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ACCOUNTING FRAUD: PLEADING SCIENTER OF AUDITORS UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT

Gideon Mark*

I.
INTRODUCTION

Beginning in the late 1990s, the United States experienced a tidal wave of accounting fraud. Many of these frauds were on a massive scale. WorldCom Inc. (now MCI) was embroiled in a $10.6 billion accounting fraud, the largest in U.S. history,[1] and other scandals at major corporations also involved billions of dollars.[2] Some of these

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* Mr. Mark is a practicing attorney in New York City. He holds degrees from Harvard, Columbia, NYU, Brandeis, and the University of California.

[1] Ken Belson, *et al.*, *A Guilty Verdict: The Overview; Ex-Chief of WorldCom Is Found Guilty in $11 Billion Fraud*, N.Y. Times, March 16, 2005, at A1; Christine Nuzum, *Executives on Trial: WorldCom Ex-Controller Traces Improper Accounting Back to 1997*, Wall St. J., Feb. 2, 2005, at C6. MCI agreed to a $750 million settlement with the Securities and Exchange Commission (SEC), after the company's accounting scandal erased more than $180 billion in shareholder value. The class action litigation produced a settlement that exceeded $4 billion, making it the largest in history. Stephen Taub, *WorldCom Settlement Tops Cendant's*, CFO Magazine, March 11, 2005 (available at http://www.cfo.com).

[2] *See* Craig M. Boise, *Playing with "Monopoly Money": Phony Profits, Fraud Penalties and Equity*, 90 MINN. L. REV. 144, 146 (2005) (since implosion of Enron in 2001, Wall Street has experienced unprecedented string of accounting fraud scandals involving publicly traded corporations); Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1425-26 (2002) ("By the late 1990s, the frequency of corporate accounting scandals had multiplied. They include corporations that are much larger and prominent than in scandals past, including such household names as Aurora Foods, Cendant (CUC International), HBOC (McKesson), Leslie Fay, Rite Aid, Sunbeam, Waste Management, Xerox, and on and on."). In 2000, Cendant paid $2.85 billion to settle shareholder suits stemming from its accounting fraud. *Cendant Case Ends in Split Verdict*, Wall St. J., Jan. 5, 2005, at B3. The accounting fraud at McKesson ultimately led to a $960 million settlement, after the stock's collapse shaved $9 billion from the company's market capitalization. Stephen Taub, *McKesson Settles Suits for $960 Million*, CFO Magazine, Jan. 14, 2005 (available at http://www.cfo.com.) The accounting scandals at Rite Aid Corp. and Xerox Corp. involved $1.6 billion and $6.4 billion, respectively. *Executives on Trial: Scandal Scorecard*, Wall St. J., Oct. 3, 2003, at B1. In 2005, KPMG agreed to pay $22.5 million to settle SEC charges related to its audit of Xerox. This was the largest payment made to the SEC by an audit firm, to that point. Stephen Taub, *KPMG Settles Xerox Charges with SEC*, CFO Magazine, Apr. 21, 2005 (available at http://www.cfo.com). Later in 2005, Deloitte & Touche agreed to pay $50 million to settle SEC charges stemming from its 2000 audit of Adelphia Communications Corp. Stephen Taub, *PCAOB Probing Deloitte Audit*, CFO Magazine, July 8, 2005. Available at http://www.cfo.com. Other massive scandals enveloped HealthSouth Corp. ($3-4 billion of fraudulent accounting), Freddie Mac (the second-biggest mortgage finance company in the U.S., with $5 billion of improper accounting), and Enron Corp. *See*, *e.g.*, Dave Cook & Helen Shaw, *Scrushy Acquitted on All Counts*, CFO Magazine, June 28, 2005 (available at http://www.cfo.com); Stephen Taub, *Trial Watch: Tyco, WorldCom, HealthSouth, Parmalat*, CFO Magazine, Jan. 31, 2005 (available at http://www.cfo.com).

frauds were undertaken in conjunction with the external auditors of the companies involved. Investors seeking redress for their losses have pursued the auditors in class action suits filed under the Private Securities Litigation Reform Act (PSLRA),[3] which was adopted in 1995 in response to perceived abuses of the class action process.[4] This Article examines the application to external auditors of the PSLRA's strict pleading requirement concerning scienter. The issue is important, because most dismissals of securities class action suits against accountants are for failure to adequately allege scienter.[5]

Part II of this Article considers the significance of accounting allegations and auditors as defendants in securities class action suits. Part III examines sources and limitations of Generally Accepted Accounting Principles (GAAP) and auditing standards

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[3] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.). The PSLRA was followed three years later by the Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 109 Stat. 737 (1998) (codified in scattered sections of 15 U.S.C.). The Uniform Standards Act was adopted by Congress to bar plaintiffs from circumventing the PSLRA by filing class actions in state court. That path is now barred, because the statute mandates exclusive federal court jurisdiction for all private securities class actions. *See, e.g.*, In re Livent, Inc. Noteholders Sec. Litig., 151 F. Supp.2d 371, 442-43 (S.D.N.Y. 2001).

[4] *See, e.g.*, Greebel v. FTP Software, Inc., 194 F.3d 185, 191 (1st Cir. 1999) ("The enactment of the PSLRA in 1995 marked a bipartisan effort to curb abuse in private securities lawsuits, particularly the filing of strike suits."); In re Electronic Data Systems Corp. Sec. and "ERISA" Litig., 2004 WL 52088, *9 (E.D. Tex., Jan. 13, 2004) (PSLRA was enacted in part to compensate for perceived inability of Rule 9(b) of Federal Rules of Civil Procedure "to prevent abusive, frivolous strike suits."). The PSLRA, described as the most sweeping reform of the federal securities laws in 60 years, received widespread support from the auditing industry. The legislation included several provisions that minimized accountants' liability for securities fraud -- stricter pleading standards, the imposition of discovery stays pending resolution of motions to dismiss, and the replacement of joint and several liability with proportionate liability. Daniel J. Kramer & James McBride, *Section 10A of the Securities Exchange Act of 1934: Auditors' Duty to Detect and Disclose Fraud Under the Federal Securities Laws*, 1309 PLI/Corp 307, 309 (May-June 2002); Robert S. Greenberger, *Questioning the Books: Panel, in Enron's Wake, To Review Lawsuit Curbs*, Wall St. J., Feb. 6, 2002, at A8 (PSLRA had strong backing of accounting industry). Some aspects of the PSLRA benefit auditors substantially more than they protect most corporate defendants. John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeeper, Stupid,"* 57 BUS. LAW. 1403, 1410 (2002).

[5] Richard P. Swanson & Richard Y. Roberts, *The Private Securities Litigation Reform Act of 1995: A Review of the Law and Recent Developments*, SH057 ALI-ABA 415, 426 (Feb. 2003).

(historically known as Generally Accepted Auditing Standards -- GAAS). As will be seen, the current financial reporting and auditing models are poor tools for measuring accounting fraud and assessing the liability of auditors. Moreover, various aspects of GAAP and GAAS serve to encourage such fraud. Six specific weaknesses of the reporting model used in the U.S. are discussed: accounting for stock options, pensions, off balance-sheet liabilities, and intangible assets; general use of a rules-based accounting system; and pro forma reporting of financial results.

Part IV briefly considers the conflicting interpretations by the federal circuits of the PSLRA's scienter requirement. The clear circuit split, unresolved by the Supreme Court, centers on whether allegations of motive and opportunity to commit fraud suffice to allege scienter. Part V examines three key issues involving the group-published or group pleading doctrine, which permits a plaintiff in a securities fraud action to treat an individual defendant as part of a group for pleading purposes. The issues discussed herein are whether the doctrine survives post-PSLRA, applies generally to the scienter of defendants, and applies specifically to the conduct of external auditors.

Part VI analyzes how federal courts have applied the scienter standard to external auditors, in the context of GAAP and GAAS violations. The impact of the Sarbanes-Oxley Act (Sarbanes-Oxley),[6] signed into federal law[7] in 2002 in direct response to the

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[6] Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). Sarbanes-Oxley has been described as "the most radical reform of corporate governance since the Great Depression of the 1930s." *A Trying Year*, Economist, Jan. 12, 2004. Available at http://www.economist.com.

[7] The legislative response to accounting fraud has not been exclusively federal. By mid-2003, 35 states had approved or were considering legislation to regulate corporate accounting and other related behavior. Michael Schroeder, *Corporate Reform: The First Year: Cleaner Living, No Easy Riches*, Wall St. J., July 22, 2003, at C1. A summary of state legislative activity can be found at the Website of the American Institute of Certified Public Accountants (AICPA). *See* http://www.aicpa.org/statelegis/index.asp. The AICPA, the national professional organization representing more than 330,000 CPAs, has issued a White

recent wave of corporate accounting scandals, is examined.[8] Part VI concludes that in numerous cases federal courts have been over-zealous in their efforts to shield external auditors from liability for fraud. Numerous federal courts have reached the unwarranted conclusion that auditors, behaving as rational economic actors, will not sacrifice their professional reputations in order to derive additional audit revenue from participating in the fraud of their clients. Such a conclusion, which effectively bars plaintiffs from successfully pleading motive to commit fraud, is completely unwarranted. As will be seen, auditors have powerful economic incentives to deliver aggressive and even fraudulent audit reports, stemming from their desire to obtain lucrative non-audit work in the form of consulting or tax services. In recent years such services have out-paced audit services as profit centers for multinational accounting firms. Other key factors include the lack of competition in the audit industry, the absence of audit firm rotation, and the revolving-door phenomenon, whereby auditors ultimately work directly for their former clients. Other courts, focusing on recklessness rather than motive and opportunity, have determined with no justification that the bar for pleading scienter of auditors should be set higher than it is for other defendants.

