into the chocolate chip cookie jar reserve. The mere existence of reserves is a chocolate chip cookie jar that management finds hard to resist when the earnings need a sugar high.

Schuetze, Enforcement Issues, *supra* note 78, at 5–6.

91. Hunt, Securities Institute, *supra* note 73, at 2; Turner, Making Financial Statements Real, *supra* note 70, at 2.

92. Staff Accounting Bulletin No. 100, 64 Fed. Reg. 67154, 67155–60 (Dec. 1, 1999) (including a lengthy section on restructuring charges); Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45151–52 (Aug. 19, 1999) (expressly rejecting the notion that a company could assume a financial item to be immaterial simply because it fell below some percentage threshold and stating that a quantitatively small misstatement might nevertheless be material if it “masks a change in earnings or other trends,” “hides a failure to meet analysts’ consensus expectations,” or “changes a loss into income” as well as advancing the staff’s view that a company and its auditor “should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to ‘manage’ earnings, are immaterial”).

93. Turner, Comments on Audit Effectiveness, *supra* note 74, at 2.

94. Levitt, Numbers Game, *supra* note 64, at 7.

The Commission, however, went far beyond exhortations to high-minded morals and reminders of enlightened, long-term corporate self-interest. Levitt and his lieutenants championed both specific, internal changes for SEC-registered companies and changes in the relationships between those companies and their outside auditors.

In the “Numbers Game,” Levitt announced that the New York Stock Exchange and the National Association of Securities Dealers were sponsoring a “blue ribbon” panel charged to develop “far-ranging recommendations” to “empower audit committees [so that they could] function as the ultimate guardian of investor interests and corporate accountability.”<sup>95</sup> That panel’s February 1999 report<sup>96</sup> recommended changes in Exchange and NASDAQ listing standards to require companies to establish audit committees with at least three board members independent of management who would operate under written charters stating that outside auditors were ultimately responsible not to companies’ executives, but to their boards.<sup>97</sup> The NYSE, AMEX, and NASDAQ all implemented this recommendation by the end of the year.<sup>98</sup>

The Commission urged companies to make such mechanical measures effective by putting hardworking, hard-nosed directors on their audit committees. Levitt declared that he was “passionate about audit committees”<sup>99</sup> and that: “Qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest.”<sup>100</sup> He urged that audit committees spend more time on their job: “I’ve heard of one audit committee that convenes only twice a year before the regular board meeting for 15 minutes and whose duties are limited to listening to a perfunctory presentation.”<sup>101</sup> Perhaps most importantly, he urged that audit committees, and all other board members, ask “tough questions of management and outside auditors,”<sup>102</sup> “the simple—but sometimes unsettling—questions,”<sup>103</sup> the “damnedest questions.”<sup>104</sup>

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95. *Id.*

96. *See supra* note 5.

97. *See supra* note 5, which contains a summary of the Blue Ribbon Committee recommendations, the resulting proposed changes in listing standards, the SEC’s approval of those changes, and the related SEC changes in proxy disclosures. Even before formal Commission action, SEC speakers praised the Blue Ribbon work. *See Johnson, Managed Earnings, supra* note 75, at 5–6; Norman S. Johnson, U.S. Securities and Exchange Commissioner, Remarks at the Harvard Club 3–4 (Apr. 29, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch272.htm> (last visited Feb. 4, 2004) [hereinafter Johnson, Harvard Club].

98. *See supra* note 5.

99. Levitt, Directors’ College, *supra* note 73, at 3.

100. *Id.*; *see also* Levitt, Numbers Game, *supra* note 64, at 6.

101. Levitt, Directors’ College, *supra* note 73, at 3; Levitt, Numbers Game, *supra* note 64, at 7.

102. *Id.*

103. Arthur Levitt, U.S. Securities and Exchange Commission Chairman, Corporate Governance: Integrity in the Information Age, Remarks at Tulane University 5 (Mar. 12, 1998),

Levitt was not alone. The Blue Ribbon Committee identified “[1] the full board including the audit committee, [2] financial management including the internal auditor, and [3] the outside auditors” as the “‘three-legged’ stool that supports responsible financial disclosure,” but argued that, among the three, “the audit committee must be ‘first among equals.’”<sup>105</sup> The Blue Ribbon Report urged that audit committee members “ask searching questions,”<sup>106</sup> display a “probing mind,”<sup>107</sup> and actively investigate the “quality,” not just the acceptability, of their companies’ reporting.<sup>108</sup>

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available at <http://www.sec.gov/news/speech/speecharchive/1998/spch206.txt> (last visited Feb. 4, 2004) [hereinafter Levitt, Corporate Governance]. Levitt said that:

Management and the outside auditor may find these questions inconvenient. They may even be embarrassing. But that’s a small price to pay, if it ensures the proper oversight of the financial reporting process.

*Id.*

104. At the Stanford Directors’ College, Levitt remarked that:

On the plane coming here last night, I began reading over the profiles of the ten outstanding directors for 1998. . . .

. . . they all showed a complete willingness to not only identify problems but also find solutions to them. . . . they were all willing to quote “ask the damnedest questions.” I especially like that one.

. . . There are too many boards that over look [sic] more than they oversee; too many boards that substitute CEO directive for board initiative; too many boards that are re-active instead of pro-active; and too many boards who never rejected an easy answer and never pursued a tough question.

Levitt, Directors’ College, *supra* note 73, at 5. He went on to wonder:

how many companies actively search for directors who won’t be outspoken; who go with the flow—no matter if it’s moving in the wrong direction. And, I wonder how many companies try to ease out directors who regularly speak up at meetings in defense of the shareholder; who are willing to break the “code” of silence.

*Id.* at 6.

105. BLUE RIBBON REPORT, *supra* note 5, at 7.

106. *Id.* at 41.

107. *Id.* at 25.

108. The Committee’s eighth recommendation was that generally accepted auditing standards

require that a company’s outside auditor discuss with the audit committee the auditor’s judgments about the quality, not just the acceptability, of the company’s accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company’s financial disclosures and degree of aggressiveness or conservatism of the company’s accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors.

*Id.* at 15. The *Blue Ribbon Report* repeatedly referred elsewhere to the need for each audit committee to concern itself with the “quality” of its company’s numbers. See *id.* (recommending that the SEC require 10-K disclosure of whether audit committees have discussed with management and outside auditors the “quality” of accounting principles that the company applies); *id.* at 32

The Blue Ribbon panel also urged strengthening the other two legs of the stool supporting sound financial reporting. It recommended that internal auditors have a direct line to the audit committee and that management promote an atmosphere encouraging internal audit reports of accounting problems.<sup>109</sup>

As for outside auditors, both the Blue Ribbon Committee and the SEC expressed concern that economic developments in the accounting profession threatened independence. The Commission's Chief Accountant summarized the changes that

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(noting the Committee's belief that "many concerns about the 'quality' of financial reporting can be attributed to a failure to question such significant subjective judgments" as "estimates, elective accounting principles and [the treatment of] new significant transactions"); *id.* at 43 (concluding with a list of topics into which an audit committee might inquire with "any other questions addressing topics that the audit committee believes may influence the quality of the financial statements").

This emphasis on the quality, not just the acceptability, of published numbers reflects the Committee's focus not so much "on fraud per se, although many of our recommendations may reduce the possibility of fraud . . . [but] on the large gray area where discretion and subjective judgments bear on the quality of financial reporting." *Id.* at 2. In keeping with this focus, the *Blue Ribbon Report* urged "transparency" in financial reporting. *See id.*; *see also id.* at 3. ("The strength of America's capital markets always has been their adherence to transparency and full disclosure."); *id.* at 8. ("If a corporation is to be a viable attraction for capital, its board must ensure disclosure and transparency concerning the company's true financial performance. . . ."). *Id.* at 19 (saying that its recommendations would make audit committees more effective "in helping to ensure the transparency and integrity of financial reporting" and arguing that "a more transparent and reliable financial reporting process ultimately results in a more efficient allocation of and lower cost of capital"). The Committee's report reprised the "inappropriate earnings management" techniques that Levitt decried in his "Numbers Game" speech. *Id.* at 18.

109. The Blue Ribbon Committee described the inherent difficulties that internal auditors face and how to relieve them:

The internal auditor occupies a unique position—he or she is "employed" by management, but is also expected to review the conduct of management. This can create significant tension since the internal auditor's "independence" from management is necessary for the auditor to objectively assess management actions, but the auditor's "dependence" on management for employment is clear. Recognizing this tension, the Committee believes that it is essential to have formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee. These mechanisms may take the form of regular meetings independent of management, or regular confidential memos or reports circulated only to the audit committee. If such meetings or correspondence are regularly scheduled regardless of the identification of irregularities or problems, independent dialogue between the audit committee and the internal auditor should lose its "taboo" nature and no longer imply treason against management.

The audit committee must establish and support a culture that promotes open discussion on the part of the internal auditor and a recognition that if the internal auditor identifies a problem and cannot obtain the support of management, that he or she has a duty to the audit committee, the full board, and shareholders to disclose the relevant information to the audit committee. Management should more than acquiesce in this duty to disclose; management should encourage and support such disclosure by word and deed.

*Id.* at 39-40.

raised alarm, explaining that, when the 1990s began: “Public accounting firms were just that—accounting firms. For four of the six largest firms, accounting and auditing services produced more than fifty percent of their total revenues.”<sup>110</sup> But by 1999: “The five largest public accounting firms are now ‘professional service firms’ that derive only a minority of their revenues from accounting and auditing services. And accounting firm members no longer stake their personal wealth on judgments made by their partners—these organizations are now limited liability partnerships.”<sup>111</sup> The Blue Ribbon Committee likewise noted the “expanding role of outside auditors, particularly in providing non-audit services,” saying that this development “further entwined the relationship of management and the outside [accountants].”<sup>112</sup>

Commissioners and staff speculated that, with this economic change, auditors might not be appropriately skeptical of the management figures that they examined. Fearful of endangering consulting fees, auditors might not vigorously push management to report numbers in a candid way.<sup>113</sup>

110. Turner, Reflections, *supra* note 73, at 2.

111. *Id.*

112. BLUE RIBBON REPORT, *supra* note 5, at 30.

113. Commissioner Johnson strung the inference together so:

I fear that many of these independence problems may be rooted in the organizational changes that have taken place in the accounting profession over the last several years. Accounting firms have found that the audit business that has been their bread and butter from the start of the profession does not allow for maximum business and financial growth. So accounting firms have looked for new sources of income and have ventured into services well beyond their traditional businesses, which may conflict with their established roles as auditors, or watchdogs for public investors.

As a result of these changes, we have observed that

- the financial importance of the audit function to accounting firms, particularly the larger ones, is declining,
- the provision of non-audit services is increasing, and
- the business relationships between auditors and their audit clients are increasing and expanding.

The conflicts of interest, or at the least, the appearance of conflicts of interest arising from these developments are troubling. It hardly seems accidental that financial fraud has increased at the same time non-audit services performed by accounting firms have proliferated and become more profitable.

Norman S. Johnson, U.S. Securities and Exchange Commissioner, The Year of the Accountant, Remarks at the Practising Law Institute’s SEC Speaks program 2 (Feb. 26, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch256.htm> (last visited Feb. 4, 2004) [hereinafter Johnson, Year of the Accountant].

It bears emphasis, however, that, in 1999, there was no convincing evidence that auditing firms were shading their accounting judgments in order to get, or keep, consulting business. Nor was there, at that time, significant public comment on the possibility or fact of the consulting businesses affiliated with auditing firms designing transactions for audit clients in which the value of the transactions lay in part in their accounting treatment. Most of the debate was, as Commissioner



To the SEC and the Blue Ribbon Committee in 1999, the remedy for declining auditor independence, as for so many other ills, lay in audit committees. The Blue Ribbon Report recommended that each auditor periodically provide each client with a complete list of the work it had done and was doing for the corporation, then have a direct and candid dialogue with the client's audit committee to discuss whether any of the work, or the work as a whole, endangered the auditor's independence.<sup>114</sup> By the

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Johnson phrased it, based on the "appearance" of possible conflicts between the auditing role and the consulting practice. See *infra* note 116.

More recent scandals may provide hard evidence that accounting can be warped when accounting firms provide consulting services to audit clients. For example, press reports said that Arthur Andersen received a total of some \$52 million from Enron in 2000 and, while accounts differed over what part of that total comprised consulting fees, all put the number in the many millions. Compare John Schwartz & Jonathan D. Glater, *At Andersen's Helm, a Winner of Battles Who Faces a War*, N.Y. TIMES, Jan. 14, 2002, at C1 (describing how Andersen Chief Executive Joseph Berardino said that only \$13 million of the \$52 million was for consulting), with Jonathan Glater, *4 Audit Firms Are Set to Alter Some Practices*, N.Y. TIMES, Feb. 1, 2002, at A1 ("Andersen was paid about \$27 million by Enron for consulting and about \$25 million for audit services in 2000."). And some reports said that an internal Andersen projection forecasted that the firm might, in time, earn \$100 million a year from Enron in consulting. Reed Abelson, *Trying Not to Be the Next Enron, Companies Scrutinize Practices*, N.Y. TIMES, Jan. 26, 2002, at C1 ("Enron was one of Andersen's largest clients, and Andersen received substantial fees for consulting work for Enron—fees that Andersen believed might reach \$100 million a year, about four times its fee as auditor, according to an internal memo."). The Enron Special Investigation Committee found that "Enron's accounting treatment was determined with extensive participation and structuring advice from [Arthur] Andersen, which Management reported to the Board. Enron's records show that Andersen billed Enron \$5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees." REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIR. OF ENRON CORP. 5 (Feb. 1, 2002), contained in Enron's Form 8-K filed Feb. 7, 2002, available at [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) (last visited Feb. 18, 2004). LJM and Chewco were two of the special purpose entities ("SPEs") entering into transactions that eventually resulted in restatement of Enron financial figures. *Id.* at 2–3. If an accounting firm is paid millions to advise on the structure of SPEs and related transactions and if the structure and transactions are designed to produce a certain accounting effect, it may well be difficult for that accounting firm to run a critical eye over that effect in an audit.

114. The Blue Ribbon Committee recommended that new listing rules:

require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

BLUE RIBBON REPORT, *supra* note 5, at 31.

The Independence Standards Board ("ISB") was a private-sector, standard-setting body that the accounting profession assembled after discussions with the SEC. In 1998, the Commission said that it intended to look to the ISB "to provide leadership not only in improving current auditor

end of 1999, new listing rules for NASDAQ and Exchange-traded companies required this report and dialogue.<sup>115</sup> Of course, to make any of this work, audit committee members had to be dedicated and tough enough to critically review the list of relationships and search behind auditors' conclusions that they remained independent despite the dollars that they received from consulting work management directed their way. Levitt's plea to staff audit committees with penetrating, even cranky, directors was key again.