This Article concludes that the judiciary should adopt a new approach to assess the scienter of auditors in federal securities fraud actions. Rather than applying an

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Paper arguing against the application of Sarbanes-Oxley's reforms to private companies at the state level. According to the AICPA, the auditing of such companies is adequately regulated. *See id.* As will be seen *infra*, the accounting industry has often successfully lobbied against reform measures. *See also* J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317 (2004); Stephen Taub, *Big Four Look to Limit Liability*, CFO Magazine, Dec. 13, 2005 (Big Four accounting firms seek to minimize exposure by including in their audit contracts punitive damages and jury trial waivers). Available at http://www.cfo.com.

[8] Sarbanes-Oxley did not alter the PSLRA's strict pleading requirements regarding scienter. Lorna G. Schofield, *The Impact of the Sarbanes-Oxley Act on Litigation Against Major Accounting Firms*, SH097 ALI-ABA 319, 328 (Dec. 2002). But Sarbanes-Oxley did impact the auditing industry, as described in various sections of this Article, *infra.*

elevated test for successful pleading of scienter on the part of auditors, federal courts should apply the same standards that they apply to other defendants.

II.
THE SIGNIFICANCE OF ACCOUNTING ALLEGATIONS AND AUDITORS AS DEFENDANTS

Securities class action filings have remained at a high level since the PSLRA was enacted in 1995. The number of suits filed in federal court increased from 110 in 1996 to 212 in 2004.[9] On average, 190 suits were filed annually during the period 1996 - 2003.[10] In general, the recent wave of filings is driven by allegations of accounting-related fraud.[11] In 2004, GAAP violations were alleged in 48 percent of securities class filings.[12] Improper revenue recognition is the most commonly alleged accounting abuse. In 2004, 60 percent of securities class action suits with alleged GAAP violations included a claim of improper revenue recognition.[13] This figure is consistent with the comparable numbers for SEC enforcement actions.[14]

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[9] *Securities Class Action Case Filings 2004: A Year in Review*, Stanford Securities Class Action Clearinghouse (Jan. 2005) at 2-3 (hereafter *2004: A Year in Review*). Available at http://www.securities.stanford.edu. The filing statistics for 2001-03 exclude a large number of non-traditional filings in three categories: (1) "IPO Allocation" filings in 2001, which contained allegations pertaining to the allocation of shares in initial public offerings; (2) "Analyst" filings in 2002, which contained allegations that defendants, primarily investment banks and analysts at these banks, issued research reports and ratings that were neither independent nor objective; and (3) "Mutual Fund" filings in 2003, which contained allegations relating to market timing, lack of disclosure, and breach of fiduciary duty by mutual fund companies and other financial intermediaries. These suits are excluded because they have characteristics unlike those of traditional securities class action cases. *Id*. at 3.

[10] 2004: A Year in Review, *supra* note 9, at 3. *See also* Elaine Buckley, *et al*., *Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides?* (June 2003) at 2 (hereafter *Recent Trends*). Available at http://www.nera.com.wwt/publications/6143.pdf.

[11] Lingling Wei, *Many Companies Were Sued by Shareholders in '02*, Wall St. J., March 18, 2003, at D3 (quoting Prof. Joseph Grundfest).

[12] 2004: A Year in Review, *supra* note 9, at 16.

[13] 2004: A Year in Review, *supra* note 9, at 16. The second most common accounting allegation, overstatement of accounts receivable, was found in 17 percent of all cases with alleged GAAP violations. *Id.* Improper revenue recognition practices come in a wide variety of flavors. For a good description of 16

Cases with auditors as defendants represent only a subset of all cases with accounting allegations. Nevertheless, that subset is significant and may expand in the aftermath of Sarbanes-Oxley. During the period 1998-2002, auditors were named as defendants in at least 84 securities class action suits[15] and approximately 15 percent of all post-PSLRA cases settled by December 2002 included accountants as named defendants.[16] Auditors were named as defendants in an additional 18 class action suits filed during 2003 and 2004.[17] Moreover, the presence of an auditor as a defendant has

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types of such practices, *see* Manning Gilbert Warren III, *Revenue Recognition and Corporate Counsel*, 56 SMU L. REV. 885, 909-922 (2003). *See also* Matthew S. Mokwa, *Enron, Sarbanes-Oxley, and the End of Earnings Management*, 39 TEX. J. BUS. L. 325, 337-48 (2003). The abundance of accounting standards has contributed to the revenue recognition problem. At least 180 different standards have been used to recognize revenue. Stephen Taub, *Setting Revenue Recognition Standards*, CFO Magazine, May 17, 2004. Available at http://www.cfo.com.

[14] During the period July 31, 1997 – July 30, 2002, the SEC filed 515 enforcement actions for financial reporting and disclosure violations, arising out of 227 investigations. Of these 227 investigations, 126 involved improper revenue recognition, including the fraudulent reporting of fictitious sales, improper timing of revenue recognition, and improper valuation of revenue. Auditors were charged in administrative or federal injunctive actions in 57 of the 227 investigations. Of the 57 enforcement matters, 16 involved one of the Big Five public accounting firms and 41 involved smaller firms. *Report Pursuant To Section 704 of the Sarbanes-Oxley Act of 2002*, Securities and Exchange Commission 1-2, 37, 39 (2003) (hereafter *Section 704 Report*). Available at http://www.sec.gov/news/studies/sox704report.pdf. More recently, in fiscal year 2005, the SEC brought more than 600 enforcement actions. Approximately 29% of these actions involved financial fraud, with revenue recognition cases heading the list. Stephen Taub, *SEC Enforcement Aims High*, CFO Magazine, Dec. 8, 2005 (available at http://www.cfo.com). *But cf.* John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 290 (2004) ("[F]rom some point in the 1980s until the late 1990s, the SEC shifted its enforcement focus away from actions against the Big Five accounting firms. . . ."); Cassell Bryan-Low, *SEC May Take Tougher Stance on Accountants in Audit Failures*, Wall St. J., Dec. 13, 2002, at A2 (in the quarter-century prior to 2003, the SEC sued large accounting firms less than ten times for audit failures); and Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. L. REV. 17, 60 (2003) (while SEC has formal authority to discipline accountants, that authority is rarely exercised).

[15] PricewaterhouseCoopers LLP, *2002 Securities Litigation Study* (2003) at 7, 9 (hereafter *PWC 2002 Study*). Available at http://pwcgobal.com.

[16] *Post-Reform Act Securities Case Settlements: Cases Reported Through December 2002*, Stanford Securities Class Action Clearinghouse 10 (2003) (hereafter *Settlements*). Available at http://www.securities.stanford.edu.

[17] 2004: A Year in Review, *supra* note 9, at 16. *See also* Edward P. Leibensperger & Lauren M. Papenhausen, *Auditor Liability for Securities Fraud After the PSLRA and Sarbanes-Oxley*, SHO83 ALI-ABA 543, 562 (May 2003) (inevitable result of Sarbanes-Oxley's focus on external auditors is increased likelihood of claims against them). In late 2004 it was estimated that there were $50 billion in claims

great significance for the settlement value of securities class action cases. Cases involving major accounting firms almost always settle.[18] One comprehensive study of securities class action litigation during the period January 1996 – December 2004 found that the naming of an accounting firm as a co-defendant increases settlements by more than two-thirds, controlling for all other characteristics of the case.[19] Other recent studies have reached similar conclusions.[20]

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outstanding against the Big Four accounting firms. *Called to Account – The Future of Auditing*, Economist, Nov. 19, 2004. Available at http://www.economist.com.

[18] Mukesh Bajaj, Sumon Mazumdar & Atulya Sarin, *Securities Class Action Settlements: An Empirical Analysis*, Stanford Securities Class Action Clearinghouse (2000) at 10 (hereafter *Empirical Analysis*). Available at http://www.securities.stanford.edu. Federal securities class actions almost always settle, whether or not they involve auditors. During the period 1996 to mid-2005, just four federal securities class actions involving post-PSLRA claims concluded in a trial verdict. Michael C. Tu, *Ten Years After the Reform Act: Trends in Securities Class Action Trials*, 19 SECURITIES REFORM ACT LITIG. RPTR. 475, 475-76 (July 2005).

[19] Elaine Buckberg, *et al., Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements* (Feb. 2005) at 7. Available at http://www.nera.com. The total value of settlements in U.S. private securities class actions was approximately $5.4 billion in 2004, the highest amount on record. PricewaterhouseCoopers LLP, *2004 Securities Litigation Study* (2005) at 7 (hereafter *PWC 2004 Study*). Available at http://pwcgobal.com. The average settlement amount in a post-PSLRA securities class action case has been almost $25 million, while the median amount has been less than $6 million. The disparity between these two figures represents the effect of a small number of settlements in excess of $100 million. Almost 65 percent of post-PSLRA cases have settled for less than $10 million. Settlements, *supra* note 16, at 3.

[20] *See* Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act Securities Settlements: Updated Through December 2004* (2005) at 7 (study of 620 securities class action settlements during period 1997 – 2004 finds that settlements as percentage of estimated damages increased from 3.4 % to 5.3% when accountant was named as defendant); Empirical Analysis, *supra* note 18, at 10 (study of 1,203 federal securities class action filings from 1988 to 1999 finds that mean and median settlements for cases involving accounting firms as co-defendants were much greater than mean and median for sample as a whole); Sherrie R. Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff's Perspective*, 1505 PLI/Corp 17, 33 (Sept. 2005) (approximately 14% of all post-PSLRA settlements have involved the issuer's accountant as a defendant, and these cases have produced significantly higher settlements). Prior to 2005 the largest settlement paid by a U.S. audit firm in a securities fraud class action suit was the $335 million that Ernst & Young paid in 1999 in connection with its audit of Cendant Corp. In 2002 Arthur Andersen offered to pay $750 million over a five-year period to settle litigation prompted by its audits of Enron Corp., but that offer was rejected. Andersen later collapsed. David Reilly, Jonathan Weil & Allesandra Galloni, *The Fall of Parmalat: Grant Thornton Is Likely To Face Skepticism It Was Ever a Victim*, Wall St. J., Dec. 29, 2003, at A2.

III.
CURRENT WEAKNESSES IN GAAP AND GAAS

GAAP and GAAS are the primary sets of standards that govern the reporting and auditing of financial results in the United States. An understanding of the standards and their sources thus is critical to an understanding of the scienter pleading requirement applicable to auditors. Equally critical is an understanding of the numerous limitations of both GAAP and GAAS. As will be seen, these limitations render the standards poor tools for measuring the conduct of auditors. Moreover, in numerous respects GAAP -- and to a lesser degree, GAAS -- have facilitated and even encouraged the recent accounting scandals. The next section of this Article discusses those topics.

A. The FASB and the PCAOB

The SEC is the primary federal agency that oversees the setting of accounting and auditing standards applicable to companies that are publicly traded in the United States. The SEC had delegated much of this responsibility prior to the enactment of Sarbanes-Oxley. The task of promulgating auditing standards was assumed by the Auditing Standards Board of the AICPA.[21] Responsibility for promulgating accounting standards was primarily delegated to the seven-member Financial Accounting Standards Board (FASB), created under the auspices of the Financial Accounting Foundation (FAF).[22]

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[21] *The Accounting Profession -- Major Issues: Progress and Concerns*, Report by U.S. General Accounting Office to House Comm. on Commerce 27 (Sept. 1996) (GAO/AIMD-96-98) (hereinafter *Accounting Profession*).

[22] The FAF has 16 trustees, 11 of whom are nominated by such constituent organizations as accounting companies and five of whom are elected "at-large" by the FAF's trustees. *Findings and Recommendations -- Part 2 (Corporate Governance) and Part 3 (Audit and Accounting)*, Conference Board Commission on Public Trust and Private Enterprise 40 n.49 (2003) (hereafter *Conference Board Commission, Parts 2 and 3*). Available at http://www.conference-board.org/pdf_free/757.pdf. The primary tasks of the FAF trustees are to raise funds to cover operating expenses and to appoint members of FASB. Paul B. W. Miller, Rodney J. Redding & Paul R. Bahnson, The FASB: The People, the Process and the Politics 20 (4th ed. 1998) (hereafter *The FASB*). *See generally* J. Richard Williams, *Funding FASB: Public Money, Public Domain*, CPA J., May 2004 (available at http://www.nysscpa.org); Tracy N. Tucker, *It Really Is Just*

Since its creation in 1973, most authoritative accounting standards have been issued by the FASB.[23] The SEC can adopt its own rules when the FASB is silent or when the SEC concludes that other principles will be more useful, but the SEC has rarely exercised this power. It officially overruled the FASB only once between 1973 and 2003.[24]

Prior to the creation of the FASB, accounting standards were issued by predecessor organizations. From 1939 to 1959, standards were issued by the American Institute of Accountants' (AIA) Committee on Accounting Procedure (CAP) in the form of Accounting Research Bulletins (ARBs). The 51 ARBs issued by CAP merely suggested accounting practices, rather than mandating them, and alternative methods were permitted. Subsequently, during the period 1959 to 1972, standards were issued by the AICPA's (the successor to the AIA) Accounting Principles Board (APB).[25] The APB issued a few dozen Opinions, many of which have since been superseded. The accomplishments of both CAP (controlled by practicing accountants) and the APB

Trying to Help: The History of FASB and Its Role in Modern Accounting Practice, 28 N.C. J. INT'L LAW & COM. REG. 1023 (2003).

[23] *See* Robert E. Litan, *Policy Brief No. 97 -- The Enron Failure and the State of Corporate Disclosure* 5 (2002) ("The SEC has effectively contracted out the setting of accounting standards to the FASB. . . .") Available at http://www.brook.edu/dybdocroot/comm/policybriefs/pb97.pdf. Additional sources of GAAP are the Governmental Accounting Standards Board (created in 1984 to set standards for state and municipal entities) and the Federal Accounting Standards Advisory Board (created in 1990 to set standards for federal government accounting). *See* Pierre L. Titard & Dean W. DiGregorio, *The Changing Landscape of Accounting Standards Setting*, CPA J., Nov. 2003. Available at http://www.cpajournal.com.

[24] The one example involved the FASB's drafting of rules in the 1970s for oil and gas exploration and development costs. Craig Schneider, *Who Rules Accounting? Congress Muscles in on FASB – Again*, CFO Magazine, Aug. 1, 2003. Available at http://www.cfo.com.

[25] *Study Pursuant to Section 108(b) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*, Securities and Exchange Commission 20-21 (2003) (hereafter *Section 108(b) Study*).

(controlled by accountants and business representatives) were minimal.[26] After the APB was disbanded, the FASB became the primary standard-setter.

The FASB retains authority to promulgate GAAP even under Sarbanes-Oxley,[27] but the Public Company Accounting Oversight Board (PCAOB) -- created pursuant to the legislation to regulate and discipline the accounting industry – has become the ultimate arbiter of accounting standards.[28] The PCAOB replaced the ineffective Public Oversight Board (POB), which was established in 1977 and terminated in May 2002.[29] The POB was a captive of the auditing industry. It was funded by membership dues of the AICPA's SEC Practice Section (SECPS), and its charter provided for the POB to submit its budget to the SECPS Executive Committee and (if the AICPA Board of Directors so requested) the AICPA Board, for consultation. The Charter also capped the POB's annual budget, at the direction of the AICPA.[30] The POB had no subpoena power and

[26] *See*, *e.g*., George Mundstock, *The Trouble with FASB*, 28 N.C. J. INT'L LAW & COM. REG. 813, 829 (2003) ("If . . . the CAP was structured to assure that it would make little progress in prescribing accounting principles, the APB was structured to do even less. . . ."); Section 108(b) Study, *supra* note 25, at 21 (both CAP and APB were unsuccessful in setting standards).

[27] Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws*, 28 N.C. J. INT'L L. & COM. REG. 725, 790 (2003). *Accord* Harold S. Bloomenthal, Sarbanes-Oxley Act in Perspective 41 (2002) (Sarbanes-Oxley clearly intends for the FASB to continue to be standard-setting board). In 2003, the SEC issued a Policy Statement reaffirming the role of FASB as the principal standard-setter in the U.S. *See* Testimony of Robert H. Herz (FASB chairman) Before House Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises 2, June 3, 2003. Available at http://www.fasb.org/news/06-03-03_testimony.pdf. *Cf.* Stephen Taub, *Take the Lead, Says SEC to PCAOB*, CFO Magazine, July 16, 2004 (SEC expects PCAOB to become primary standard-setter). Available at http://www.cfo.com.

[28] Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 133 (2002).

[29] *See* http://publicoversightboard.org/about.htm.

[30] *The Accounting Profession: Status of Panel on Audit Effectiveness Recommendations to Enhance the Self-Regulatory System*, Report by U.S. General Accounting Office to House Comm. on Energy and Commerce 15 (May 2002) (GAO-02-411). Available at http://www.gao.gov.

little ability to impose penalties.[31] The POB ultimately voted to terminate its existence in protest of efforts by the AICPA and the major accounting firms to further marginalize its oversight role.[32] In the 25 years prior to this vote the POB never sanctioned a major accounting firm, even when peer reviews uncovered serious shortcomings in audit procedures.[33]

The successor PCAOB consists of five members appointed by the SEC. A majority of its members are non-CPAs and its Chair cannot have practiced public accounting for at least five years prior to assuming the position. PCAOB members serve full-time five-year terms (with a two-term limit) and are subject to removal for cause by the SEC. In addition to appointing PCAOB members, the SEC must approve the PCAOB's annual budget, support fees, rules, and professional standards. The SEC also acts as an appellate authority for PCAOB disciplinary actions and disputes related to inspection reports about accounting firms.[34]

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[31] Steve Liesman, Jonathan Weil & Michael Schroeder, *Dirty Books? Accounting Debacles Spark Calls for Change: Here's the Rundown*, Wall St. J., Feb. 6, 2002, at A1.

[32] Thomas W. Morris, *The Accounting Credibility Crisis*, CPA J., May 2003 (quoting former POB chairman Charles Bowsher) (available at http://www.cpajournal.com); Scot J. Paltrow & Jonathan Weil, *Accounting Industry Review Board Votes To End Its Existence in Protest*, Wall St. J., Jan. 23, 2002, at A2. This vote took place after the AICPA ended the POB's funding, in response to the POB's agreement with the SEC's request to examine the Big Five's compliance with standards for auditor independence. Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 994-95 (2005).