*This extensive commentary by the SEC demonstrates that, by the end of 1999, the Commission was, with near religious fervor, spreading the word that pressures from analysts invited improper accounting, that top executives sometimes yielded to those pressures, and that outside auditors were being compromised by consulting revenue. Commissioners and staff urged that, to fight off these evil influences, corporations should strengthen audit committees, bolster internal audit effectiveness, and ensure the independence of professionally skeptical, outside auditors.*

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independence requirements, but also in establishing and maintaining a body of independence standards applicable to the auditors of all Commission registrants." Commission Statement of Policy on the Establishment and Improvement of Standards Related to Auditor Independence, 63 Fed. Reg. 9135, 9136 (1998). The ISB issued its Standard No. 1 in 1999, which required that, to be independent within the meaning of the federal securities laws, at least annually, an auditor must:

- a. disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;
- b. confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the [securities] Acts; and
- c. discuss the auditor's independence with the audit committee.

ISB Standard No. 1 (1999). After the SEC amended its own auditor independence rules, *see infra* note 116, the Commission said that those rules "address many of the issues that led to the creation of the ISB" and therefore the SEC would "no longer look to the ISB to provide leadership" in this area. Commission Policy Statement on the Establishment and Improvement of Standards Related to Auditor Independence, 66 Fed. Reg. 38149, 38151 (2001). But the Commission said that it would continue to view ISB Standard No. 1 as having "substantial authoritative support for the resolution of auditor independence issues." *Id.*

115. The new listing standards required that each audit committee charter specify the committee's responsibility for ensuring receipt of a written statement of relationships consistent with ISB Standard No. 1 from the auditor and expressly acknowledged the committee's responsibility for both engaging in a dialogue with the auditor about independence and taking action to preserve auditor independence. *See* AMEX 1999 Audit Committee Listing Rules, *supra* note 5, 64 Fed. Reg. at 71519 (noting AMEX Company Guide § 121 B(a)(ii)); NASDAQ 1999 Audit Committee Listing Rules, *supra* note 5, 64 Fed. Reg. at 71523 (noting NASD Rule 4310(c)(26)(A)(ii)); NYSE 1999 Audit Committee Listing Rules, *supra* note 5, 64 Fed. Reg. at 71530 (noting NYSE Listed Company Manual, § 303.01(B)(1)(c)).

C. *The Limited Explanatory Power of the First Contrast in Light of Press Articles and SEC Speeches About Corporate Accounting*

Make no mistake. Our first contrast—that the client in scene one asks for advice while the client in scene two does not—has considerable explanatory power. Since it was not requested, the need for the 1999 advice—at least in the extensive form hypothesized—was not as clear as the need for counsel in scene one.

Moreover, some of the long, second-scene exegesis seems ill-timed to make much of an impression. The talk about one-time charges for discontinuing lines of business, for example, might have seemed irrelevant to the young entrepreneur taking a one-product company public.

In addition, some of the SEC prescriptions rested on assumptions still not proved in 1999. This was particularly true of the assumptions that consulting had in fact biased audit performance by outside accountants<sup>116</sup> and that audit committees—each a mere handful of directors performing a part-time, supervisory role—could bring corporate accounting back to the straight and narrow.

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116. In the year after our second scene, the SEC proposed and then adopted amendments to its auditor independence rules that, with some exceptions, prohibited outside auditors from providing nine categories of nonaudit services to their audit clients. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76008, 76084–85 (Dec. 5, 2000) (setting out this portion of the new rule) [hereinafter SEC 2000 Auditor Independence Rules].

The accounting profession maintained there was no proof to demonstrate that providing such services biased audits. Floyd Norris, *3 Big Accounting Firms Assail S.E.C.'s Proposed Restrictions*, N.Y. TIMES, July 27, 2000, at B9 (“At a hearing . . . by the Securities and Exchange Commission . . . representatives of KPMG, Arthur Andersen and Deloitte & Touche argued that there were no proven cases in which an audit had been compromised because the auditing firm had other relationships with the company.”).

When the Commission adopted the amendments, it did not cite any such hard proof. Instead, it referenced “academics who have studied the ‘self-serving’ bias” and whose research “tend[ed] to show that subtle but powerful psychological factors skew the perceptions and judgments of persons—including auditors—who have a stake in the outcome of those judgments.” SEC 2000 Auditor Independence Rules, *supra*, 65 Fed. Reg. at 76016. But the SEC acknowledged that other academics pointed to “countervailing reputational interests and concerns about . . . legal liability, audit committee review, and peer review.” *Id.* at 76017. The SEC did not purport to resolve this debate, but relied on what former Federal Reserve Chairman Paul Volcker claimed was “the real *threat* posed by the ‘insidious, hard-to-pin down, not clearly articulated or even consciously realized, influences on audit practices’ that flow from non-audit relationships with audit clients.” *Id.* (emphasis added).

In large part, the Commission supported the prohibition against auditors providing nonaudit services with the need to maintain the appearance, not just the fact, of audit independence. The SEC saw the prohibition justified to “protect investor confidence” and even cited an investor opinion poll favoring the new rules. *Id.* at 76018, 76019. The adopting release asserted that courts had “rejected the need for proof of prior harm as an antecedent to government action designed to safeguard public confidence in the integrity of public actors and processes.” *Id.* at 76020.

However, while our second attorney, unlike the first, was not presented with a request to judge conduct that the client proposed, the press and the principal regulator supplied the ingredients for the counsel that our 1999 attorney did not render. We cannot fully understand our second lawyer's inaction by some simple theory that our attorney had never heard of the risks and remedial steps that our imagined advice describes.

V. A SECOND CONTRAST: THE LAWYER IN SCENE ONE HAS NO ECONOMIC FEAR OF LOSING HIS CLIENT BY PROVIDING THE ADVICE, WHILE THE LAWYER IN SCENE TWO MAY FEAR THAT THE COUNSEL WILL HARM BOTH THE ATTORNEY'S INCOME AND MOBILITY

The economics of the legal profession offer another possible explanation for our second-scene lawyer's reluctance to read the sermon we suppose he did not preach. The counselor in scene one was a sole practitioner, responsible only to himself. His long-term relationship with his client was so close that it would not founder on the criticism the attorney delivered.

The economics were different in 1999. The modern lawyer's professional mobility<sup>117</sup> and take-home pay,<sup>118</sup> in a large law firm with a compensation committee

117. For example, when attorneys left Bronson, Bronson & McKinnon in 1999, articles regularly reported the "books of business" that they took with them. See Kevin Livingston, 2 *Corporate Partners Leave Bronson for Allen, Matkins*, THE RECORDER, Jan. 19, 1999, at 3 (noting that one of the partners "takes with him his \$1 million-plus book of business"); Kevin Livingston, *Bronson Weighs Future Amid Defection Rumors*, THE RECORDER, Apr. 2, 1999, at 1 (saying that "another top rainmaker is headed for the door" and that he "is expected to take a \$2 million book of business"). One legal recruiter hazarded the view that any of the Bronson attorneys "who doesn't have a minimum book of business of \$500,000 'will have difficulty finding an equivalent position.'" Brenda Sandburg, *Only Top Partners Will Secure a Soft Landing*, THE RECORDER, Apr. 5, 1999, at 8.

Reports of attorneys who sought places after Jackson, Tufts, Cole & Black dissolved also emphasized the business that the attorneys could carry with them. Kelly Flaherty, *Jackson Group Finds Harbor With Crosby*, THE RECORDER, Feb. 19, 1999, at 1 (reporting that a corporate partner and his colleagues moving to Crosby, Heafy, Roach & May "bring a \$4 million to \$5 million book of business with them"); see also Kevin Livingston, *Changes at Graham Prompt Some to Exit*, THE RECORDER, Mar. 26, 1999, at 1 (noting that a Graham & James, Palo Alto partner "took his high-tech client list and his \$2 million book of business one mile south to the Palo Alto office of McCutchen, Doyle, Brown & Enersen").

118. It is difficult to find reports on the compensation systems used by particular Silicon Valley firms in 1999 and those systems may have varied significantly. An end-of-century perspective piece included these comments:

Long before it became the title of a John Grisham novel, "rainmaker" had become the hot designation among law firm lawyers.

Describing those powerful partners who contribute significantly to a firm's financial bottom line, the term entered the profession's mainstream vocabulary sometime in the 1980s.

....

keenly aware of the bottom line, significantly depended on the dollar value of the

[B]eginning in the 1980s, long-time relationships and personal connections became less significant factors to clients in hiring their outside lawyers.

....

Clients' new mantra became, "We hire lawyers, not law firms," recalled Ralph Baxter, chair of San Francisco-based Orrick, Herrington & Sutcliffe . . .

....

Because legal work from large companies was suddenly up for grabs, a whole new breed of attorneys became powerful at law firms. Lawyers who brought in new clients resulting in significant billings for the firm were highly compensated and gained administrative power.

....

In the '70s and '80s, according to Baxter, law firms went from largely lock-step compensation systems based on seniority to more merit-based systems. Whether an attorney contributed significantly to the firm's overall revenue became an important factor in measuring merit.

"Rainmakers were rewarded," [a rainmaker from a Southern California firm] said. "There was recognition that some lawyers were more valuable than others: excellent lawyers and business producers."

Leslie A. Gordon, *Rainmakers' Revolution*, L.A. DAILY J., Dec. 29, 1999, at 1, 8 [hereinafter Gordon, *Rainmakers*]. The article also notes a backlash, however, with Baxter saying that rainmaking was not just "an individual sport." *Id.* at 8. To maintain morale, "firms had to emphasize that all kinds of contributions go into the compensation decision." *Id.* The very high demand for corporate legal service in the Valley at the end of 1999 was further a factor that may have moderated, at least to some degree, the importance of business generation in compensation schemes. *See infra* notes 119–20.

Rainmaking's impact on compensation is illustrated by the reported difficulties that one Bay Area firm had in trying to move away from partner pay based largely on origination and billing credit. Brenda Sanderling, *Brobeck's Balancing Act*, THE RECORDER, May 20, 1999, at 1, 10. A newspaper sold to the Northern California legal community said that "One of the keys to changing [the firm's] culture is altering the way [it] deals with rainmakers." *Id.* To do that, the firm was trying to credit "multiple attorneys for bringing in new business. Though partners say this has been a concept embraced by the firm for some time, [the current chair] has made it company policy. Income generated by a client is not necessarily attributed to the partner who brought the client to the firm. It's not clear, however, how much has been done to implement the new rainmaker model." *Id.* While the chair "insist[ed] that [he would] keep pushing those that bring in the most business to share the wealth," the firm's "biggest business generator until he went in-house to E\*Trade Group Inc., in March, acknowledged that 'it's very hard to implement such a policy.'" *Id.*

Two articles on high-powered, Bay Area women attorneys also suggest a link between bringing in the business and taking home the money. Susan Beck, *There's Something About Mary*, XXI THE AM. LAW. No. 2, Mar. 1999, at 65, 66 (saying of the Pillsbury, Madison & Sutro chair: "Her book of business is roughly \$9 million, placing her near the top of the firm, and helping to put her annual draw in recent years above \$500,000"); Krysten Crawford, *Shortchanged?*, XXI THE AM. LAW. No. 2, Mar. 1999, at 68, 70 (paraphrasing a former federal judge who became a partner at Orrick, Herrington & Sutcliffe: "when it comes to compensation . . . [a]s time passes, more and more women will become major business-getters who command top dollar").

business that the individual lawyer originated or billed. The attorney not only needed to work long hours, but to bring in and keep new clients. In that environment, an attorney might have foreseen personal risk in giving executives a lecture that could drive them to a competing firm, which would craft transaction documents and SEC filings without any unrequested talk of how post-IPO events might tempt top executives to gull the investment community.

But, as tempting as this explanation might be to those who generally lament the increasing commercialization of the profession, it is easy to overplay this factor. We set our second scene in the Silicon Valley in late 1999. The legal market in Northern California blazed hot then.<sup>119</sup> Indeed, a client company might have felt fortunate at that time to simply find a competent partner with the “bandwidth” to perform the transaction work in order to complete an offering.<sup>120</sup>

Even putting aside this supply problem, with an offering imminent, a client would have been reluctant to leave an established lawyer, regardless of whether executives took offense from a ten-minute moral rearmament. Throwing over well-regarded counsel might raise unwanted questions with investment bankers and potential investors. At a minimum, changing lawyers would delay the offering.

Moreover, the speech in the second scene is not couched in terms that necessarily offend and thereby risk client defection. Indeed, that counsel carried less risk of injuring client dignity than the counsel in our first case. The lawyer of yore faced the

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119. Torri Still, *1999 Firm Revenues Looking Strong*, THE RECORDER, Nov. 24, 1999, at 1 (“Managers at several Northern California firms say that when the books slam shut on 1999, they expect to post greater gains than in years past.”). Demand for corporate transaction work had been strong throughout the year. One firm “had a hand in a whopping 47 IPOs in the first two quarters of this year” and “worked on 77 mergers and acquisitions;” another firm “racked up 40 initial public offerings and 70 mergers and acquisitions in the same time period.” Renee Deger, *Wilson Sonsini, Brobeck Pull Away From Tech Rivals*, THE RECORDER, July 8, 1999, at 4. By mid-December, those two firms had, respectively, worked on more than 100 and fifty-five IPOs, with the next three firms at thirty-three, twenty-four, and twenty-three. Uncharacteristically, the heated pace continued into the holiday season. Renee Deger, *Holiday Blahs? Not When the Market Is Merry*, THE RECORDER, Dec. 16, 1999, at 4.