[33] Barbara Roper, *Investor Protection Lessons from the Enron Collapse and an Agenda for Reform – Report of Consumer Federation of America* 10, Feb. 11, 2002. Available at http://www.consumerfed.org/enron_auditor_rpt.pdf.

[34] Testimony of William H. Donaldson (SEC chairman) Before House Comm. on Financial Services, Sept. 17, 2003. Available at http://sec.gov/news/testimony/091703tswhd.htm. *See also* Daniel Goelzer, et al., *The Work of the Public Company Accounting Oversight Board*, SK017 ALI-ABA 415 (Oct. 2004); Cassell Bryan-Low, *Accounting Panel Plans Inspections of Big Four Firms*, Wall St. J., May 2, 2003, at C9. The PCAOB planned to inspect hundreds of small accounting firms in 2005, compared with only 91 such inspections in 2004. Craig Schneider, *PCAOB Prepares to Ramp Up Inspections*, CFO Magazine, March 22, 2005. Available at http://www.cfo.com.

The PCAOB differs from the POB in several important respects, including source of funding. The PCAOB's annual budget is funded by 5,000 or so public companies, 3,000 or so open-end mutual funds, and other investment companies, with fees based on average monthly market capitalization. The 1,000 largest companies in the U.S. shoulder most of the burden, contributing about 87 percent of the total budget. Accounting firms contributed only $2 million of the PCAOB's $103 million budget in 2004.[35] The foregoing split is designed to reinforce the PCAOB's independence from the accounting profession.[36] The PCAOB is clearly more independent than was the predecessor POB. Whereas the POB engaged in virtually no disciplinary action, in 2005, two years after it was created, the PCAOB censured several public accounting firms, by revoking their registrations.[37]

B. Sources of GAAP

The meaning of the term "GAAP" has varied over time. Originally, GAAP referred to accounting policies and procedures that were widely used in practice by accountants. Later, the term came to refer more to the pronouncements issued by accounting bodies such as the FASB. Today, many different sources of authoritative

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[35] *See* Nagy, *supra* note 32, at 1021; *Accounting Board Votes To Lift Budget 51% To $103 Million*, Wall St. J., Nov. 26, 2003; and Judith Burns, *Bills Come Due To Cover the Cost of Oversight Panel*, Wall St. J., Aug. 6, 2003, at C9.

[36] *But see* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 944 (2003) (suggesting that these measures are more structure than substance).

[37] Stephen Taub, *PCAOB Revokes Two Registrations*, CFO Magazine, Dec. 2, 2005 (available at http://www.cfo.com); Stephen Taub, *PCAOB Brings First Action*, CFO Magazine, May 25, 2005 (available at http://www.cfo.com). Also in 2005, the PCAOB launched its first formal probe of a Big Four accounting firm. Deloitte & Touche was investigated in connection with its 2003 audit of Navistar International Corp. Stephen Taub, *PCAOB Probing Deloitte Audit*, CFO Magazine, July 8, 2005 (available at http://www.cfo.com).

literature exist,[38] some of which are still in effect but are no longer being issued.[39] These authoritative sources are organized unto a hierarchy of five categories, which was established in 1975 by AICPA's Statement on Auditing Standards No. 69. Conflicts that exist between authoritative sources are supposed to be resolved according to the relative placement of the authority in the chain. When multiple sources of GAAP within a given level of the hierarchy conflict, the approach that better portrays the substance of the transaction should be followed.[40]

The current GAAP hierarchy is organized as follows: Level A -- FASB's Statements of Financial Accounting Standards (FAS) and Interpretations, APB Opinions, and ARBs; Level B -- FASB Technical Bulletins, and AICPA Industry Audit and Accounting Guides and Statements of Position; Level C -- Emerging Issues Task Force (EITF) Consensuses and AICPA Practice Bulletins; and Level D -- AICPA accounting interpretations, FASB staff Q&As, and industry practice. Other literature that may be consulted by accountants include AICPA Issues Papers, textbooks, and articles in professional journals.[41] The foregoing constitutes the fifth level. In total, there are probably thousands of rules and interpretations that comprise GAAP.[42]

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[38] The Supreme Court has observed that "[f]ar from a single-source accounting rulebook, GAAP encompasses the conventions, rules, and procedures that define accepted accounting practices at a particular point in time." Shalala v. Guernsey Mem. Hosp., 514 U.S. 87, 101 (1995).

[39] Examples include APB Opinions and ARBs. Jan R. Williams, Miller GAAP Guide -- Restatement and Analysis of Current FASB Standards, at xiii (2005).

[40] *Id.*

[41] Section 108(b) Study, *supra* note 25, at 41. *See* Matthew A. Melone, *United States Accounting Standards – Rules or Principles?*, 58 U. MIAMI L. REV. 1161, 1173-74 (2004).

[42] George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 EMORY L.J. 1325, 1334 (2003). In 2005, the FASB proposed to adopt its own GAAP hierarchy that would be directed toward companies and reporting entities, in place of the current AICPA standard, which is

Currently, much of GAAP is compiled in a three-volume set of Original Pronouncements (FASB FASs, AICPA Pronouncements, FASB Interpretations, FASB Concepts Statements, and FASB Technical Bulletins) that encompasses over 4,500 pages.[43] By 2005, 153 FASs -- the primary source of GAAP -- had been issued. Thirty-three of these standards had been rescinded or superseded.[44] The FASB takes years to issue new standards. While specific standards typically take two years to issue, many take much longer. The initial derivatives standard (FAS No. 133) took more than a decade.[45]

Some GAAP rules are extremely complex. The standard on derivatives (FAS No. 133 -- "Accounting for Derivative Instruments and Hedging Activities") encompasses 800 or so pages,[46] following carve-outs for hedging deals, forward contracts for

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directed toward auditors. Craig Schneider, *FASB Reexamines GAAP Hierarchy*, CFO Magazine, Aug. 29, 2005. Available at http://www.cfo.com.

[43] Original Pronouncements, Vols. I, II, and III, Financial Accounting Standards Board (2002). *See also* Dana A. Basney, *Selected Case Studies of Financial Statement Fraud*, 1406 PLI/Corp 323, 334 (Jan. – Feb. 2004) (accounting and auditing rules include 192 Ethics Interpretations, 150 FASB Pronouncements, 102 Staff Accounting Bulletins, 100 Statements on Auditing Standards, 46 FASB Interpretations, 43 Accounting Research Bulletins, 31 Opinions, 30 Auditing Interpretations, and 14 ACSEC Practice Bulletins): Walter Wriston, *The Solution to Scandals? Simpler Rules*, Wall St. J., Aug. 5, 2002, at A10 (arguing that 4,530 complex pages of GAAP have contributed to recent accounting scandals in the United States). *Cf.* Mike McNamee & Kerry Capell, *FASB: Rewriting the Book on Bookkeeping*, BusinessWeek Online, May 20, 2002 (GAAP consists of 100,000-plus pages of rules). Available at http://www.businessweek.com. This much higher estimate no doubt includes sources from all five levels of GAAP.

[44] All 153 FASs are available on the FASB's Web site. *See* http://www.fasb.org.

[45] Accounting Profession, *supra* note 21, at 102. *See also* David C. Cates, *Time for New Metrics: Sarbanes-Oxley Is Part of the Solution, But a Management/Analyst-Led Shift To Non-GAAP Metrics Could Lead To True Transparency*, 95 A.B.A. BANKING J. 45 (Apr. 1, 2003) (rule-making process of GAAP-based accountancy moves at glacial pace).

[46] Steve Liesman, Jonathan Weil & Michael Schroder, *Dirty Books? Accounting Debacles Spark Calls for Change: Here's the Rundown*, Wall St. J., Feb. 6, 2002, at A1. FAS No. 133 was amended by FAS No. 149 in April 2003. The latter standard is effective for contracts entered into or modified after June 30, 2003. *See* http://www.fasb.org/st/summary/stsum149.shtml. Earlier, FAS No. 137 delayed application of No. 133 by one year, and FAS No. 138 clarified No. 133.

materials, insurance policies, and other special cases.[47] Leases are covered by 16 FASB Statements and Interpretations, nine Technical Bulletins, and more than 30 EITF Issues.[48] This dispersion of authority is not unique to accounting for leases. The accounting profession does not have a single, searchable database containing all of the authoritative guidance pertaining to many kinds of transactions.[49]

C. Limits of GAAP

A common assertion by the SEC is that United States GAAP is superior to all other sets of accounting standards in the world,[50] but there is a "dearth of empirical evidence to support the assertion."[51] U.S. GAAP has numerous limitations that show it is far removed from an ideal measuring rod against which alleged accounting violations in securities fraud actions can be tested. Indeed, certain aspects of GAAP have facilitated or encouraged the recent wave of accounting fraud. The next section of this Article considers GAAP limitations in five areas: (1) accounting for stock options; (2) accounting for pension liabilities; (3) accounting for off-balance sheet liabilities; (4) accounting for intangible assets; and (5) general use of a rules-based system. As will be seen, GAAP does a remarkably poor job in each of these five subject areas, and

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[47] McNamee & Capell, *supra* note 43.

[48] Section 108(b) Study, *supra* note 25, at 24.

[49] *Id*. at 44.

[50] *See*, *e.g.*, *id.* at 5. *Accord 2002 Annual Report*, Securities and Exchange Commission 98 ("U.S. GAAP has long been recognized as the most comprehensive and robust body of accounting guidance in the world."). Available at http://www.sec.gov.pdf/annrep02/ar02full.pdf. *See also* Kenji Taneda, *Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation*, 2003 COLUM. BUS. L. REV. 715, 751 ("Americans generally take it for granted that U.S. GAAP is the world's most stringent. . . .").

[51] Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 28 (2003). *See also* Christian Luez, *IAS v. U.S. GAAP: Information Asymmetry-Based Evidence from Germany's New Market*, 41 J. ACCT. RES. 445, 469 (2003) (U.S. GAAP does not does not produce financial statements of higher informational quality than do international accounting standards).

Sarbanes-Oxley does nothing to improve performance.[52] A sixth significant area of weakness in the U.S. financial reporting model -- the widespread use of misleading pro forma reports -- also is examined. Numerous other limitations of the U.S. model, including GAAP's inability to adequately account for revenue recognition, are beyond the scope of this Article.

(1) Stock Options

GAAP's treatment of stock options dates back at least to 1972, when the APB (FASB's predecessor) issued APB Opinion 25. That rule ("Accounting for Stock Issued to Employees") specified that the cost of options at the grant date[53] should be measured by their intrinsic value -- the difference between the current fair market value of the stock and the exercise price of the option. No cost was assigned to options when their exercise price was set at the current market price. The APB approach became obsolete a year later, as a result of two events. The first was the publication of the Black-Scholes option-pricing model, which correlates the current price of a stock, its price volatility, the risk-free interest rate, the strike price of the option, and its time to expiration.[54] The

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[52] Benston, *supra* note 42, at 1347-48 (Sarbanes-Oxley is not concerned with reform of GAAP or the GAAP-related reasons that gave rise to recent accounting scandals); Andrew F. Kirkendall, Comment, *Filling in the GAAP: Will the Sarbanes-Oxley Act Protect Investors from Corporate Malfeasance and Restore Confidence in the Securities Market?*, 56 SMU L. Rev. 2303, 2323 (2003) (Sarbanes-Oxley does little to remedy the problems caused by GAAP).

[53] The grant date is the date that a company awards a stock option to an employee. *Understanding the Stock Option Debate*, Report by the Joint Economic Comm. 1 (2002). Available at http://www.jec.senate.gov/stock_options.pdf. *See generally* Melissa A. Chiprich & Phillip J. Long, *Is Midnight Nearing for Cinderella? Corporate America Faces Reality with Stock Option Accountability*, 39 WAKE FOREST L. REV. 1033 (2004).

[54] *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. Pol. Econ. 637 (1973); Fischer Black & Myron Scholes, *The Valuation of Option Contracts and a Test of Market Efficiency*, 27 J. FIN. 399 (1972). *See generally* Joseph Blasi, Douglas Kruse & Aaron Bernstein, In the Company of Owners: The Truth About Stock Options (and Why Every Employee Should Have Them) 71 (2003) (hereafter *Truth About Stock Options*).

publication of this model enabled investors and employees to effectively price options for the first time, and this ability sparked a booming market for publicly-traded options. The second event was the opening of the Chicago Board Options Exchange (CBOE) by the Chicago Board of Trade. Previously, options had been traded over the counter. By providing an open market, the CBOE turned options into a mainstream investment.[55]

APB 25 was widely criticized, but FASB did not undertake a project to reconsider the issue until 1984. It took almost another decade before FASB issued an Exposure Draft of a new standard that would have required expensing of stock options.[56] This draft of FAS No. 123, issued in 1993, was greeted with severe criticism from Congress and the high-technology industry.[57] The Big Six public accounting firms also unanimously opposed the FASB's plan.[58] The FASB backed down when confronted with such tremendous pressure, and its Exposure Draft was revised to eliminate expensing. In 1995 the FASB issued the final version of FAS No. 123. This new rule ("Accounting for Stock-Based Compensation") only required footnote disclosures of fair values of fixed

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[55] *See* Zvi Brodie, Robert S. Kaplan & Robert C. Merton, *For the Last Time: Stock Options Are an Expense*, HARV. BUS. REV. 62, 63 (March 2003).

[56] *See generally* Joyce Strawser, *Accounting for Stock-Based Compensation: The FASB's Proposal*, 63 C.P.A. J. 44 (1993).

[57] Legislation was introduced by Sen. Joseph Lieberman that would have prohibited public companies from following any final FASB rule requiring expensing. This bill would have nullified the effect of proposed FAS No. 123 and effectively put the FASB out of business. *See* Craig Schneider, *Who Rules Accounting? Congress Muscles in on FASB – Again*, CFO Magazine, Aug. 1, 2003 (Senate ultimately voted 88 to 9 in favor of non-binding resolution urging FASB not to require expensing) (available at http://www.cfo.com). *Accord* Pat McConnell & Janet Pegg, *Bear Stearns Equity Research – Employee Stock Option Expense: Is the Time Right for Change?* 8-9 (July 2002) (Congress threatened to abolish FASB if the board did not back down). Available at http://www.bearstearns.com.

[58] The FASB, *supra* note 22, at 139.

plan employee stock options. It did not require that stock-based compensation be reported as an expense in determining an enterprise's net income.[59]

Following the issuance of FAS No. 123, virtually no corporations elected to adopt the fair value method of reporting employee stock options as an expense in their income statements. By May 2002, only two companies (Boeing Co. and Winn-Dixie Stores, Inc.) in the S&P 500 reported options as an expense.[60] This was true even though stock option programs had become the standard practice of the vast majority of S&P 500 companies.[61] Moreover, such programs were not restricted to the S&P 500. By 2002, the 1,500 largest public companies in the U.S. had issued at least 12 billion options, with an estimated value of $820 billion. This accounted for ten percent of the value of all outstanding shares in the 1,500 companies, which in turn represented the bulk of the value of all publicly traded shares in this country.[62]

In October 2003, the FASB circled back to the position it originally took in 1993 and again proposed expensing of options. An Exposure Draft reflecting this decision was issued by the FASB in the first quarter of 2004. A final rule -- FAS 123R -- was issued

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[59] Steven Balsam, Haim A. Mozes & Harry A. Newman, *Managing Pro Forma Stock Option Expense Under SFAS No. 123*, 17 ACCT. HORIZONS 31, 33 (2003). *See also* Abraham J. Brilof, *Accounting for Stock Options*, CPA J., Dec. 2003 (FAS 123 has been universally condemned). Available at http://www.cpajournal.com.

[60] David M. Blitzer, Robert E. Friedman & Howard J. Silverblatt, *Measures of Corporate Earnings* 4 (2002). Available at http://www.standardandpoors.com.

[61] McConnell & Pegg, *supra* note 57, at 8.

[62] Truth About Stock Options, *supra* note 54, at 186. Another estimate is that S&P 500 companies granted about 24.9 billion stock options during the period 1998-2001. The total value of these options increased from $43 billion to $105 billion during the same time period. McConnell & Pegg, *supra* note 57, at 11-12. Some options payouts have been staggering -- $706 million for Larry Ellison of Oracle Corp., $233 million for Michael Dell of Dell Computer, $200 million for Sanford Weill at Citigroup, and $174 million for Thomas Siebel of Siebel Systems. Matt Murray, *Options Frenzy: What Went Wrong?*, Wall St. J., Dec. 17, 2002, at B1.

in late 2004, with mandatory expensing to first be reflected for many companies in profits reported for first quarter 2006.[63] In the interim, voluntary expensing, while increasingly common, was the clear exception. By December 2005, 65% of public companies still had not begun to comply with 123R, including 86% of health care companies and 76% of technology companies – traditionally the biggest issuers of stock options.[64] Moreover, many companies that did expense switched from stock options to restricted stock,[65] and then issued pro forma earnings reports that excluded the cost of such stock.[66]

The effect on earnings of the failure to expense options historically has been significant. If options had been expensed in 2002 by all companies in the S&P 500, 23 percent of the earnings of these corporations would have been erased.[67] The more recent effect has been less pronounced, partly because corporate profits have grown faster than expected (thereby reducing the relative importance of option costs), and the value of

[63] Stephen Taub, *Staggered Start for Options Expensing*, CFO Magazine, June 1, 2005 (available at http://www.cfo.com); Stephen Taub & Dave Cook, *SEC Postpones Options-Expensing Rule*, CFO Magazine, Apr. 18, 2005 (available at http://www.cfo.com); and Louis Lavalle, *Time to Start Weighing the Options; New FASB Rules Make Stock Options An Expense. How Will Companies Cope?*, BusinessWeek, Jan. 17, 2005, at 32. The International Accounting Standards Board announced in 2004 that companies using international accounting standards must expense stock options beginning January 1, 2005. This decision will affect about 7,000 publicly traded companies in 90 countries, excluding the United States. Stephen Taub, *This Year's Leap: Expensing Options*, CFO Magazine, March 1, 2004. Available at http://www.cfo.com.

[64] Stephen Taub, *Companies Slow to Expense Options*, CFO Magazine, Dec. 12, 2005. Available at http://www.cfo.com.

[65] "Restricted stock" refers to shares issued to employees that can be sold only in the future. Typically, employees forfeit their shares if they leave the company before the stock vests. At some companies, an employee forfeits the shares if certain financial targets are not met. Ruth Simon, *The Employee Guide to Restricted Stock*, Wall St. J., July 10, 2003, at D1. A 2005 survey of 115 companies found that 43% of the companies had moved portions of their long-term incentive compensation from stock options to restricted stock. Stephen Taub, *Survey Finds Shift from Stock Options*, CFO Magazine, May 24, 2005 (available at http://www.cfo.com).