The heightened demand for legal services created a heightened demand for associates which, in turn, led to associate pay raises. In late December 1999, Menlo Park-based Gunderson, Dettmer, Stough, Villeneuve & Hachigian raised first-year associate salaries to \$145,000. Leslie A. Gordon, *Gunderson Ups Pay in Effort to Lure Associates*, L.A. DAILY J., Dec. 23, 1999, at 1. One of the named partners explained that “Demand for the firm’s services has ‘far outstripped’ its capacity.” *Id.*

120. The chief financial officer of one Silicon Valley firm said that “We’re up way more than last year. . . . We’re turning business away.” Still, *supra* note 119, at 8. Saying that technical lawyering at the end of 1999 was a larger factor in making partner than bringing in business, one associate at the same firm commented: “We’re drinking from a fire hose. . . . Senior partners and junior partners are turning away good work” because the firm was so busy. Leslie A. Gordon, *Professional Trapeze*, L.A. DAILY J., Dec. 6, 1999, at 14, 16. “According to Cooley [Godward’s] Mendelson [in Palo Alto], in today’s booming economy, most law firms are so swamped with work that they’re forced to turn business away. As a result, less emphasis has gone to rainmakers.” Gordon, *Rainmakers*, *supra* note 118, at 8.

daunting task of telling a client, face to face, that the client's plan to extract his business from a financial jam was morally wrong. The lawyer in the second scene faced no such challenge. Our 1999 lawyer needed only to deliver a warning against future temptations. Our second-scene attorney could even palliate the warning, saying that it would be quite unlike the client to twist numbers so as to mislead investors. The lawyer could blame the need to speak at all on systemic pressures that the client did not create.

VI. A THIRD CONTRAST: THE ADVICE IN SCENE ONE DOVETAILS WITH THE PREVAILING COMMUNITY VALUES OF OLD, WHILE THE ADVICE IN SCENE TWO MAY CHALLENGE THE DIFFERENT VALUES OF 1999

Local culture, as well as law firm economics, separates our first and second lawyers. We set our first attorney in a small town that held honesty as a paramount virtue. The lawyer expressly called upon community values in the prelude to his advice, recounting the client's long reputation as a straight shooter. Indeed, the attorney's counsel is little more than advice that the act his client contemplates violates local mores. In a sense, local commercial culture drives the entire scene.

Our second attorney practiced in the very different milieu of the Silicon Valley in 1999.<sup>121</sup> The Valley was a micro-society in which entrepreneurial success and drive were honored, public virtues. The young executives who displayed those virtues had launched the country on a technological revolution, raised productivity in virtually all businesses, and fueled a tremendous increase in the wealth of those who invested in the tech stocks that the Valley spawned.<sup>122</sup>

Valley culture held that stock options, and founders stock, aligned the interests of executives with those of other shareholders. The opportunity for founders to achieve great wealth from stock ownership was a benign impetus, spurring young engineers to create technology benefiting all of society and driving each company's executives to increase share prices for the good of all the company's stockholders.<sup>123</sup>

121. We could have set the scene elsewhere—in New York or along Boston's Route 128. A similar culture prevailed in a number of locales. See, e.g., Judith H. Dobrzynski, *C.E.O. Round Table; Online Pioneers: The Buzz Never Stops*, N.Y. TIMES, Nov. 21, 1999, Section 3, at 1 (recording excerpts from interviews with four chief executive officers of dot.com companies in the Flatiron district of Manhattan called "Silicon Alley").

122. An article in late November 1999 said that "Average productivity growth in the 1990s . . . stands at 2%—a rate that few economists expected the U.S. to ever reach again," that "The past four years are even better, showing an economy able to sustain productivity gains in excess of 2.5% annually;" that "the productivity slowdown that started around 1973 now seems to be decisively over;" and that "the New Economy has been evolving since the early 1980s, when companies sharply boosted their spending on information-technology software and hardware." Michael J. Mandel, *How Fast Can This Hot-Rod Go?*, BUS. WK., Nov. 29, 1999, at 40, available at 1999 WL 27296408. As for stock market wealth, see the NASDAQ figures *supra* note 1.

123. A 1996 *Business Week* Special reported that: "For all the talk of money in the Valley,

Great wealth to entrepreneurs from their equity holdings was a just reward in a meritocracy prizing creativity; a reward won only by assuming the risks of committing to a startup company that was, by the odds, much more likely to stagnate or fail than to succeed.<sup>124</sup> The press lionized those who rose to riches by such efforts.<sup>125</sup> The clients in scene two discuss their hopes of great wealth from stock appreciation in broad daylight, not in the night meeting in which the scene-one client seeks to shield his plan from even the attorney's office staff.

Our second-scene speech, however, identifies the riches that founders could gain from stock sales as a possible motive for illegal and deceptive conduct. In that respect, the counsel collided with a basic Silicon Valley tenet by identifying wealth from equity as at least a dormant force for evil. Instead of calling on community values to drive home the advice, our second lawyer would, in our imagined oration, swim against the cultural current of time and place. Perhaps lawyers in 1999 hesitated to do so.

Absent a reliable survey, there is no way to empirically test the theory that Silicon Valley values deterred lawyers from delivering the "speech not given." The theory is likely to appeal or repulse according to the observer's own views of the Valley in its heyday. And, as with law firm economics, it is easy to attribute too much importance to this third contrast.

Silicon Valley culture did not laud accounting rascality and most of our second-scene speech addresses accounting issues located at some distance from the Valley's core beliefs. Indeed, the only part of the advice risking heresy is the identification of executive stock ownership as a latent or likely motivation for wrongdoing.

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there is just as much verbiage about 'making a difference'—in how people get information, crunch it, use it, and entertain themselves with it. . . . Making millions and making a difference is the Silicon Valley mantra." Reinhardt, *supra* note 3, at 70. Valley companies also fueled growth measured in traditional ways. "More than 50,000 new jobs were created [in 1996], while wages grew five times the national average. . . . [T]he region led the U.S. in worker productivity and export growth. 'This is an economic miracle taking place, right before our eyes,' says Thomas M. Siebel, the founder of Siebel Systems. . . ." *Id.* at 68.

124. In the Valley, "the reality is that few dreams are realized—only one in 10 startups hits it big, six limp along, and the rest are destined to implode. . . ." Reinhardt, *supra* note 3, at 69.

As to whether those who succeeded deserved to do so, the culture was well-expressed by one of its high priests. "'Silicon Valley is a meritocracy,' says Steve Jobs, co-founder of Apple Computer Inc. 'It doesn't matter what you wear. It doesn't matter how old you are. What matters is how smart you are.'" *Id.* at 72.

125. A *New York Times* magazine story about Jim Clark, founder of Silicon Graphics and Netscape, provides an outstanding example of such hagiography. Michael Lewis, *The Search Engine*, N.Y. TIMES MAG., Oct. 10, 1999, at 77. It proclaims in large type at the front that Clark is "the embodiment of a new kind of economic man." *Id.* The story, which describes the founding of what became WebMD and the company's history through its IPO, has all the Valley elements: A desire to change the world into a better place; a cadre of the finest engineers on the planet; risk-taking; transforming ideas; and, not incidentally, equity-generated wealth at the end. *Id.*



Regarding that single issue, local culture could have affected lawyers, as a practical matter, in two somewhat unlikely ways. First, because they knew executives subscribed to the culture, 1999 lawyers might have been reluctant to read the second scene lines for fear that they might offend their listeners and thereby lose clients. But this seems implausible for the reasons discussed in section V above. With client demand for corporate lawyering high and supply comparatively low, the odds of losing a client by the supposed remarks were probably pretty low in late 1999. A client about to go public would also not want to risk the questions that would attend dismissal of a firm for giving cautionary advice or delay an offering by changing counsel.

Culture might have deterred our 1999 lawyer in a second way: The attorney's own belief in executive equity as a force for good<sup>126</sup> might have served as an internal check. But this, too, seems easy to exaggerate. Lawyers regularly counsel clients on risks created by philosophies with which they disagree. Attorneys who disagree with government regulations in their substantive fields, for example, nevertheless counsel clients to obey those regulations.

Moreover, even if embarrassed by a few phrases in our supposed speech, our second lawyer could have talked around them. Instead of saying, for example, that the opportunity for wealth through stock appreciation would tempt the executive, our counselor could have said that this is what the SEC believed. He could have added that it would be wise to take the preventive steps the Commission favored so that, if innocent accounting errors crept into the company's financials, the company could tell the SEC that this had happened despite best efforts to avoid it. The monologue would have lost some of its punch, and most of its patronizing flavor, but its substance would have largely survived.

Summing up the second and third contrasts: Law firm economics and aggressive entrepreneurial culture may have reduced the odds that lawyers would have given the long-form lecture of scene two in 1999, but not by much.

VII. A FOURTH CONTRAST: THE FIRST ATTORNEY'S SOCIAL POSITION  
AND SELF-IMAGE AFFIRMATIVELY PROMPT THE ADVICE, WHILE  
THE SECOND LAWYER'S STATUS AND SENSE OF SELF ARE UNAFFECTED BY HIS  
FAILURE TO SPEAK

Our first lawyer chose his client, in part, because the community admired the client's integrity. The attorney's social standing benefited by his association with that client<sup>127</sup> and the lawyer was genuinely pleased at the end of the scene by having kept

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126. This cultural analysis is not a polemic. Silicon Valley was not evil. The point is only that it saw the sudden wealth of founders from the appreciation of their stock as good, not bad.

127. It is hard to know whether this vision reflects the reality of years gone by or whether all of scene one is simply a romantic view of the past. Some sociological work does suggest that small-town practice is responsive to the kind of social norms suffusing our first vignette. See Ted

the client on the moral straight and narrow. The attorney saw this moral mentoring as one of his appropriate roles.

In contrast, by 1999, the profession did not ask lawyers to forcefully encourage fair dealing over and above legal obligations and attorneys played a diminished role in their clients' moral lives. The partner in our second scene is much more a technician than a moral minder. While individual attorneys and law firms no more wanted to be associated with out-and-out crooks in 1999 than they did in years far gone, there was no social or professional stigma—nor a blow to self-image—if a client followed the formal accounting rules, but nevertheless published opaque financial statements. The division of labor between attorneys and accountants (of which more will soon be said) encouraged this view.

The fourth factor did not discourage the second counselor from speaking. However, the social and moral interests that affirmatively prompted our first attorney to act were largely absent in scene two.

VIII. A FIFTH CONTRAST: THE LAWYER IN SCENE ONE IS THE SOLE ADVISOR, WHILE THE ATTORNEY IN SCENE TWO IS BUT ONE OF MANY AND, INDEED, IN THE "SPEECH NOT GIVEN," WOULD HAVE COUNSELED ON MATTERS THAT WERE THE PRIMARY RESPONSIBILITY OF ANOTHER PROFESSION

Perhaps the greatest contrast between our first and second cases lies in the cast of each scene. The long-ago lawyer is the only professional advisor in his scene. By contrast, a retinue of professionals surrounded the youthful executives in 1999. Venture capitalists urged young companies to go public so that the venture capital—having done its job by financing corporate infancy—could cash out at a profit. Investment bankers hovered close by to make their own money from underwriting IPOs. Most importantly, the young executives in 1999 had accountants. The crisis reported by the press and trumpeted in SEC speeches was a crisis of *accounting*.

This is a crucial difference. The attorney in scene one felt fully competent to counsel on whether his client's plan was right or wrong.<sup>128</sup> In contrast, it was unclear just how far any attorney in 1999 should advise on *accounting*. The detail in the second-scene speech shows how quickly the attorney could stumble when providing such accounting advice. In the speech not given, the lawyer cautions against recording revenue from sales made to customers who possess unqualified rights of

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Schneyer, *Moral Philosophy's Standard Misconception of Legal Ethics*, WIS. L. REV. 1529, 1546 (1984) (referencing a study performed by Donald Landon which, as Schneyer summarizes it, found that the attorneys "were sometimes reluctant to accept cases, not because of moral qualms, but because it would make them unpopular in their community and be bad for business;" the lawyers "were also reluctant to pursue their clients' initial aims without considering the appropriateness of those aims").

128. For this essay, we put aside the argument that breaking deals can promote economic efficiency and that, provided costs are properly internalized by the various actors, efficiency gains should displace other considerations of commercial justice.

return and even suggests that recognizing revenue on such sales would be a criminal fraud.

But, in fact, accounting principles permitted recognizing such revenue, *provided* the seller satisfied certain conditions and established a reasonable reserve. Indeed, in 1999, the First Circuit affirmed the dismissal of a securities case in which the plaintiffs alleged that “sales were contingent because there were unlimited return rights.”<sup>129</sup> The court found that:

[Statement of Financial Accounting Standards No.] 48 permits sellers to recognize sales that include a right of return, so long as the required conditions are met and the seller establishes a reasonable reserve for returns. The granting of a right of return in a particular transaction, or even a general policy of granting return rights, does not per se mean that revenue cannot be recognized at the time of sale.<sup>130</sup>

If the attorney in our second drama had delivered the detailed talk hypothesized, the lawyer would have misled the client on this accounting issue. At the very least, the lawyer would have oversimplified.

Our imagined unconditional condemnation of “bill and hold” transactions was also too quick. The SEC staff’s own accounting bulletin on revenue recognition seems to admit, albeit grudgingly, that issuers can recognize revenue from such sales under limited circumstances.<sup>131</sup>

Moreover, at the time the second scene is set, any possible wrongdoing lay in the future and would arise out of the peculiar facts facing the client at that time. Regardless of the speech about hypothetical temptations and despite the injunction to remember the lawyer’s warnings at the end of each quarter, the company would not likely rely on the pre-problem speech by outside counsel to decide fact-driven revenue recognition calls as it closed its books for a quarter. Nor would the client ordinarily depend on that oration to determine whether a plan to exit a business was sufficiently detailed to justify a restructuring charge or whether individual costs associated with such a plan could be estimated so reliably that the company could include them in such a charge.<sup>132</sup> These were accounting issues. If the client sought

129. *Greebel v. FTP Software*, 194 F.3d 185, 201 (1st Cir. 1999).

130. *Id.* at 205. The Court of Appeals went on to emphasize that the question of whether the issuer had a proper reserve required detailed information:

Plaintiffs merely make an allegation that FTP failed to adequately reserve and materially overstated FTP’s revenues. Without any information on FTP’s experience with past return rates, the size of its reserve for returns, or how the reserve changed over time, it is difficult to infer that FTP’s revenue recognition decisions were unreasonable enough to violate GAAP. . .

*Id.*

131. Staff Accounting Bulletin No. 101, 64 Fed. Reg. 68936, 68938–39 (Dec. 9, 1999).

132. The Commission staff has stated that, in order to take a current charge for future

expert advice on them, the client would turn to its outside accountant to address the specifics surrounding these issues, as they arose.

Many attorneys may have deferred to the accountants, figuring that the accountants would themselves speak whatever portion of scene-two advice applied to a particular company and would do so at the most appropriate time. Indeed, if an attorney had spoken all the words imagined and the client had later called with detailed accounting questions, the attorney would have likely punted, advising that the client had properly spotted a worthy issue and should call its auditing firm to resolve it. So too, if a lawyer had later reviewed a draft 10-K and seen a restructuring charge on the income statement, the attorney might have taken the initiative to ask the client if it had talked to its outside accountants and asked if they were satisfied with the charge. Simply considering malpractice liability and even possible securities law liability,<sup>133</sup> the lawyer would not have wanted to go on the hook for an accounting call.