[66] *See*, *e.g.*, Craig Schneider, *Stock Options, Meet Pro Formas*, CFO Magazine, Oct. 31, 2005 (available at http://www.cfo.com); Stephen Taub, *FAS 123R Reining in Tech Options*, CFO Magazine, July 21, 2005 (available at http://www.cfo.com).

[67] Nanette Burns, *Beyond Options*, BusinessWeek, July 28, 2003, at 36.

options granted has sharply declined.[68] Recent estimates are that expensing would reduce earnings of the S&P 500 by five percent in 2005[69] and by three percent in 2006.[70] The most significant impact will be in the high-technology industry. A Merrill Lynch study projected that expensing stock options would result in a decline of approximately 70 percent in earnings per share in that industry, compared with declines of 12 percent in the telecom industry, nine percent in the consumer and materials industries, and from two to seven percent in other industries.[71]

Moreover, stock option awards that were excluded from income statements made a major contribution to the accounting scandals that began to unfold in the late 1990s. Executives with significant options that are linked to corporate performance have powerful incentives both to maintain the market price of their stock by inflating reported net income and to pressure their external auditors to approve improper accounting.[72]

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[68] *No Compensation Without Costs*, Economist, Oct. 27, 2005 (available at http://www.cfo.com).

[69] Lavelle, *supra* note 63, at 36 (expensing will reduce S&P 500 earnings by $3 to $4 per share in 2005 -- roughly a five percent slice off estimated average earnings of $65 per share).

[70] *No Compensation Without Cost*, Economist, Oct. 27, 2005 (available at http://www.economist.com).

[71] *See Finding and Recommendations -- Part 1: Executive Compensation*, The Conference Board Commission on Public Trust and Private Enterprise 5 n.6 (Sept. 17, 2002). *Accord Now for Plan B: The Battle to Fend Off Sensible Accounting*, Economist, March 13, 2003 (expensing options under the Black-Scholes method would cut technology firms' reported profits by 70 percent). Available at http://www.economist.com. *But cf.* Stephen Taub, *Options Expenses Now A Factor in S&P 500*, CFO Magazine, Nov. 21, 2005 (expensing in 2005 will decrease earnings by 18% for companies in information technology sector) (available at www.cfo.com); *No Compensation Without Cost*, Economist, Oct. 27, 2005 (expensing in 2006 will reduce consensus profit estimate by 23% for semiconductors and semiconductor equipment sector) (available at http://www.economist.com).

[72] *See*, *e.g.*, Arthur Levitt, Jr., *Reclaiming the Profession's Heritage*, CPA J., Feb. 2004 (accounting standards -- especially as they relate to to expensing of stock options -- were a catalyst to recent accounting scandals) (available at http://www.cpajournal.com); Matt Murray, *Corporate Governance (A Special Report)*, Wall St. J., Oct. 27, 2003, at R10 (abuses in executive compensation can lead to executives applying undue pressure on accounting firms to overlook certain accounting treatments in order to keep stock prices high) (statement of Peter C. Chapman, senior vice president at TIAA-CREF); Craig Schneider, *Who Rules Accounting? Congress Muscles in On FASB – Again*, CFO Magazine, Aug. 1, 2003 (widespread use of non-expensed stock options had led to inflated stock-market valuations and accounting frauds) (available at http://www.cfo.com).

These incentives to engage in fraudulent conduct are not purely hypothetical. A study of 71 companies subject to SEC enforcement actions for accounting violations found that the CEOs of such companies had much larger stock option holdings than CEOs of companies not involved in accounting irregularities.[73] While the prevailing built-in incentives to engage in fraudulent behavior could be minimized by indexing options to alternate measures such as the performance of peer companies, an industry, or the economy in general,[74] to date few corporations have chosen that path. The situation is not likely to change.[75]

(2) Pensions

GAAP's treatment of pensions has been as deeply flawed as its treatment of options. Currently, accounting for pensions primarily takes place pursuant to FAS No. 87 ("Employers' Accounting for Pensions"), which was issued in December 1985. This standard was issued 11 years after the Employee Retirement Income Security Act[76] was enacted.[77] The fundamental flaw in FAS No. 87 is that it permits the use of various accounting techniques that fall under the rubric of "smoothing." The techniques include: (1) reporting expected return on assets, rather than actual gains or losses, and (2) placing certain assets and obligations off the balance sheet and amortizing them over time as

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[73] Joanne S. Lublin, *Deals and Deal Makers: Study Blames Accounting Fraud on Takeover Fever, Age of Officers*, Wall St. J., July 3, 2003, at C4.

[74] Marie Leone, *Stronger Than Dirt*, CFO Magazine, Oct. 17, 2003. Available at http://www.cfo.com.

[75] *See, e.g.,* Marie Leone, *Compensation and Cash Flow*, CFO Magazine, Jan. 16, 2004 (20% of largest U.S.-based, publicly-held companies use a cash-flow metric to calculate short-term compensation, and the number of such companies is rising) (available at http://www.cfo.com).

[76] 29 U.S.C. §§ 1001, *et seq*. (2000).

[77] David Zion & Bill Carache, *Credit Suisse First Boston Equity Research -- The Magic of Pension Accounting* 37 (Sept. 27, 2002). Available at http://www.csfb.com.

income or expenses.[78] The permitted use of these techniques led one comprehensive study to describe pension accounting under GAAP as "convoluted, complicated, [and] misleading."[79]

With respect to the first factor, GAAP provides little guidance for setting the assumed return, and the assumptions used vary widely.[80] The median expected rate of return used by companies in the S&P 500 was 9.2 percent in 1997 and remained at that level until 2002.[81] Yet, the actual rate of return has been much lower.[82] The net effect on S&P 500 earnings of the disparity between expected and actual rates of return for pension plans has been substantial. If actual rates of return had been used, the aggregate earnings of the S&P 500 would have plunged by 67 percent (more than $100 billion) in 2001 and 2002.[83] More recent data is less dramatic, but still compelling. From 2000-2003, the

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[78] Arden Dale, *Audit Watchdog Targets Pensions*, Wall St. J., Dec. 11, 2002, at B5.

[79] Zion & Carcache, *supra* note 74, at 4. *See also* Mary Williams Walsh, *Pension Reserve: What's Enough?*, N.Y. Times, June 22, 2003, at 3:1 ("Accounting is a dismal science, pension accounting even more so.").

[80] Scott Sprinzen, *Pitfalls of U.S. Pension Accounting and Disclosure* 5 (March 3, 2003). Available at http://www.standardandpoors.com. *See also America's Corporate Pensions Need Reform, Not Tinkering*, Economist, Sept. 11, 2003 (reported pension fund income is whatever a company says it expects it to be) (available at http://www.economist.com).

[81] Zion & Carache, *supra* note 77, at 82.

[82] For example, the actual rate of return on pension plan assets for the S&P 500 was –7.5 percent in 2001 and only 4.94 percent in 2000. The vast majority of plans lost value in 2001. Zion & Carache, *supra* note 77, at 86-87. *See also* Thomas T. Amlie, *Finding the True Cost of Pension Plans*, CPA J., Jan. 2004 ("Over the past few years, most businesses have suffered losses on their pension plan assets while continuing to use positive expected rates of return in computing periodic pension costs.") (available at http://www.cpajournal.com); Elizabeth McDonald, *Pension Panic*, Forbes.com, Dec. 10, 2002 (while S&P 500 companies expected their pension plans to return on average 9.2% in 2001, such plans had an actual average loss of 6.9%) (available at http://www.forbes.com).

[83] Mary Williams Walsh, *New Scrutiny on Auditing of Pensions*, N.Y. Times, June 23, 2005, at C1. *Cf.* Joseph McCafferty, *Pension Accounting a Sham*, CFO Magazine, Jan. 2003 (study by actuarial firm Milliman USA shows that 50 of the largest U.S. companies counted roughly $54 billion of pension fund gains as profits in 2002, when they actually lost almost $36 billion). Available at http://www.cfo.com. *See also* Judith Burns, *Pension Plan Gains Inflated S&P 500 Stocks -- Fed Study*, Aug. 19, 2003 (pension accounting distortions inflated stock prices for S&P 500 firms by 10% on average, while prices for dozens

pension plans of 100 of the largest U.S. companies earned, on average, an annual investment return of only 1.3 percent, while the plans used average expected rates of return that did not dip below nine percent until 2003.[84] If actual return rates had been used during this time period, aggregate earnings would have markedly declined.[85]

The second smoothing technique permitted by GAAP is the placement of certain pension plan assets and obligations off the balance sheet and the amortization of them over time as income or expenses. For example, S&P 500 companies carried an estimated $992 billion in off-balance sheet liabilities and $900 billion in off-balance sheet assets at the end of 2001. If the total off-balance sheet pension liability for S&P 500 companies were treated as debt, aggregate debt for the S&P 500 would have increased by 16 percent in 2001. Debt would have more than doubled for 71 companies and more than tripled for

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of firms were inflated by 20%) (available at http://news.morningstar.com/news/DJ/M08/D19/1061321463918.html0); David Henry, *Tripping Over Pension Shortfalls*, BusinessWeek Online, May 14, 2003 (magic of pension accounting boosts corporate profits) (available at http://www.businessweek.com).