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expenses associated with discontinuing part of a business, a company needs to develop and commit to an "exit plan." Staff Accounting Bulletin No. 100, 64 Fed. Reg. 67154, 67156 (Dec. 1, 1999). In "assessing whether an exit plan has sufficient detail [to support a restructuring charge], the staff would expect generally that a company's exit plan would be at least comparable in terms of the level of detail and precision of estimation to other operating and capital budgets the company prepares, such as annual business unit budgets." *Id.* As to whether a company can accrue a particular cost when the company commits to an exit plan, but before the company incurs the cost, the staff has opined that "the company must be able to estimate reliably the nature, timing, and amount" of each such cost, referring here to FASB Concept Statement No. 2 and seven factors that could bear on the reliability of such estimates. *Id.*

133. The Supreme Court ruled, in *Central Bank of Denver v. First Interstate*, that private plaintiffs cannot use an aiding and abetting theory to add defendants in 10(b)(5) actions. 511 U.S. 164 (1994). The Ninth Circuit subsequently held that plaintiffs could still sue a defendant as a *primary violator* if the defendant "played a significant role in drafting and editing" a misleading document. *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1995); *see also* *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) ("[W]e have held that substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements."). An attorney who rendered accounting advice making a material difference in a financial number that a Silicon Valley client reported might arguably be a primary violator under this standard, if the number was found to be false and shareholders could plead and prove the other 10(b)(5) elements. In other circuits, the attorney would probably not be liable in a private 10(b)(5) case, absent some public disclosure of the attorney's role. *See, e.g.*, *Wright v. Ernst & Young, LLP*, 152 F.3d 169, 175 (2d Cir. 1998) ("A secondary actor cannot incur primary liability under the [Securities Exchange] Act for a statement not attributed to that actor at the time of its dissemination."). The SEC espouses the view that an attorney who writes a falsehood into a securities filing "creates" the falsehood and is thereby a primary violator if the other 10(b)(5) elements can be proved. *In re Enron Corp. Sec. Derivative Litig.*, 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002) ("The SEC proposes . . . the following rule for primary liability of a secondary party under § 10(b): 'when a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator . . . if . . . he acts with the requisite scienter.' [SEC] Brief at 18."). Employing this theory, the court in *Carley Capital Group v.*

## IX. CONCLUDING THOUGHTS AND THE SCENE TODAY

All this leaves us with three questions: Why did attorneys in 1999 not consistently give the second-scene advice in its fullest form? Can we fault our profession for not doing so and, if so, how great was the fault? What do these ruminations suggest for counseling in the post-Enron world we now inhabit?

A. *Why Attorneys Did Not Deliver the "Speech Not Given"*

Where were the counselors in 1999? Why did they not declaim in the manner imagined in the "speech not given"? Our first contrast provides part of the answer. Clients did not request this counsel. Despite reports of some financial scandals as well as Arthur Levitt's and Lynn Turner's crusading, there was, in 1999, nothing like the sense of urgency today for lawyers to take the initiative to advise on accounting issues. Moreover, some of the remedial steps that the Commission favored assumed hard facts that were yet unproved.

Our second and third contrasts also provide some insight. Perhaps some attorneys forbore from self-interest, not willing to risk offending clients. Perhaps some were unwilling to speak advice explicitly based on assumptions running counter to prevailing entrepreneurial values. Yet the very time and place, with its fevered demand for corporate lawyering, suggest that these were not large factors.

Our fourth and fifth contrasts are more important. Attorneys did not feel much moral or social accountability for misdirection accomplished by technically correct financial statements or perhaps even for financial fraud that clients committed without active attorney complicity. Lawyers also appropriately recognized that some part of the second-scene advice required accounting knowledge that they simply did not have. Attorneys deferred to the accountants advising their clients.

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*Deloitte & Touche, L.L.P.* denied accountants' motions to dismiss and for judgment on the pleadings where plaintiffs alleged that (a) the accountants had specifically directed a company to include revenue and income from a particular contract in summary figures that the company published in a press release reporting quarterly financial results; (b) the revenue should not have been recorded in the quarter in which it was counted; and (c) the company subsequently wrote that revenue off. 27 F. Supp. 2d 1324 (N.D. Ga. 1998). The court said that it was adopting the SEC's position that a defendant should be primarily liable in a private 10(b)(5) action if the defendant "creates" the misrepresentation and: "More than mere participation, complicity, or assistance, the Plaintiffs have essentially alleged that the [accountants were] the author of the alleged misstatement." *Id.* at 1334-35. Just so, the SEC might apply its theory of primary liability to a lawyer who insisted that a client employ a particular accounting treatment to a transaction that produced what the SEC concluded were misleading numbers, arguing that the attorney "created" those numbers.

In any event, while private plaintiffs cannot employ aiding and abetting theories, the SEC can. 15 U.S.C. § 78t(e) (2000). The Commission may also bring administrative actions against anyone who "was . . . a cause of [a] violation." 15 U.S.C. §§ 77h-1(a); 78u-3(a) (2000). An attorney providing accounting advice could be at risk under either of these theories as well.

B. *Was it a Mistake to Forego the Speech and, if so, How Serious a Mistake?*

Explanation is not enough. We also ask the normative question: Do any of these factors, or all of them combined, excuse the failure to deliver the counsel imagined? At the risk of playing the Monday morning quarterback, the response may be: “No, not entirely.”

1. First Contrast (No Request for the Advice)

A good attorney should anticipate the kinds of problems that clients *might* encounter and consider advising clients of the consequent risks and possible preventive measures. The initial counseling decision—whether to raise the potential problem even if the client does not raise it—turns on: (1) the probability that the problem might arise; (2) the consequences to the client if it does; and (3) the cost and efficacy of preventive measures that the lawyer might recommend. While the probability of an accounting failure for any given company was low,<sup>134</sup> the probability was arguably sufficient, in light of the potentially severe consequences,<sup>135</sup> that the first two considerations supported giving the speech.

It is harder to cast back in time to fairly consider the third factor—the cost and efficacy of preventative measures. Yet this third factor is important. There is but small value in a lawyer identifying a legal risk if the only steps the lawyer can recommend to reduce that risk are either prohibitively expensive or unlikely to work. The cost of some of the preventive measures in the “speech not given” was not initially large. It might be hard to find audit committee members who would ask and pursue tough questions. The search might consume scarce executive time. It would take additional time to consider carefully whether consulting work by the outside auditor might damage independence and possibly direct such work to a firm that did not perform the audit. Conversations with the auditors during this consideration

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134. See, e.g., Richard H. Walker, U.S. Securities and Exchange Commission Director of Division of Enforcement, Remarks to the Panel on Audit Effectiveness 2 (Oct. 9, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch306.htm> (last visited Feb. 4, 2004) [hereinafter Walker, Panel on Audit Effectiveness] (“There are between 14,000 and 15,000 public companies in the United States. The percentage of these companies charged each year with financial fraud is small.”); GAO Study, *supra* note 37, at 16 (showing that only 1.73% of listed companies restated in 1999 because of material misstatements in financial reports).

135. The COSO 1999 Report found that many of the companies in SEC enforcement actions were small and that the amounts of the frauds were large relative to the size of those companies, with the median fraud involving \$4.1 million, compared with median assets of \$16 million. *Supra* note 38, at 3. The researchers also found that thirty-six percent of the companies went out of business or into bankruptcy. *Id.* at 28. The study did not convincingly demonstrate that the misreporting drove these companies to their demise. It could, of course, be true that the misreporting was itself due to economic decline brought on by other factors, with hard-pressed officers then trying to hide bad business results behind fanciful numbers.

could produce awkward moments. None of these steps, however, would cost large dollars.

The value of such relatively inexpensive measures, however, was hard to determine. On balance, they were probably worth suggesting because they *might* work and because, if the company did experience an accounting failure, the company could use these measures as an argument that it had done its best and that the enforcement authorities should therefore not impose too harsh a penalty.

Other steps that were probably more effective were far more costly—hiring a strong CFO and spending the money to beef up accounting and internal audit staffs. In the end, the question of how much to spend on such infrastructure was a business judgment for each board and each management.

Attorneys should have suggested these expensive steps anyway. A push from counsel might have produced more generous financing for accounting and internal audit and might have saved some companies great trouble down the line. In light of the publicity that accounting failures garnered in 1998 and 1999 and the drumbeat of SEC concern in particular, the fact that clients did not affirmatively seek scene-two advice is scant excuse for not providing it.

## 2. Second and Third Contrasts (Advice Might Drive Clients Away or Conflict with Commercial Culture)

As a normative matter, lawyers should have risen above any concerns that second-scene advice would somehow damage them economically or would offend entrepreneurial sensibilities. Providing advice that the client needs, regardless of whether the client likes the advice or not, is part of being a professional.<sup>136</sup> In any event, the probability that the “speech not given” would hurt a corporate lawyer’s Silicon Valley business in 1999 was too slight to justify silence, even if this were a legitimate normative consideration. The speech, with minor tuning, would not have run counter to the culture in which clients then lived. The forces identified by the second and third contrasts cannot provide a normative defense for lawyers’ silence.

## 3. Fourth Contrast (No Social or Moral Stake for the Lawyer in Client Accounting)

Can lawyers be faulted for failing to rank their social position and to reckon their self-regard according to whether their clients’ financial statements were right or

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136. Obviously, this is easy to say. In the real world, attorneys seldom consciously decide against giving advice because it might hurt their personal pocketbooks. It is more likely that such a consideration is at the back of an attorney’s mind and subconsciously influences the way in which he or she balances other, more appropriate factors. Professional training and, more importantly, the culture of the firm in which the attorney practices, must constantly press back against inappropriate subliminal inclinations.

wrong and whether those statements went beyond GAAP compliance to tell the full economic story? The answer depends on whether society should charge lawyers with holding clients to that standard and whether we believe that lawyers have the competence to perform well if so charged. It seems safe to argue that attorneys should encourage clients to publish financials reflecting economic truth and that society should view the legal profession as having a duty to push clients in this direction. The culture in the profession generally, and the culture in law firms representing public companies particularly, should promote such advice. To the extent that this was not so in the late 1990s, we can fault society as a whole, the legal profession, the law firms representing corporate clients, and the lawyers providing that representation.

Granted, we must be careful here. Lawyers must restrict their counsel to matters that they understand. Those matters are unlikely to extend deep into accounting and financial analysis. Moreover, lawyers represent their corporate clients, not the public at large.

All in all, however, it seems fair to fault lawyers, in recent years, for presenting themselves to the world and thinking of themselves too much as facilitators and not enough as champions of fair financial reporting. We can also fault society for accepting that lawyers should simply paper the transactions that their clients wish to undertake, rather than serve as a moral brake.

#### 4. Fifth Contrast (Accounting Professionals Had Primary Responsibility for Complicated Matters that Attorneys Did Not Fully Understand)

While the issues addressed in the “speech not given” were indeed accounting issues and while attorneys did need to guard against giving advice in a complicated area that they did not fully understand, the portions of the speech regarding analysts and preventive measures did not require mastery of complicated accounting rules. The section discussing the audit committee addressed corporate governance, a matter on which attorneys have traditionally given counsel.

As to the rest, the lawyer could have largely avoided the problems identified through our fifth contrast by steering clear of details. On revenue recognition issues, for example, the attorney could have said simply that selling products with full rights of return or in “bill and hold” transactions can raise questions; that the revenue from such sales can be counted only if the company meets particular conditions; that the pressure to meet or beat Street estimates might tempt the company to count such revenue even when it does not satisfy those conditions; and that therefore the company should be particularly careful to meet the conditions before recording revenue when selling products in these ways. As set out in the discourse not delivered, the attorney’s discussion of reserves and restructuring charges fits this mold. There the lawyer highlights the issues for the client, but does not delve into the minutiae that the attorney likely has not mastered.



Overall, lawyers cannot use the fact that accounting is a complex art to justify failing to provide most of the imagined advice. Most of that advice was—or could have been—reworded so that it would not trip on accounting arcana.

This still leaves the question whether lawyers justifiably left second-scene advice to accountants—the professionals directly responsible for accurate and informative financial disclosure. In hindsight, we can see that the accounting profession, even as manifested by its largest firms, failed to prevent companies from publishing slippery numbers.

Whether attorneys should have seen this coming in 1999 is more difficult to say. Given the press reports and SEC warnings, there was enough to suggest that simply leaving all of the “speech not given” to the accountants might be unwise. On the other hand, attorneys may have believed that, in light of the bad press and SEC criticism, the accounting profession would right itself. And, in a given case, an attorney might have had confidence in the individual, outside accountants working with a client.

Weighing all of this, attorneys should probably have concluded, in more cases than they did, that adding their voices to whatever the accountants were saying might help and (at least if a lawyer’s comments remained at an appropriately general level) would not hurt. While it is a close case—particularly when we view the matter from an attorney’s perspective in 1999—the fact that accountants were on the scene is not a complete justification for failing to give scene-two counsel.

## 5. Normative Conclusion

In a specific case, an attorney might properly have decided against speaking much of the second-scene advice because the lawyer thought that the risk of accounting failure at the particular client was too low to justify spending the time on this counseling or for other reasons identified above. However, lawyers should have given most of the second-scene speech more often than they did.

It is a very different question to ask how great the fault was in failing to do so. That determination depends critically on whether consistently delivering the full “speech not given” would have done much good. In accounting, the rubber most frequently meets the road when companies record revenue from particular sales, compute reserves, calculate one-time charges, and close the books at the end of each quarter. For the most part, outside lawyers do not participate in these events.<sup>137</sup> But,

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137. This article speaks from the perspective of outside counsel. In-house counsel may find themselves involved to a much greater extent in matters that affect accounting directly. For example, the sales organization in a company may rely on the general counsel’s office to advise on whether a contract has been finalized by the end of a quarter, which in turn may factor into determining whether any of the revenue from the contract can be recorded in that quarter.

If consulted on such matters, in-house counsel may find it more difficult to hold the line that they believe should be retained than lawyers in an outside firm. Aggressive management may be able to bring more direct and immediate pressure on in-house counsel than on outside counsel to raise no questions and go along with the plan to report the financial results that analysts want to read.

these are occasions when companies violate revenue recognition protocols, manipulate reserves, and record restructuring charges, including inappropriate amounts.