[84] Data reported at http://www.milliman.com/eb/pension-fund-survey/. *See also* Elizabeth McDonald, *Pension Pangs*, Forbes.com, June 9, 2003 (S&P 500 companies were using a median expected return rate of 8.8% in 2003). Available at http://www.forbes.com. A separate survey of 100 large U.S. corporations found a median expected rate of return of 8.55% in 2003 (data available at http://www.milliman.com/eb/pension-fund-survey); Craig Schneider, *One Giant Leap for Pension Returns*, CFO Magazine, Apr. 16, 2004. Available at http://www.cfo.com.

[85] Boeing Co. lost $3.3 billion on pension investments in 2002, but reported a $404 million pension gain based on its assumed 9% rate of return. This was 82% of its net income for the year. More generally, it is estimated that $2 of the $55 earnings per share for companies in the S&P 500 in 2003 came from aggressived pension return assumptions. *Pumped Up Pension Plays?*, BusinessWeek Online, Oct. 25, 2004. Available at http://www.businessweek.com. *But see* Alix Nyberg Stuart, *Death to Smoothing*, CFO Magazine, Feb. 22, 2005 (recent sudy shows that actual median annualized asset return for large corporate pension funds was 9.4% during period 1993-2003, compared with average assumed rate of return of 8.8%). Available at http://www.cfo.com.

36 companies.[86] More recently, an SEC study released in June 2005 suggests that U.S. companies are still carrying $414 billion in pension liabilities off-balance sheet.[87]

In sum, the smoothing permitted by FAS No. 87 renders financial statements misleading, because it removes pension plan volatility, thereby distorting both the balance sheet and the income statement.[88] These distortions give firms the flexibility to manipulate earnings. A 2004 study of 3,247 company pension plans during the period 1991-2002 found that firms tended to hike pension-return assumptions the year before buying a company, or before their chief executive exercised his stock options.[89] The distortions also tend to mask the true extent of pension plan underfunding, which increased from $39 billion in 2000 to at least $450 billion in 2004.[90] While the FASB ultimately may attempt to resolve these issues, by December 2005 it had simply tweaked the accounting standard applicable to the reporting of pension obligations, without

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[86] Zion & Carache, *supra* note 77, at 5. *See also Time to End A Scandal*, Economist, Oct. 28, 2004 (if they had properly accounted for their pension obligations, many large companies might be bankrupt) (available at http://www.economist.com).

[87] *See* Lisa Yoon, *Rethink Off-Balance-Sheet Reporting: SEC*, CFO Magazine, June 18, 2005 (available at http://www.cfo.com).

[88] Zion & Carache, *supra* note 77, at 45. *See also Funded Status of Defined Benefit Pension Plans Continued To Decline in 2002*, FTI Consulting (June 2003) (smoothing permitted by GAAP has resulted in pervasive and sometimes massive distortions between net pension pre-paid asset or accrued liability of companies and the actual funding deficit or surplus of their plans) (available at http://www.fticonsulting.com/press_releases/FTI_Pension_Fund_Analysis.pdf); Jonathan Weil, *Pension-Plan Accounting Rules Led To Overvalued Stock*, Wall St. J., March 28, 2003, at C7 (study by Federal Reserve Board shows that stocks of companies reporting substantial earnings from their pension plans were systematically overvalued in recent years, as a result of application of GAAP).

[89] *Murk in the Gloom: An SEC Investigation Will Shine Much-Needed Light on the Sorry State of Accounting for Retiree Benefits*, Economist, Oct. 28, 2004. Available at http://www.economist.com.

[90] *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, U.S. General Accounting Office, GAO-05-294 (May 2005) at 9, 11. The S&P 500 represents only a share of this funding gap. At the end of 2004, the 369 S&P 500 companies that offered defined-benefit plans were underfunded by a total of $164 billion. Stephen Taub, *Pension Funding Holding Steady*, CFO Magazine, July 18, 2005. Available at http://www.cfo.com.

making substantive changes to FAS No. 87.[91] This tweaking, which has had little effect,[92] followed assertions by the FASB in both 1966 and 1985 that accounting for pension costs was "in a transitional stage."[93] Apparently the transition continues, at a snail's pace.

(3) Off-Balance Sheet Liabilities

A third area where GAAP has historically failed concerns off-balance sheet liabilities. This arcane area of accounting first came to the public's general attention in connection with the implosion of Enron Corp. Enron, a conservative natural gas drilling and pipeline company in the 1980s, transformed into an aggressive energy trader in the 1990s. At the beginning of 2001, Enron enjoyed a market capitalization that exceeded $60 billion and ranked as the seventh largest corporation in the world by revenue.[94] Enron achieved this lofty position in large part by creating at least 4,000 off-balance

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91 *See News Release -- FASB Issues Accounting Standard to Improve Disclosures About Pension and Other Postretirement Benefit Plans*, Financial Accounting Standards Board, Dec. 23, 2003 (available at http://www.fasb.org/news/nr122303.shtml); *News Release -- FASB Proposes Improvements to Financial Statement Disclosure for Pension and Other Postretirement Plans*, Financial Accounting Standards Board, Sept. 15, 2003 (available at http://fasb.org/news/nr091503.shtml).

92 *See* Alix Nyberg, *Death to Smoothing*, CFO Magazine, Feb. 22, 2005 (new disclosure requirements have been met with mixed reviews and smoothing appears to be safe at least until 2006). Available at http://www.cfo.com. In November 2005, the FASB voted to conduct an examination of FAS No. 87. Lisa Yoon, *Pensions Go On the Balance Sheet: FASB*, CFO Magazine, Nov. 14, 2005. Available at http://www.cfo.com.

93 *See Summary of Statement No. 87*, Financial Accounting Standards Board, Dec. 1985 (available at http://www.fasb.org/st/summary/stsum87.shtml); Brian W. Carpenter & Daniel P. Mahoney, *Pension Accounting: The Continuing Evolution*, CPA J., Oct. 2004 (measurement issues related to defined benefit plans have been unchanged since 1985, when FASB issued SFAS 87, which was intended to be a stopgap measure) (available at http://www.nysscpa.org.) The FASB may be concerned about negative effects resulting from the abolition of smoothing. According to one survey of major pension fund managers, nearly half would reallocate an average of nine percent of their assets from equities to fixed income to reduce the volatility that might result from an end to smoothing. This reallocation could remove $250-$600 billion from the stock market. Alix Nyberg Stuart, *Death to Smoothing*, CFO Magazine, Feb. 22, 2005. Available at http://www.cfo.com.

94 Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (June 2005) at 15 (hereafter *SEC Sec. 401(c) Report*).

sheet Special Purpose Entities (SPEs) that housed the company's massive debt.[95] Enron incurred approximately $14 billion of off-balance sheet debt through structured finance transactions involving the use of SPEs.[96] This elaborate financial charade unraveled in 2001. In November of that year Enron filed a Form 8-K, disclaiming the reliability of its financial statements for the previous four years. When the SPEs were consolidated onto Enron's financial statements, the company lost well over $1 billion in shareholder equity and reduced previously reported net income by approximately $600 million. Shortly thereafter, Enron filed for Chapter 11 bankruptcy protection.[97] Subsequent Enron-related class action litigation resulted in settlements that exceeded $7 billion by 2005.[98]

Enron's extensive use and misuse of SPEs was an extreme example of a common practice.[99] The use of SPEs as financing vehicles began in the early 1980s and became very popular by the late 1990s. SPEs are established by sponsoring companies too off-load debt and assets. A typical arrangement involving an SPE is an asset-backed securities transaction involving the sale of a security whereby repayment is directly tied

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[95] Gretchen Morgenson, *How 287 Turned into 7: Lessons in Fuzzy Math*, N.Y. Times, Jan. 20, 2002, at A1. Just one of these SPEs concealed over $1 billion of Enron's debt. Susan E. Squires, Cynthia J. Smith, Lorna McDougall & William R. Yeack, Inside Arthur Andersen 9 (2003). *Cf.* Alan Reinstein & Thomas R. Weirich, *Accounting Issues at Enron*, CPA J., Dec. 2002 (Enron used about 500 SPEs and thousands of other questionable partnerships). Available at http://www.cpajournal.com.

[96] SEC Sec. 401(c) Report, *supra* note 94, at 16.

[97] Hunter Carpenter, Comment, *Special-Purpose Entities: A Description of the Now-Loathed Corporate Financing Tool*, 72 MISS. L.J. 1065, 1067 (2003); Cunningham, *supra* note 2, at 1421 n.4.

[98] Stephen Taub, *Enron Settlements Hit Record $7 Billion*, CFO Magazine, Aug. 3, 2005. Available at http://www.cfo.com.

[99] Jackie Spinner, *Rules Mean Uncertainty for Enron-Style 'SPEs*,' Wash. Post, Jan. 24, 2003, at E01 ("[M]ost large companies have some type of relationship with an SPE."); Andrew Osterland, *Reining in SPEs: New Rules for Special-Purpose Entities May Result in Bigger Corporate Balance Sheets*, CFO Magazine, May 1, 2002 ("Tougher rules on SPE consolidation could affect virtually every Fortune 500 company."). Available at http://www.cfo.com.

to the cash flow of a segregated pool of assets.[100] By 2002, the total outstanding value of asset-backed debt in the U.S. involving SPEs was an estimated $1.3 trillion.[101]

Synthetic leases are another application of SPEs, whereby a corporation uses the vehicle to acquire real estate or equipment. The synthetic lease permits the corporation to obtain the tax benefits of ownership, while keeping the debt associated with acquisition of the property off its balance sheet.[102] Corporations seek to avoid balance sheet debt because financial ratios used by analysts to value them are negatively affected by such debt.[103] Enron, one such corporation seeking to obscure its debt, made extensive use of synthetic leases.[104]

In June 2005, the SEC released a study, mandated by Sarbanes-Oxley, concerning SPEs and off balance sheet reporting. The study of 200 issuers of stocks and bonds with total equity market capitalization of $7.75 trillion -- including the 100 largest companies

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[100] Carpenter, *supra* note 97, at 1072. *See also* Angela Petrucci, Note, *Accounting for Asset Securitization in A Full Dislcosure World*, 30 J. Legis. 327, 327 (2004) (off-balance sheet financing is often criticized unfairly); Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99, 113 (2003) ("SPEs are a legitimate way for a corporation to buy or sell risks as a form of hedging.").