By itself, a pre-IPO speech of the sort that the second scene imagines might have seemed a heroic gesture. Alone, however, such a Dutch uncle talk would probably have had little chance of preventing a run-of-the mill accounting fraud of the sort against which the “speech not given” warns. Perhaps the second-scene counsel, coupled with extensive follow-up on such things as the client’s implementation of the suggested preventive measures, would have made a difference at a few companies. Even this is uncertain. We must be careful, as a profession, not to overstate our own importance. It is hard to make a responsible case that lawyers could have prevented the accounting crisis.<sup>138</sup> Our profession was at fault for failing to consistently deliver the “speech not given.” But the fault was not great, as making the speech would likely have prevented few frauds or forestalled much “gray area” accounting.

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Lawyers in a small, general counsel office may not have anything like the cultural support and financial independence available at a large firm to resist such influence. See Order Instituting Public Administrative Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission’s Rules of Practice, Making Findings and Imposing Remedial Sanctions and Cease-and-Desist Order, *In re James A. Fitzhenry*, File No. 3-10943, 2002 WL 31617720 (S.E.C. Nov. 21, 2002) (sanctioning a senior vice president/general counsel/secretary who, the SEC concluded, attempted personally and unsuccessfully to obtain a binding and unconditional agreement for a sale, but nevertheless thereafter signed management representation letters to auditors saying that the risk of loss had passed to the purchaser and that the purchaser had made a fixed commitment to buy; the attorney consented to the order without admitting or denying the Commission’s findings).

138. This essay addresses primarily preventive counseling that begins when a company decides to go public. It does not address what attorneys should do when evidence of possibly serious past or ongoing accounting problems come to light in an internal investigation or when an SEC investigation is imminent. See, e.g., Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143 (2002); Harvey L. Pitt, U.S. Securities and Exchange Commission Chairman, Remarks Before the Annual Meeting of the American Bar Association’s Business Law Section (Aug. 12, 2002), available at <http://www.sec.gov/news/speech/spch579.htm> (last visited Feb. 4, 2004); see also *infra* note 174 (describing the new attorney conduct rules that the SEC has adopted). Nor does this essay address the questions that an attorney faces when advising on the textual description in SEC filings of a transaction that the client has designed to hide liabilities from public view by, for example, keeping them off the reported balance sheet. While such questions hold interest, the fact that the events involving Enron have highlighted off-book financing has diverted a good deal of the discussion from much more common fact patterns leading to restatements. See SEC, REPORT PURSUANT TO SECTION 704 OF THE SARBANES-OXLEY ACT OF 2002 [hereinafter SEC 2002 STUDY OF TYPES OF FINANCIAL FRAUD] (reporting results of a study of all Commission enforcement actions from July 31, 1997 through July 30, 2002; during that period, the SEC “brought the greatest number of actions in the area of improper revenue recognition; 126 of the 227 enforcement matters involved such conduct, including the fraudulent reporting of fictitious sales, improper timing of revenue recognition, and improper valuation of revenue”).

### C. *What this Analysis Suggests for Today's and Tomorrow's Counseling*

What about today? With accounting wrongdoing regularly in the headlines since Enron collapsed, well-publicized enforcement efforts against senior executives, and the Sarbanes-Oxley Act of 2002, attorneys fully recognize the need for counseling in order to prevent accounting failures.<sup>139</sup> Attorneys are keenly aware of accounting failures and do not suppose that those failures involve so few companies that warnings to clients are unnecessary. As to corporate governance steps designed to prevent misleading financials, many are now required by law or new listing standards. To the extent that they remain optional, the public clamor to adopt them may outweigh any reservations about their efficacy. The factor identified by our first contrast plays no role.

With newspapers printing pictures showing executives literally being led off in handcuffs,<sup>140</sup> with new certification requirements putting top officers more publicly on the line for financial reports, and with the most extreme forms of entrepreneurial culture fading with the NASDAQ index, executives should now *want* advice on how to avoid violating the law as they report their companies' financial results. Even if not, their in-house lawyers see the need for help just to comply with new legislation, regulations, and exchange rules.<sup>141</sup> Such counsel being in demand, the attorneys who provide it will not drive clients away. Neither law firm economics nor popular business culture is likely to deter counselors from speaking up. The factors identified in the second and third contrasts should not deter attorneys in 2004.

But a word of caution is in order about these two factors. The tide could turn. In time, memories of Enron and WorldCom headlines will fade. Business pressures to report results that boost stock prices and an extreme entrepreneurial culture may rise

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139. See, e.g., Jenny B. Davis, *Sarbanes Sells, Firms Create New Practice Units to Attract Corporate Compliance Work*, A.B.A. J., Apr. 2003, at 26; Lucia Hwang et al., *Hot Practice Areas*, CAL. LAW., Aug. 2003, at 17, 18 (including "corporate counseling" on Sarbanes-Oxley). Some executives, however, are distressed with the scope and cost of reforms. See Nanette Byrnes, *Reform: Who's Making the Grade*, BUS. WK., Sept. 22, 2003, at 80, 81 ("[M]any CEOs and CFOs have begun to exhibit acute reform fatigue. They argue that the new rules have gone too far, that they are stifling risk-taking, and that companies have been saddled with broader and more expensive audits and higher bills for insuring officers and boards. A recent PricewaterhouseCoopers survey found that the number of executives with a favorable opinion of Sarbanes-Oxley had fallen from 42% last October to 30% this June."). See also Floyd Norris, *Too Much Regulation? Corporate Bosses Sing the Sarbanes-Oxley Blues*, N.Y. TIMES, Jan. 23, 2004, at C1.

140. In late summer 2002, *The New York Times* carried photographs of two former WorldCom executives who "were publicly escorted in handcuffs to the Federal District Courthouse for a brief hearing." Kurt Eichenwald, *2 Ex-Officials at WorldCom Are Charged in Huge Fraud*, N.Y. TIMES, Aug. 2, 2002, at A1. Enron's former CFO similarly appeared in wrist bracelets. Kurt Eichenwald, *An Ex-Official Faces Charges in Enron Deals*, N.Y. TIMES, Oct. 3, 2002, at A1.

141. See, e.g., Renee Deger, *The High Cost of Compliance, In-House Counsel Are Spending a Pretty Penny to Get Their Companies in Line with Provisions of the Sarbanes-Oxley Act*, THE RECORDER, Sarbanes-Oxley Supplement, June 30, 2003, at S4.

again. If such a time should coincide with diminished demand for corporate lawyering, clients interested in cutting corners may find attorneys who badly need business. The second and third factors might then play a large part in forestalling second-scene advice. The profession, each law firm, and each attorney must guard against the possibility that the economics of modern law practice and the business culture of a particular time may inhibit frank advice that discourages accounting wrongdoing.

As to the considerations identified by our fourth contrast, society does not yet view as moral renegades those law firms or lawyers who accepted and retained clients that pushed accounting to its limits—or beyond—in order to avoid disclosing or highlighting bad financial news. There have been a few articles in the popular press suggesting that some of the blame for accounting calamities lies with attorneys.<sup>142</sup> But, in most cases, the names of the particular lawyers involved, and even the names of their firms, have remained far from the public eye.

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142. The press coverage has focused principally on attorneys for Enron. See, e.g., Mike France, *What About the Lawyers?*, BUS. WK., Dec. 23, 2002, at 58 (suggesting that Enron's lawyers might have known that some of the deals on which they worked were suspicious); Kurt Eichenwald, *Enron Panel Finds Inflated Profits and Self-Dealing*, N.Y. TIMES, Feb. 3, 2002, at Section 1, 1, 27 (summarizing the report of a special committee of Enron's Board: "Vinson & Elkins, Enron's major outside law firm, played a lesser but distinct supporting role in Enron's downfall, according to the report. Like Andersen, it failed to prevent Enron from issuing financial statements that obscured the essence of the partnerships, the report concluded. Nor did Vinson insist on full and clear disclosure of Mr. Fastow's conflicting interests;" but also quoting Vinson's spokesperson as saying that "when all the facts are known about the role we played, it will be seen that we met our professional obligations"); Richard A. Oppel, Jr., *Lawmakers Contend Lawyers for Enron Should Have Raised Concerns*, N.Y. TIMES, Mar. 15, 2002, at C7 ("Lawyers for Enron failed to recognize serious conflicts of interest and did not act on information that clearly should have raised concerns about the company's accounting, members of Congress investigating the company's collapse said today," while also noting that: "Lawyers from Vinson & Elkins defended their firm's work").

The Enron debacle dates back at least to the restatement it presented in a Form 8-K filed Nov. 8, 2001. About half a year later, the legal press suggested that Vinson & Elkins ("V&E") would not be greatly hurt by its association with the fallen client. Alison Frankel, *Without a Scratch?*, AM. LAW., Apr. 2002, at 19. Indeed, one of its partners reportedly forecast little damage by, as the reporter put it, comparing V&E with "examples set by other firms that have survived associations with such radioactive clients as Drexel Burnham Lambert Group, Inc. (New York's Cahill, Gordon & Reindel and Los Angeles's Latham & Watkins) and Charles Keating, Jr. (New York's Kaye Scholer)." *Id.* By the end of 2002, it was less clear that V&E had escaped without harm. Its profits per partner were down 7.9%, while Fulbright & Jaworski (also headquartered in Houston) enjoyed a 16.3% increase. *The Am Law 100 2003*, AM. LAW., July 2003, at 147. V&E had reduced staff by thirteen percent. *Chronicle 100*, HOUSTON CHRON., June 1, 2003, at 5, available at 2003 WL 57420471. But its revenues were up in 2002 and its managing partner said that the firm had replaced the Enron revenue that had accounted for more than seven percent of the total in 2001. *Annual Report on Firm Finance*, TEX. LAW., June 30, 2003, at 25. One article in the local press quoted a Texas law professor as saying: "I do think [Enron] hurt V&E. . . . It's not a major thing, I don't think they have clients leaving hand over fist. What I think they don't like is the word of mouth." Julie Mason, *Vinson & Elkins Adds ex-SEC Lawyer / New Partner in Washington 'Reassured' about Enron Fallout*,

Within the profession, there may be less willingness to admire lawyers who facilitate transactions that produce income statements and balance sheets that deflect investor attention from unhappy financial facts. To retain and enhance their self-respect, more corporate attorneys may speak up if they feel that clients are failing to candidly report their financial conditions and results. More will provide today's version of scene-two advice for the same reasons.

But are the lawyers who fail to do so, or who represent clients in transactions that create obscure financials, or clients who have restated financial results, still welcome in their firms? Are those attorneys able to move comfortably to other firms, taking with them the possibly lucrative business that such clients can provide? Are those lawyers now, or will they ever be, considered apostates who have renounced an important part of the profession's creed? Are attorneys who serve corporations with clean and forthright financials honored in any way? Do today's attorneys seek out with special zeal the straight-shooting corporate clients who are the modern-day analogues to the businessman whose commercial honesty attracted the counselor in our opening scene? Even if attorneys do search out such clients, is it more to contain their own risk, rather than because they wish to fulfill themselves as professionals by devoting their talents to the honest?

It is difficult to know. We can say that social and moral pressures operate to a greater extent now than in 1999 to prompt attorney advice about the pressures pushing companies toward bad and fuzzy numbers and the ways that companies can push back against such pressures. We can also confidently conclude, however, that we remain many leagues from the small-town lawyer in scene one on whom social and moral forces operated with large effect.

What of the fifth contrast? Surely, attorneys today will not remain silent on accounting matters and defer completely to a sister profession, which is itself in crisis.

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HOUSTON CHRON., June 21, 2003, available at 2003 WL 57422112.

V&E lost about fifty lawyers (fourteen of them partners) in 2003. Miriam Rozen & Brenda Sapin Jeffreys, *Texas Powerhouse Vinson & Elkins No Longer Invincible*, THE RECORDER, Dec. 31, 2003, at 3. V&E's managing partner reportedly expected 2003 profits per partner to be a little higher than profits per partner in 2002, but revenues to be five per cent lower than in 2002. *Id.* The judge in the private civil securities cases denied Vinson & Elkins's motion to dismiss. *In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 704-05 (S.D. Tex. 2002). She dismissed claims against the firm in the related ERISA litigation. *In re Enron Corp. Secs. Derivative & ERISA Litig.*, No. MCL 1446, CIV.A.H-01-3913, 2003 WL 22245394, at \*3-4, \*125 (S.D. Tex. Sept. 30, 2003) (identifying counts on which V&E was sued and granting V&E's motion on those counts). In his final report, the Enron bankruptcy examiner concluded that there was "sufficient evidence from which a fact-finder could determine" that Vinson & Elkins "committed malpractice" or "aided and abetted breaches of fiduciary duty by Enron officers," but added that this only meant that, in the examiner's opinion, the evidence was sufficient to reach a fact-finder and that V&E could have potential defenses if the wrongful conduct of officers were imputed to Enron as a corporate entity. *In re Enron Corp.*, Chapter 11 Case, No. 01-16034 (AJG), Final Report of Neal Batson, Court-Appointed Examiner, dated Nov. 4, 2003, at 13, 27, 32, 48-49. The managing partner at Vinson & Elkins disagreed with the examiner's conclusions. Rozen & Jeffreys, *supra* at 3.

But that easy observation avoids the difficult issue of how far into the field of accounting attorney advice should extend. This question presses us in 2004 even more than in 1999, as new requirements seem to call for counsel that is a mixture of law *and* accounting, with the mix weighted more heavily towards accounting in some cases than to what we traditionally view as law.

For example, section 302 of the Sarbanes-Oxley Act of 2002 required that the SEC promulgate rules mandating certifications in annual and quarterly reports by principal executive officers and principal financial officers.<sup>143</sup> The resulting regulations force those officers to certify in 10-Ks and 10-Qs to a broad array of facts, including that, to the officers' knowledge, "the financial statements, and other financial information included in this report fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report."<sup>144</sup>

Today's lawyer can advise that this "fair presentation" language in the certification goes beyond stating the officer's belief that the company has complied with technical accounting requirements. The attorney can provide this counsel because the Commission said as much in its adopting release:

We believe that Congress intended this statement to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles. In our view, a "fair presentation" of an issuer's financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary

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143. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302(a), 116 Stat. 745, 777 (2002). The Commission produced those rules. Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57276, 57291-92 (Sept. 9, 2002) [hereinafter Certification Release] (showing the certifications for 10-Qs and for 10-Ks (collectively, the "302 Certifications")). The Commission changed the certification when it published new rules regarding reports on internal controls, required by Sarbanes-Oxley section 404 and discussed *infra* at notes 147-157. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36636 (June 18, 2003) [hereinafter Final Section 404 Rule Release]. The text of the certification is now located in 17 C.F.R. § 229.601(b)(31) (2003) and the requirement to include the certification in 17 C.F.R. §§ 240.13a-14(a), 240.15d-14(a) (2003).

As a criminal statute, section 906 of the Act also adds a provision requiring CEOs and CFOs to certify that, among other things, each periodic report filed under the Securities Exchange Act containing financial statements "fairly presents, in all material respects, the financial condition and results of operations of the issuer." Sarbanes-Oxley Act § 906, 116 Stat. at 806. While both apply to 10-Qs and 10-Ks, this article will not address the relationship between the 302 certifications and the certifications required by section 906.

144. 17 C.F.R. § 229.601(b)(31).

to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.<sup>145</sup>

This echoes our second-scene admonition that public companies should not employ accounting protocols that produce misleading numbers, even though they pass GAAP tests.

Attorneys, however, are still attorneys, not accountants or financial analysts. Lawyers are no more qualified today than they were in 1999 to say (in any but the clearest cases) that the revenue or cost from a particular transaction must be reported in a particular way or that a GAAP-approved treatment is so misleading that an officer cannot sign the certification if the numbers are reported as that treatment prescribes.

Nor will attorneys be much help on the more technical matters underlying the certifications. Looking over draft financial statements for a 10-Q or 10-K and reviewing the accompanying text, outside counsel may be able to spot some accounting issues. But, in the end, most attorneys who want to avoid possibly misinforming a client (and who have any care for possible professional liability) are unlikely (again, except in the clearest cases) to opine, in the words of the SEC's adopting release, on "the selection of appropriate accounting policies [and the] proper application of appropriate accounting policies."<sup>146</sup>

New law addressing "internal controls" presents similar problems. The Sarbanes-Oxley Act required the SEC to formulate rules requiring companies covered by the Securities Exchange Act to annually provide "an internal control report," which shall not only state the responsibility of management for establishing "an adequate internal control structure and procedures," but must also contain an "assessment, as of the end of the most recent fiscal year . . . , of the effectiveness of the internal control structure and procedures . . . for financial reporting."<sup>147</sup>

"Internal control"—virtually, an accounting term of art—"pertains to an issuer's financial reporting and control of its assets."<sup>148</sup> It comprises the systems and procedures that a company has in place to record ongoing financial events in a way that will ensure that the company (a) knows how its resources are being used and (b) can report its financial condition and history accurately.<sup>149</sup>

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145. Certification Release, *supra* note 143, 67 Fed. Reg. at 57279.

146. *Id.*

147. Sarbanes-Oxley Act § 404, 116 Stat. at 789.

148. Certification Release, *supra* note 143, 67 Fed. Reg. at 57280.

149. In October 2002, the Commission proposed to define the phrase "internal controls and procedures for financial reporting" to mean "controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards 319 or any superseding definition or other literature that is issued or adopted by the Public Company Accounting Oversight Board." Disclosure Required By Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, 67 Fed. Reg. 66208, 66220 (Oct. 30, 2002). In June 2003, the SEC issued final

The Commission's rules fleshing out the new internal control reporting requirement provide that, after applicable compliance dates, management must "evaluate, with the participation of the . . . principal executive and principal financial officers . . . the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting" and that the "framework on which management's evaluation . . . is based must be a suitable, recognized control framework. . . ."<sup>150</sup> Based on this evaluation, management must then provide an "assessment" of the internal controls in its annual report, "including a statement as to whether or not internal control over financial reporting is effective."<sup>151</sup> This assessment "must include disclosure of any material weakness" in the internal controls and management "is not permitted to conclude that the . . . internal control over financial reporting is effective if there are one or more material weaknesses."<sup>152</sup> The annual report must also include an attestation to the management report on internal controls by the outside accounting firm that is auditing the company's books.<sup>153</sup>

While companies do not need to conduct such an overall evaluation of their internal controls each quarter, management must—at the end of the first three quarters (as well as at the end of the fourth)—evaluate "any change in the

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rules to implement Section 404 of the Sarbanes-Oxley Act and used "internal control over financial reporting" as the operative phrase. It defined that term to mean:

a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers . . . and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets of the issuer;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made in accordance with authorizations of management and directors of the issuer; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

Final Section 404 Rule Release, *supra* note 143, 68 Fed. Reg. at 36666–67 (codified at 17 C.F.R. §§ 240.13a-15(f), 240.15d-15(f) (2003)).

150. 17 C.F.R. §§ 240.13a-15(c); 240.15d-15(c) (2003). The "framework" that the SEC specifically approved was one that the COSO developed and published in 1992. Final Section 404 Rule Release, *supra* note 143, 68 Fed. Reg. at 36639, 36642 n.42.

151. 17 C.F.R. § 229.308(a)(3) (2003).

152. *Id.* "Material weakness" is another accounting term of art, which the SEC used in its technical sense. See Final Section 404 Rule Release, *supra* note 143, 68 Fed. Reg. at 36642 & n.63 (referencing Statement on Auditing Standards No. 60).

153. See Sarbanes-Oxley Act § 404(b); 17 C.F.R. § 229.308(b) (2003).



[company's] internal control over financial reporting, that occurred during [the quarter], . . . that has materially affected, or is reasonably likely to materially affect" the company's internal controls and disclose any such change.<sup>154</sup> Both the principal executive officer and principal financial officer of each reporting company must include in their certifications for each 10-K and 10-Q statements that: They are responsible for establishing and maintaining internal controls; their company has "designed" such controls "to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;" they have disclosed in the report any change that has "materially" affected the company's internal control over financial reporting (or is reasonably likely to do so in the future); and they have advised the auditors and the audit committee of "All significant deficiencies and material weaknesses in the design or operation" of internal controls.<sup>155</sup>

Most attorneys are not experts on internal financial controls. Attorneys may urge clients to pay attention to their internal controls and spend money to develop and implement them. Lawyers might counsel clients to consider hiring a second outside accounting firm to help design or assess these controls and should (and very likely will) counsel all clients to pay close attention to comments on internal controls from their auditors, whether delivered in a management letter at the end of the annual audit, in connection with the now-required auditor attestation to management's internal control report,<sup>156</sup> or otherwise. The lawyers will also help their clients phrase the

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154. 17 C.F.R. §§ 240.13a-15(d), 240.15d-15(d), 229.308(c) (2003).

155. 17 C.F.R. § 229.601(b)(31) (2003). The Commission defined "significant deficiency" by reference to specific accounting standards. See Final Section 404 Rule Release, *supra* note 143, 68 Fed. Reg. at 36643 & n.73.

In addition to all of this reporting on internal controls, the SEC has, in connection with the 302 certifications, also required issuers to develop "disclosure controls and procedures." See 17 C.F.R. § 229.601(b)(31); 17 C.F.R. §§ 240.13a-15(e), 240.15d-15(e) (2003). In September 2002, the Commission distinguished disclosure controls from internal controls by at least implying that the former focused on "non-financial information." Certification Release, *supra* note 143, 67 Fed. Reg. at 57280. But, in June 2003, the SEC blurred the difference between the two by saying that there is "substantial overlap" between them. Final Section 404 Rule Release, *supra* note 143, 68 Fed. Reg. at 36645. This article does not address "disclosure controls" to the extent that disclosure controls do not subsume internal financial controls.

156. *Supra* note 153 and accompanying text (discussing the attestation). The accounting profession and reporting companies are now actively considering whether the same accounting firm can or should both participate in the design of a company's internal controls and audit the company's financial statements (with the audit including the Sarbanes-Oxley attest report on the internal control system). See Jonathan D. Glater, *Worry Over a New Conflict for Accounting Firms*, N.Y. TIMES, Sept. 23, 2003, at C1 (saying that Grant Thornton will not help audit clients to design internal controls and that MCI retained for internal control assistance an accounting firm different from the accounting firm that performs its audit). Sarbanes-Oxley Section 101 created the Public Company Accounting Oversight Board ("PCAOB"), which, among other things, is charged with establishing or adopting auditing and independence standards relating to the preparation of audit reports for public companies. Sarbanes-Oxley Act § 101(c)(2). In late 2003, the PCAOB proposed an auditing

“internal control” reports for SEC filings. But, on the key issues of whether management’s assessment of the effectiveness of the controls is correct, whether management has disclosed all significant deficiencies and material weaknesses in such controls to outside auditors, and whether management’s report identifies all changes in the most recent quarter that materially affect (or are reasonably likely to materially affect) internal control, the attorneys may have little to say.<sup>157</sup>

To be sure, attorneys will now advise in detail on a host of new laws and regulations facing public companies in the wake of Enron, such as application of the criteria for “independence” that the Sarbanes-Oxley Act imposes for service on the audit committee of a public company;<sup>158</sup> identification and disclosure of a “financial

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standard regarding internal controls. Paragraph thirty-two of the proposed standard said that: “If the auditor were to design or implement controls, that . . . would place the auditor in a management role and result in auditing the auditor’s own work. This does not necessarily preclude the auditor from making substantive recommendations as to how management may improve the design or operation of the company’s internal controls.” Public Company Accounting Oversight Board, PCAOB Release No. 2003-17, Proposed Auditing Standard—An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, Appendix—Proposed Auditing Standard, ¶ 32 (Oct. 7, 2003), available at <http://www.pcaobus.org/rules/Release2003-017.pdf> (last visited Feb. 4, 2004). The proposed release said that:

While the Board has not proposed to provide specific guidance on permissible internal control-related non-audit services in the proposed standard on the audit of internal control, the Board intends to conduct an in-depth evaluation of independence requirements in the future.

*Id.* at ¶ 21.

157. The text offers only a few examples of the areas in which lawyers will face the limitation of the advice they give. As required by Sarbanes-Oxley, the SEC has adopted new rules governing disclosure of off-balance sheet transactions and the use of pro forma figures in 10-Qs and 10-Ks. Sarbanes-Oxley Act § 401, 116 Stat. at 786; see Disclosure in Management’s Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 68 Fed. Reg. 5982 (Feb. 5, 2003); Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. 4820 (Jan. 30, 2003) (relating to use of pro forma numbers); see also U.S. Securities and Exchange Commission, *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures* (June 13, 2003), available at <http://www.sec.gov/divisions/corpfin/faqs/nongapfaq.htm> (last visited Feb. 4, 2004). In each case, lawyers will seek to find their role, and the accountants’ role, in providing detailed compliance counseling.

158. A director is not “independent” for this purpose under the new law if he or she is “an affiliated person” of the company or if, in a capacity other than as a member of the board, the director accepts “any consulting, advisory, or other compensatory fee” from the company. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (adding new subsection (m) to section 10A of the Securities Exchange Act of 1934, with the quotations from subparts (3)(B)(i) and (ii)); see also SEC’s Implementing Regulations, 17 C.F.R. § 240.10A-3(b)(1) (2003), adopted in Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18788 (Apr. 16, 2003). Sarbanes-Oxley section 301 required the Commission to issue regulations requiring exchanges and NASDAQ to adopt rules that would prohibit the listing of companies on the exchanges or traded through NASDAQ whose audit committee members did not fit the statutory definition of independence. Sarbanes-Oxley Act § 301. The listing rules effectively imposed the independence standard on publicly traded companies, for

expert” on the audit committee;<sup>159</sup> creation of the procedures that Sarbanes-Oxley requires in order to permit whistle-blowing employees of listed companies to contact

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any company that did not comply with the listing rules could not have its stock traded on the exchanges or through NASDAQ.

The new law also imposes a host of specific duties on audit committees and on auditors, as they communicate with the committees. For example, it requires auditors to timely report to those committees “all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the [auditor].” Sarbanes-Oxley Act § 204, 116 Stat. at 773; with complementary regulation at 17 C.F.R. § 210.2-07 (2003). The auditors must also give the committees any schedule of unadjusted differences. *Id.* Sarbanes-Oxley then provides that the SEC must issue regulations requiring the exchanges and NASDAQ to prohibit trading the listing of companies whose audit committees are not “directly responsible for the appointment, compensation, and oversight of the work of the [outside auditor] employed by that issuer (*including the resolution of disagreements between management and the auditor regarding financial reporting*)” or to whom the auditors do not “report directly.” *Id.* § 301, 116 Stat. at 775–76 (emphasis added); with SEC regulation at 17 C.F.R. § 240.10A-3(b)(2) (2003). Section 401 requires financial statements that are filed with the Commission and required to be prepared in accordance with GAAP to “reflect all material correcting adjustments that have been identified by [the auditor]. . . .” 116 Stat. at 785–86. The net result appears to be that whenever management and the auditor disagree over the accounting treatment of a financial event, that disagreement must go to the audit committee, with the audit committee then resolving the dispute. One important limit on the committee’s leeway in such resolutions is that, where the disagreement is embodied in a “correcting adjustment” that is “material,” the audit committee must simply ensure that the auditor’s treatment prevails. *Id.* Lawyers may play a negligible role in all of this—except perhaps to say to audit committees that the safe route is simply to side with the auditors on all issues or in the unlikely case that the lawyers see themselves as competent to choose between the position taken by management (presumably supported by the company’s own accountants) and the position taken by the outside auditor.

159. Section 407 of Sarbanes-Oxley required the Commission to issue rules defining a “financial expert” and, in doing so, to:

consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions—

- (1) an understanding of generally accepted accounting principles and financial statements;
- (2) experience in—
  - (A) the preparation or auditing of financial statements of generally comparable issuers; and
  - (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;
- (3) experience with internal accounting controls; and
- (4) an understanding of audit committee functions.

*Id.*, 116 Stat. at 790. Sarbanes-Oxley mandated that the new rules also require each 34 Act reporting company to disclose whether at least one member of its audit committee is a “financial expert” within the SEC’s definition and, if not, why not. *Id.* The Commission has published these rules. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110 (Jan. 31, 2003) [hereinafter Final SEC 406 and 407 Rules] (introducing the term “audit committee

their audit committees;<sup>160</sup> the manner in which to phrase “codes of ethics” for senior financial officers and disclosures of any waivers of such code;<sup>161</sup> and the reach of the

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financial expert” at 5111). The rules are at 17 C.F.R. § 229.401(h) (2003), with an elaborate definition of “audit committee financial expert” at (h)(2). As a practical matter, companies may choose to include such an expert on their audit committees rather than explain why they have not done so.

Lawyers will assist clients with the required disclosure about audit committee financial experts. Attorneys may also provide some limited help to boards as they determine whether a particular director is an “audit committee financial expert,” particularly insofar as the boards must determine whether a candidate director has an understanding of audit committee functions.

160. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (leading to subpart (4) of new subsection (m), which was added to section 10A of the Securities Exchange Act). Congress effectively, but indirectly, imposed this requirement to create whistleblower procedures by ordering the SEC to issue a rule saying that exchanges and NASDAQ must adopt a prohibition against listing the securities of any company without an audit committee having a procedure for the receipt and treatment of complaints regarding accounting matters, including anonymous and confidential complaints by employees. *Id.* The Commission issued that rule. 17 C.F.R. § 10A-3(b)(3) (2003).

161. Section 406 of the Sarbanes-Oxley Act required the SEC to issue rules mandating each 34 Act reporting company to disclose “whether or not, and if not, the reason therefor, [the company] has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer.” 116 Stat. at 789. As a practical matter, companies will adopt such codes rather than try to explain why they have not done so. Moreover, as set out below, new listing standards now require codes.

The statute provides that the code must include:

such standards as are reasonably necessary to promote—

- (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the [company]; and
- (3) compliance with applicable governmental rules and regulations.

*Id.* The law also mandates regulations requiring the “immediate disclosure . . . of any change in or waiver of the code for senior financial officers.” *Id.* The Commission issued its ethics code rules in January 2003. Final SEC 406 and 407 Rules, *supra* note 159, 68 Fed. Reg. at 5118. The rules require disclosure of whether the code covers the chief executive officer, as well as the financial officers, and, if a company says that it has a code, the rules require that the company disclose even “implicit” waivers of that code. *Id.* at 5118, 5120, 5127–29. Both the NYSE and NASDAQ have adopted new listing standards requiring codes that apply even more broadly to all directors, officers, and employees. On November 4, 2003, the SEC approved a number of new NYSE and NASD rules including those requiring codes of ethics. Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes (SR-NYSE-2002-33 and SR-NASD-2002-141) and Amendments No. 1 Thereto; Order Approving Proposed Rule Changes (SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138 and SR-NASD-2002-139) and Amendments No. 1 to SR-NASD-2002-80 and SR-NASD-2002-139; and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to SR-NYSE-2002-33, Amendment Nos. 2, 3, 4 and 5 to SR-NASD-2002-141, Amendment Nos. 2 and 3 to SR-NASD-2002-80, Amendment Nos. 1, 2, and 3 to SR-NASD-2002-138, and Amendment No. 2 to SR-NASD-2002-139, Relating to Corporate Governance, 68 Fed. Reg. 64154

new prohibition against personal loans from public companies to directors and executives.<sup>162</sup> New corporate governance requirements from the NYSE and NASDAQ will create more legal issues.<sup>163</sup> This is just a partial list.

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(Nov. 12, 2003) [hereinafter SEC Nov. 2003 Order Approving New Listing Standards].

New section 303A.10 of the NYSE Listed Company Manual requires all Exchange-listed companies to adopt a “code of business conduct and ethics for directors, officers and employees” and to “promptly disclose any waivers of the code for directors or executive officers.” *Id.* The accompanying commentary says that such codes should address conflicts of interest; corporate opportunities; confidentiality of information received from either the company or its customers; fair dealing with customers, suppliers, competitors, and employees; protection and proper use of company assets; compliance with laws, rules, and regulations (specifically referencing insider trading laws); and efforts to encourage the reporting of illegal or unethical behavior. The commentary adds that each code must “contain compliance standards and procedures” and “should ensure the prompt and consistent action against violations of the code.” *Id.*

For NASDAQ, new NASD Manual subsection 4350(n) likewise requires each listed company to adopt a “code of conduct applicable to all directors, officers and employees.” *Id.* The new NASDAQ rule further requires that the code “must provide for an enforcement mechanism” and that waivers for directors and executive officers must both be approved by the board and disclosed. *Id.*

162. Sarbanes-Oxley Act § 402, 116 Stat. at 787. This section has already created confusion over whether, for example, it prohibits the split-dollar insurance policies that are part of the compensation package for many executives. Tracie Rozhon & Joseph Treaster, *Insurance Plans of Top Executives May Violate Law*, N.Y. TIMES, Aug. 29, 2002, at A1; Andre J. Willms, *Split-Dollar Insurance: New Rulings, New Regulations (And Sarbanes-Oxley?)*, 17 PRAC. TAX LAW. 23, 26–27 (2003); see also Kathryn Stewart Lehman, *Recent Developments, Executive Compensation Following the Sarbanes-Oxley Act of 2002*, 81 N.C. L. REV. 2115 (2003) (reviewing this and other interpretive questions raised by the loan prohibition).

163. Both the NYSE and NASDAQ have adopted revisions to the corporate governance portions of their listing standards. The SEC approved the revisions, with transition provisions, on November 4, 2003. SEC Nov. 2003 Order Approving New Listing Standards, *supra* note 161.

New NYSE Listed Company Manual section 303A.01 adds the requirement that each board contain a majority of independent directors. New 303A.02 defines “independence,” with new sections 303A.06 and 303A.07(b) adding the requirement that audit committee members satisfy additional independence criteria in SEC regulations issued under Sarbanes-Oxley. See *supra* note 158. Revised NASDAQ listing standards place the definition of “independent director” in NASD Manual subsection 4200(a)(15), require a majority of independents on the board in 4350(c)(1), and add Sarbanes-Oxley requirements for audit committee member independence in 4350(d)(2)(A)(ii).

The new NYSE rules require that listed companies have nominating and compensation committees composed entirely of independent directors, with each such committee having a written charter addressing the committee’s purpose and responsibilities and an “annual performance evaluation” of the committee. LISTED COMPANY MANUAL §§ 303A.04, 303A.05. New NASDAQ rules similarly require independent director approval of director nominations and compensation for the CEO and other executive officers, but the NASDAQ mechanics are more flexible than those prescribed by the NYSE rules. The NASDAQ standards permit either a committee of independent directors or a majority of all independent directors on the board to approve nominations and compensation. They also include a limited exception for one nonindependent director on any nominating or compensation committee. NASD MANUAL § 4350(c)(3) & (4).

Lawyers have a role in interpreting and helping companies apply the new definitions of an

Lawyers can also advise on some matters even more closely related to accounting. Considering the ever-present possibility of private litigation and possible SEC investigation, attorneys can counsel on the wisdom of supporting the Sarbanes-Oxley certifications (by those executives who are required to sign under the new law) with subcertifications (by lower-ranking officers or staff).<sup>164</sup> Lawyers can encourage filling the audit committee with accounting-savvy directors who will practice active oversight and may be able to comment knowledgeably on particular candidates for audit committee membership. Attorneys can advise audit committees on the need to meet frequently enough to really dig into their review work.<sup>165</sup> Lawyers can identify accounting issues that the SEC has publicly highlighted for particular review and advise on the language of audit committee charters.<sup>166</sup>

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“independent” director as well as in helping companies draft any necessary charters for nominating and compensation committees. Attorneys will similarly assist audit committees as they revise their charters to conform to new listing company standards that set out new responsibilities for those committees. See NYSE LISTED COMPANY MANUAL § 303A.07(c)(iii); NASD MANUAL § 4350(d)(3).

Lawyers will also counsel audit committees of NASDAQ companies (or other designated independent bodies of such companies’ boards) on approval of related-party transactions under revised NASD Manual subsection 4350(h). Attorneys will likewise advise boards of NYSE companies as they discharge their new responsibilities to adopt and disclose “corporate governance guidelines.” Those guidelines will address a wide variety of matters including director qualifications, continuing education for directors, CEO succession, and the board’s self-evaluation, which should be conducted at least once a year. See NYSE LISTED COMPANY MANUAL § 303A.09, and related commentary.

164. See, e.g., Claudia H. Deutsch & Joseph B. Treaster, *Other Executives Voice Satisfaction at Arrests*, N.Y. TIMES, July 25, 2002, at C5 (“At several companies . . . the chiefs are already insisting that division presidents and chief financial officers sign off on their unit’s numbers, with the expectation that if anything is amiss, the chief executive will not bear the brunt of blame.”).

165. Today’s received wisdom is that audit committees can play an important role, perhaps the key role, in raising financial reporting to a consistently reliable standard. That remains to be seen. Audit committees do not themselves audit. They are merely supervisors and not even in the ordinary sense. Even a very active audit committee, meeting ten, or a dozen, or even twenty times a year, would still provide only episodic oversight. This essay assumes that lawyers should give the extended advice about audit committees and much of it must now be given in light of new rules. It is a task for another day to discuss whether, in fact, audit committees are consistently effective against financial fraud or whether they have simply been an attractive and available target for reform.

166. For an example of the kinds of advice attorneys can render, see Pillsbury Winthrop, LLP, *Audit Committee Responsibilities*, Aug. 2002, BANK & CORP. GOVERNANCE L. REP.

Attorneys will also have to monitor their own interaction with auditors. Section 303(a) of Sarbanes-Oxley makes it unlawful for any officer, director, “or any other person acting under the direction thereof” to “fraudulently influence, coerce, manipulate, or mislead” an auditor in contravention of Commission rules. 116 Stat. at 778. The SEC has issued regulations under this section. The adopting release says that the “types of conduct that the Commission believes could constitute improper influence (if the person engaged in that conduct knows or should know that the conduct, if successful, could result in rendering the issuer’s financial statements materially misleading) include . . . Providing an auditor with inaccurate or misleading legal analysis.” Improper

Attorneys are also well within their scope to warn about the possible pressures that Street expectations can place on corporate accounting. They can urge clients to build accounting infrastructure. They can suggest the wisdom of an internal audit staff whose reports to the audit committee do not require clearance by the accounting personnel whom the internal auditors monitor.<sup>167</sup> Lawyers can caution clients on the need for auditor independence and the possible compromise of that independence by consultant work that accounting firms provide.<sup>168</sup> They can urge management to establish and maintain an uncompromisingly honest “tone at the top.” All this is much as imagined in scene two.

Attorneys, however, will continue to confront what may have been the most powerful deterrent to the second-scene lawyer’s fully extended speech—the fact that most attorneys are not qualified to give detailed accounting advice.<sup>169</sup> It is one thing, to provide another example, for a lawyer to advise that the SEC is encouraging

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Influence on Conduct of Audits, 68 Fed. Reg. 31820, 31823 (May 28, 2003).

167. New NYSE listing standards require that each company on the Exchange have “an internal audit function” and that its audit committee “meet separately, periodically . . . with internal auditors (or other personnel responsible for the internal audit function). . . .” NYSE LISTED COMPANY MANUAL § 303A.07(c)(iii)(E) & (d).

168. In December 2000, the SEC, by rule, prohibited audit firms from performing a raft of nonaudit services for audit clients. SEC 2000 Auditor Independence Rules, *supra* note 116. Section 201 of the Sarbanes-Oxley Act put such prohibitions into the Exchange Act, added a proscription against providing expert services unrelated to audits, and further provided that the Commission may identify other impermissible services. 116 Stat. at 745, 771–72; *see also* § 208(a), 116 Stat. at 775 (mandating that the SEC issue implementing regulations for the auditor independence provisions and certain other provisions in Sarbanes-Oxley). In response, the SEC broadened the description of certain categories of prohibited engagements, eliminated exemptions from those proscriptions, and added the prohibition against expert services. Strengthening the Commission’s Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006 (Feb. 5, 2003), *corrections* at 68 Fed. Reg. 15354 (Mar. 31, 2003) [hereinafter SEC 2003 Auditor Rules]; *see also* U.S. Securities and Exchange Commission, *Application of the January 2003 Rules on Auditor Independence Frequently Asked Questions*, available at <http://www.sec.gov/info/accountants/ocafaquaudind080703.htm> (last visited Feb. 4, 2004).

169. “Accounting for attorneys” courses now abound. For some of the 2003 courses, see Practising Law Institute, *Institutes & Programs January–June 2003*, at 23 (including description of a course entitled “Basics of Accounting & Finance Summer 2003: What Every Practising Lawyer Needs to Know”); Continuing Education of the Bar, University of California, CEB Publications & Programs (including an announcement for an August 2003 program entitled “Analyzing Financial Statements After Enron: What Every Lawyer Needs to Know”); American Bar Association Center for Continuing Legal Education, Announcement for “Comprehending Basic Financial Statements—A Primer for Attorneys” (holding the program in March 2003). The year 2004 promised more such courses. The Practising Law Institute announced that its “Basics of Accounting and Finance Winter 2004: What Every Practising Lawyer Needs to Know” program would be presented live at multiple locations and also Webcast. Practising Law Institute, *Institutes and Programs January–June 2004* at 34. The January 2004 CLE Bulletin published by the Bar Association of San Francisco described, on page three, a lunchtime course called “Do You Have the Accounting Smarts Required Under Sarbanes-Oxley?” Lawyers do not become accountants by such modest education.

companies to include in annual reports “full explanations, in plain English, of their ‘critical accounting policies,’ the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.”<sup>170</sup> It is still within the attorney’s realm to advise that the audit committee of each SEC-reporting client should closely examine these policies<sup>171</sup> and also appropriate for the lawyer to participate with accountants in wordsmithing a “critical accounting policy” disclosure into understandable language.

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170. In December 2001, the Commission issued a cautionary release containing this recommendation. Accounting Policies; Cautionary Advice Regarding Disclosure, 66 Fed. Reg. 65013 (Dec. 17, 2001) [hereinafter SEC Caution on Critical Accounting Policies]. In May 2002, the SEC proposed rules to require a discussion of “critical accounting policies” in certain filings. Disclosure in Management’s Discussion and Analysis About the Application of Critical Accounting Policies, 67 Fed. Reg. 35620 (May 20, 2002) [hereinafter Proposed MD&A Critical Accounting Policies Rule].

In December 2003, the Commission issued interpretive guidance for preparation of MD&A in which the SEC said that the rules it had proposed in May 2002 “remain under consideration.” Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, 68 Fed. Reg. 75056, 75058, 75064 (Dec. 29, 2003) [hereinafter 2003 Critical Accounting Guidance]. This 2003 guidance referred to “critical accounting estimates.” *Id.* at 75064–65. The guidance said that each company:

should consider whether [it has] made accounting estimates or assumptions where:

- The nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
- The impact of the estimates and assumptions on financial condition or operating performance is material.

*Id.* at 75064–65.

The 2003 Critical Accounting Guidance advised that a company should “provide disclosure about [such] critical accounting estimates or assumptions in [its] MD&A”—disclosure that would “supplement, not duplicate, the description of accounting policies that are already disclosed in the notes to the financial statements.” *Id.* at 75065. Each company should “address specifically why its accounting estimates or assumptions bear the risk of change” and discuss “such factors as how [the company] arrived at the estimate, how accurate the estimate/assumption has been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future.” *Id.* Moreover, the disclosure should include an analysis of the estimates’ and assumptions’ “sensitivity to change, based on other outcomes that are reasonably likely to occur and [that] would have a material effect,” with “quantitative as well as qualitative disclosure when quantitative information is reasonably available.” *Id.* The 2003 guidance uses the long-term rate of return employed to generate pension plan numbers as an example of a critical estimate or assumption. *Id.*

171. The SEC cautionary release stated that: “Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods.” SEC Caution on Critical Accounting Policies, *supra* note 170, 66 Fed. Reg. at 65013.



It is quite another matter, however, for a lawyer to counsel on which protocols meet the Commission's definition of a "critical accounting policy," let alone provide substantive guidance in making the elaborate disclosures that the SEC's proposed rules on these policies would require.<sup>172</sup> In some situations, an attorney may be able

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172. The Commission's proposed rule is aimed at identifying "critical accounting estimates." Proposed MD&A Critical Accounting Policies Rule, *supra* note 170, 67 Fed. Reg. at 35620. To determine whether an estimate falls into that category, the issuer would have to answer two questions:

1. Did the . . . estimate require us to make assumptions about matters that were highly uncertain at the time the . . . estimate was made?
2. Would different estimates that we reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, have a material impact on the presentation of our financial condition, changes in financial condition or results of operations?

If the answers to both questions are "yes," the . . . estimate would be a "critical accounting estimate."

*Id.* at 35621.

After isolating these estimates, the issuer would have to "identify where and how they affect the company's reported financial results, financial condition and changes in financial condition, and, where material, identify the affected line items." *Id.* The company would need to describe the methodology and assumptions used to reach each estimate. *Id.* "If applicable, a company would have to discuss why it could have chosen in the current period estimates that would have had a materially different impact on the company's financial presentation. Similarly, a company would have to discuss, if applicable, why the accounting estimate is reasonably likely to change in future periods with a material impact" on the issuer's financial condition or results. *Id.*

Beyond all this, the issuer would have to include a sensitivity analysis which would either (1) show how the estimate would have changed if the "most material" underlying assumption(s) were changed in a "reasonably possible way" or (2) set out "the ends of the range of reasonably possible amounts which the company likely determined when formulating its recorded estimate." *Id.* The rule would require additional disclosure when a company adopts a new accounting policy that (a) has a material impact on financial condition or results and (b) is not required by a new rule promulgated by a recognized accounting standard setter. *Id.* at 35621-22.

The examples in the proposed release show that the "critical estimates" could include some of the manipulable numbers our scene-two attorney discussed. *Id.* at 35631-32 (warranty claim costs); *Id.* at 35632-33 (returns). Attorneys could examine disclosures that issuers make under the proposed rule to advise whether they address all of the matters the rule prescribes. Beyond that, lawyers could probe draft disclosures with questions. But the value of those questions would depend on the lawyers' knowledge of each issuer's business and industry and the lawyers' knowledge of relevant accounting rules. In many cases, attorneys would add little.

Lawyers will likely be able to provide the same sort of assistance—and face the same limitations in providing counsel—when they advise on the application of the 2003 Critical Accounting Guidance to the MD&A for a particular client. *Supra* note 170. Sarbanes-Oxley expressly provides that auditors "shall timely report to the audit committee of the issuer all critical accounting policies and practices to be used." 116 Stat. at 773. The SEC has also placed that requirement in its regulations. SEC 2003 Auditor Rules, *supra* note 168, 68 Fed. Reg. at 6048 (adding 17 C.F.R. § 210.2-07(a)(1)). The law and regulations confirm common sense: the accountants are the professionals charged with advising on critical accounting policies.

to offer such help. In many others, most lawyers will not have the training or experience to do so.

Attorneys, as they counsel today, and law schools, as they train students to eventually become counselors, must struggle to find the balance between remaining within their competence and guiding clients away from accounting wrongdoing. This task may be surprisingly difficult. Clients may be concerned that their outside auditors will not keep them out of trouble and may, for this reason, refer questions to their attorneys that they would have only asked of their accountants in the past.<sup>173</sup>

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173. Referring an accounting question to a lawyer could raise serious practical issues, going beyond whether the attorney knows what he or she is doing. If an attorney is performing accounting work, rather than legal work, the communications between the client and the attorney may not be privileged. *See* U.S. v. Frederick, 182 F.3d 496, 501 (7th Cir. 1999) (“The Supreme Court has held that an accountant’s worksheets are not privileged . . . , and a lawyer’s privilege . . . is no greater when he is doing accountant’s work.”). Presumably, the attorney reviewing accounting work for a securities filing could argue that he or she is providing legal counsel on disclosure matters. But, in a later lawsuit, if the attorney really made the accounting call, plaintiffs’ counsel would work hard to convince a court that, just as in some cases involving preparation of tax returns, a lawyer advising on accounting decisions engages in unprivileged communications with the client.

Similar problems could arise if corporations want their outside counsel to talk directly with outside auditors. *U.S. v. Arthur Young & Co.* held that no work-product protection shields accountant workpapers from disclosure. 465 U.S. 805, 815-21 (1984). In passing, the Supreme Court quoted with approval from an earlier decision, saying that “no confidential accountant-client privilege exists under federal law.” 465 U.S. at 817 (quoting *Couch v. United States*, 409 U.S. 322, 335 (1973)). A number of cases recognize that documents otherwise guarded by the attorney-client privilege can lose that protection when transmitted to a client’s outside accountant in the course of the accountant’s audit work. *U.S. v. El Paso Co.*, 682 F.2d 530, 540 (Temp. Emer. Ct. App. 1982) (“As the securities laws require, independent accountants . . . verify the financial statements by probing the corporation’s reasons for allocating a given amount to its noncurrent tax account. In *El Paso*’s case, the tax pool analysis is revealed to the independent accountants as part of their audit. . . . *El Paso*’s disclosure of the tax pool analysis to the auditors destroys confidentiality with respect to it. With the destruction of confidentiality goes as well the right to claim the attorney-client privilege.”); *In re John Doe Corp. v. U.S.*, 675 F.2d 482, 488 (2d Cir. 1982); *U.S. v. South Chicago Bank*, Nos. 97 CR 849-1, 97 CR 849-2, 1998 WL 774001, at \*3 (N.D. Ill. Oct. 30, 1998); *In re Pfizer Inc. Sec. Litig.*, No. 90 Civ. 1260 (SS), 1993 WL 561125, at \*7 (S.D.N.Y. Dec. 23, 1993) (“Disclosure of documents to an outside accountant destroys the confidentiality seal required of communications protected by the attorney-client privilege, notwithstanding that the federal securities laws require an independent audit.”); *see also* *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162 (9th Cir. 1992) (“Pennzoil concedes that the district court was correct in ordering disclosure of the documents actually provided to the outside auditor.”). These authorities suggest that even an e-mail from an attorney to a client, if forwarded by the client to its auditor, may fall outside the privilege protection. *A fortiori*, direct communications from the client’s counsel to the auditor (and the records of those communications in workpapers or elsewhere) risk discovery in a later government investigation or a civil lawsuit. *See In re Honeywell Intern., Inc. Sec. Litig.*, No M8-85 WHP, 2003 WL 22722961, at \*3 (S.D.N.Y. Nov. 18, 2003).

Section 7525 of Title 26 created, in 1998, a limited privilege (good against the federal government only and only in noncriminal matters) for “federally authorized tax practitioners” who could be accountants. 26 U.S.C. § 7525 (2000). This statute complicates the analysis somewhat, but

Lawyers, for their part, may yield to their desire to be helpful or conclude that, in light of a new SEC rule addressing lawyer conduct, they must more seriously consider insisting on preventive or remedial client action when the attorneys believe that clients are about to publish funny numbers.<sup>174</sup> In the general breast-beating after

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most of the communications relevant to the accounting issues that this article addresses would not concern the “tax advice” to which 7525 is confined. *Frederick*, 182 F.3d at 502 (“Nothing in the new statute suggests that these nonlawyer practitioners are entitled to privilege when they are doing other than lawyers’ work.”); *U.S. v. BDO Siedman*, 337 F.3d 802, 811 (7th Cir. 2003) (“The party asserting a privilege must show that the attorney-client communication was made for the purpose of obtaining legal advice, or, more precisely in the case of the § 7525 privilege, tax advice.”); *U.S. v. KPMG, LLP*, 237 F. Supp. 2d 35, 39 (D.C.D.C. 2002) (“The privilege does not protect communications between a tax practitioner and a client simply for preparation of a tax return.”). The statutory privilege therefore should not extend, at least in the great majority of cases, to communications for the purpose of performing an audit or closing a company’s books at the end of a quarter.

174. The Sarbanes-Oxley Act mandated that the SEC issue rules:

- (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
- (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

Sarbanes-Oxley Act § 307, 116 Stat. at 784.

In response to this legislation, the Commission has adopted rules that require an attorney to go “up the ladder” if the attorney reasonably believes that a material violation of the securities laws has occurred, is occurring, or is about to occur. Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296 (Feb. 6, 2003) (adding Part 205, or “Final Attorney Rules,” to Title 17 of the Code of Federal Regulations). If a client does not have what the new rules define as a “qualified legal compliance committee” (“QLLC”), the rules require an outside attorney who is helping an issuer prepare an SEC filing and who believes that the filing will materially violate the securities laws to report “forthwith” the evidence of the impending violation to either “the issuer’s chief legal officer [‘CLO’] . . . or to both the issuer’s [CLO] and its [CEO].” 17 C.F.R. § 205.3 (b)(1) (2003). The CLO must then conduct an investigation to determine whether a material violation is afoot. If it is, the CLO must take all reasonable steps to cause the issuer to prevent the impending violation. The CLO must notify the outside attorney either that no violation was in fact about to occur or, if it was, what steps have been taken to prevent it. 17 C.F.R. § 205.3(b)(2). If that outside attorney does not receive an “appropriate response” from the CLO within a reasonable time, the outside attorney must report the evidence to the audit committee, to another committee consisting of outside directors (if the company does not have an audit committee), or to the board as a whole (if there is no such other committee). 17 C.F.R. § 205.3(b)(3). If the outside attorney still does not receive an “appropriate response,” the attorney must explain—to the CLO, CEO, and directors to whom the attorney reported—the reasons that the attorney believes the response is inadequate. 17 C.F.R. § 205.3(b)(9).

The Commission has also proposed additional attorney rules for comment. Under those further

Enron, the profession may partially convince itself that lawyers should play a greater accounting role.<sup>175</sup>

While all this may blur or move the line between accounting and lawyering, that line remains. The attorneys' challenge will be to provide as much of the current equivalent to our second-scene speech<sup>176</sup> as is on the attorney side of the line; self-

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rules, the reporting attorney who does not receive an "appropriate response" after reporting to the audit committee and who reasonably believes that the violation about to occur "is likely to result in substantial injury" to "investors" must (1) withdraw from the representation; (2) advise the Commission that he or she has done so "based on professional considerations;" and (3) "promptly disaffirm" any document that has been filed with the SEC, which the attorney helped to prepare and that the attorney "reasonably believes is or may be materially false or misleading." Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324, 6326 (Feb. 6, 2003). As an alternative to this required "noisy withdrawal" in steps (2) and (3) above, the SEC is considering a requirement that the issuer who receives the attorney's resignation "based on professional considerations" in step (1) itself be required to report that fact to the Commission. *Id.*

Among other things, the new "up the ladder" rule means that the lawyer who decides today that he or she knows enough to make an accounting call had better be certain. Gone may be the day when outside counsel assisting in the preparation of a 10-Q could have a brief, spirited phone call with the CFO about an accounting issue and end with: "That's my view. I know that you disagree and that you are going with your different number. It's your call, Ed. Enjoy the 49ers game this Sunday." If the attorney really believes that a number the company is about to file in the 10-Q is materially off, the lawyer will not be able to stop with the CFO. Instead, the rules require the attorney to go over the CFO's head and report the CFO to the top in-house counsel. Unless the company has a QLCC, that report would in turn force the in-house counsel to conduct an investigation. If (as a result of that investigation and subsequent action) the outside attorney did not either receive a convincing argument that the CFO's number was correct or notice that the 10-Q would use a different number that the lawyer thought was right, the outside attorney would then have to report the matter to the audit committee. If the SEC adopts its additional proposed rules, all of this could lead to a mandatory resignation followed by a report of that resignation to the Commission which, in turn, would virtually ensure an immediate investigation of the attorney's now former client.

175. Some suggest that lawyers should now become more active in client accounting and some advocate expanded accounting education for lawyers. See Lawrence A. Cunningham, *Sharing Accountings's Burden: Business Lawyers in Enron's Dark Shadow*, 57 BUS. LAW. 1421 (2002). This essay argues for caution. While lawyers should develop enough knowledge to spot some accounting issues, it is unrealistic to suppose that attorneys will serve as extra, consulting accountants. That would require too much training and it would require lawyers to keep up with accounting developments as well as legal ones. Most attorneys would not have the time. Moreover, lawyers would need to think very hard before taking actions that would cause them to voluntarily shoulder the liabilities, as well as the other "burdens," that accountants carry today.

176. A lawyer giving the speech today would have to modify it to warn against additional financial chicanery featured in more recent wrongdoing: off-balance-sheet financing that disguises the true extent of a company's liabilities, improper nonmonetary (or "barter") and "roundtrip" transactions to inflate revenue and profits; and capitalization of operating expenses to avoid matching them with the revenue that they generate. See SEC 2002 Study of Types of Financial Fraud, *supra* note 138, at 14-15, 25-27, 28-30. Today's lawyer might also ask executives to consider the possibility that their companies not make any public earnings projections, as this might reduce the market's focus on achieving warnings estimates. See Bloomberg News, *Coke to End Forecasting Of*

start to find issues for clients to take to the accountants on the other side of the line; and do their best to ensure that they do not lead their clients—or their firms or liability insurers—into waters that the attorneys do not know and upon which they are not fit to navigate.

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*Earnings*, N.Y. TIMES, Dec. 14, 2002, at C3 (“The Coca-Cola Company said today that it would stop making earnings forecasts after this quarter, following the lead of a large shareholder, Warren E. Buffett. . . . Mr. Buffett, a Coca-Cola director, does not make such forecasts at his investment company, Berkshire Hathaway. The Gillette Company, another company where Mr. Buffett is a director and shareholder, stopped such estimates in January 2001.”). The attorney might also warn of a different threat to auditor independence—fees that auditing firms receive from executives in exchange for advice on personal tax avoidance strategies. See Jonathan D. Glater & Stephen Labaton, *Auditor Role in Working for Executives Questioned*, N.Y. TIMES, Feb. 8, 2003, at C1.