[101] Glenn R. Simpson, *Power Play: Deals That Took Enron Under Had Many Supporters -- Big-Name Lobbying Stymied FASB Push To Disclose Off-Balance-Sheet Entities*, Wall St. J., April 4, 2002, at A1. *See also* Cassell Bryan-Low, *Accounting Board Clarifies Rule -- FASB To Narrow Criteria for Entities That Firms Must Bring Onto Books*; Wall St. J., Nov. 3, 2003, at A11B (estimates of the assets in SPEs run into the trillions of dollars); Joyita R. Basu, Note, *Accounting for and Disclosure of Special Purpose Entities by Financial Holding Companies: Lessons from PNC Financial Services*, 7 N.C. BANKING INST. 177, 178 (2003) ("Financial institutions have been using SPEs for decades to monetize loans and receivables on their balance sheets.").

[102] Baron v. Smith, 2004 WL 1847751, *4 (1st Cir., Apr. 8, 2004); Ray A. Smith, *Firms Await Ruling on Use of Synthetic Leases*, Wall St. J., Oct. 2, 2002, at B8. The mechanics of synthetic lease transactions are described in Steven G. Frost & Paul Carmen, *Federal and State Tax Consequences of Synthetic Leasing – Multiple Benefits, Minimal Risks*, 95 J. TAX'N 361 (2001); Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 J. CORP. L. 445 (2000); and H. Peter Nesvold, *What Are You Trying To Hide? Synthetic Leases, Financial Disclosure, and the Information Mosaic*, 4 STAN. J.L. BUS. & FIN. 83 (1999).

[103] Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: the Book-Tax Accounting Conformity Defense*, 2003 COLUMBIA BUS. L. REV. 35, 50-51.

[104] Ray A. Smith, *Firms Await Ruling on Use of Synthetic Leases*, Wall St. J., Oct. 2, 2002, at B8.

in the United States -- determined that an enormous amount of debt remains off balance sheet. The study, extrapolating from results for the 200 issuers, concluded that there is approximately $1.25 trillion in non-cancelable future cash obligations committed under operating leases that are not recognized on issuer balance sheets.[105] The study also suggested that approximately $414 billion in pension liabilities remain off balance sheet.[106]

Accounting for SPEs was, until 2003, primarily governed by FAS No. 140 ("Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities") and ARB No. 51 ("Consolidated Financial Statements"). Additional guidance was provided by EITF Issue Nos. 90-15, 96-21, and 97-1, and EITF Topic No. D-14.[107] FAS No. 140 governed, and still continues to govern, the accounting for securitizations of financial assets through Qualifying Special Purpose Entities (QSPEs).[108] When FAS No. 140 does not apply (as it generally did not in the case of Enron), SPEs are evaluated based on voting control. Until 2003, a company was not required to consolidate onto its balance sheet an SPE when it owned less than a majority

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[105] SEC Sec. 401(c) Report, *supra* note 94, at 64.

[106] *Id*. at 56. *See also* Lisa Yoon, *Rethink Off-Balance-Sheet Reporting: SEC*, CFO Magazine, June 18, 2005 (available at http://www.cfo.com).

[107] *See Summary of Decisions Reached at the December 17, 2003 Board Meeting Regarding FASB Interpretation No. 46, Consolidation of Variable Interest Entities* 2 n.2, Financial Accounting Standards Board, Dec. 17, 2003. Available at http://www.fasb.org/12-17-03_mtg_fin46.pdf. The FASB has admitted that the accounting literature concerning SPEs has been fragmented and incomplete. Luppino, *supra* note 103, at 77.

[108] A QSPE is a trust that meets all of then following conditions: (1) it is legally distinct from the transferor; (2) its activities are prearranged and limited; (3) it holds only passive financial instruments; and (4) it can only sell assets automatically and in response to certain events. QSPEs include the credit card, mortgage, home equity, auto loan, and other passive securitizations that account for the majority of the asset-backed securities market. They continue to be exempt from mandatory balance sheet inclusion. David Zion & Bill Carache, *Credit Suisse First Boston Equity Research -- FIN 46: New Rule Could Surprise Investors* 8 (June 23, 2003) (hereafter *FIN 46*). Available at http://www.securitization.net/pdf/FIN_46_New_Rule.pdf.

of the vote and the independent majority owner contributed at least three percent of the SPE's total capital.[109] This rule, derived from various EITF Issues and Topics, enabled Enron to conceal its staggering debt.[110]

The FASB had debated reform of accounting for SPEs for two decades before Enron's accounting fraud was exposed.[111] The FASB considered, and then abandoned, a series of proposals that would have required public companies using SPEs to disclose that information on their consolidated income statements. The major accounting firms were among the vocal opponents of these reform measures. It was not until September 2000 that the FASB issued rules requiring disclosure about SPEs in the footnotes to financial statements. The new rules did not extend beyond footnote disclosure[112] and compliance with them was sporadic.[113] In January 2001, nine months before Enron filed for bankruptcy protection, the FASB announced that it was tabling its project to reform the rules concerning consolidation of SPEs.[114]

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[109] FIN 46, *supra* note 108, at 8.

[110] Mark P. Holtzman, Elizabeth Venuti & Robert Fonfeder, *Enron and the Raptors*, CPA J., Apr. 2003. Available at http://www.cpajournal.com. The details of Enron's use of SPEs have been extensively documented. *See*, *e.g.*, William C. Powers, Jr., *et al.*, *Enron Corporation, Report of Investigation by the Special Investigative Commission of the Board of Directors of Enron Corporation* (2002). Available at http://news.findlaw.com.hdocs/enron/sicreport020102.pdf.

[111] Conference Board Commission (Parts 2 and 3), *supra* note 22, at 39 ("[E]fficient capital markets cannot tolerate a . . . 20-year delay for the publication of a standard relating to off-balance sheet, special purpose entities.").

[112] Simpson, *supra* note 101, at A1.

[113] Cassell Bryan-Low, *Deals & Deal Makers: Off-Balance Sheet Operations Are Focus of New Regulations*, Wall St. J., July 15, 2003, at C5. The SEC has also imposed reporting requirements. In January 2003, the SEC adopted amendments to implement Section 401(a) of Sarbanes-Oxley, which requires each annual and quarterly financial report filed with the SEC to disclose all material off-balance sheet transactions, arrangements and obligations. *See* Testimony of William H. Donaldson (SEC chairman) Before Senate Comm. on Banking, Housing and Urban Affairs 13, Sept. 9, 2003. Available at http://www.sec.gov/news/testimony/090903tswhd.htm.

[114] *Badly in Need of Repair*, Economist, May 2, 2002. Available at http://www.economist.com.

Enron, which restated earnings to the extent of approximately $600 million after accounting for off-balance sheet activity and income from securitization, did not act alone. Between 1997 and 2002, at least five other companies restated earnings by at least $40 million apiece to reflect such accounting.[115] But it was primarily the spectacular Enron fraud that finally compelled the FASB to respond.[116] In February 2002 the standards board recommenced work on a project to reform accounting for SPEs. In January 2003, the FASB issued a complex new rule that governs SPEs and other off-balance sheet activity -- Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51."[117]

FIN 46 was superseded by FIN 46(R) in December 2003.[118] Both interpretations are designed to provide guidance as to whether a company should place its off-balance sheet activity on its balance sheet. This activity is not limited to SPEs. FIN 46(R) addresses Variable Interest Entities (VIE), which encompass both SPEs and such other financing vehicles as hedge funds, venture capital partnerships, joint ventures, general partnerships, limited partnerships, trusts, and leases. Under 46(R), entities are classified as either variable interest or voting interest. In the case of the former classification, the entity is evaluated for possible consolidation according to a risk-and-rewards approach

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[115] Simpson, *supra* note 101, at A1. *See also* Osterland, *supra* note 99 (stock of Adelphia Communications Corp. plunged by nearly 50 percent after the company disclosed $2.7 billion in off-balance-sheet debt housed in SPEs).

[116] *FASB Rule Will Clip Enronesque Alliances*, Wall St. J., Jan. 16, 2003, at C3.

[117] *See News Release -- FASB Issues Guidance To Improve Financial Reporting for SPEs, Off-Balance Sheet Structures and Similar Entities*, Financial Accounting Standards Board, Jan. 17, 2003. Available at http://fasb.org/news/nr011703.shmtl.

[118] *See generally* Jalal Soroosh & Jack T. Ciesielski, *Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R)*, CPA J., July 2004. Available at http://www.nysscpa.org.

that requires an estimation of expected losses and returns. Consolidation is required if the company is vulnerable to a majority of the entity's risk of loss, is entitled to receive the bulk of the entity's residual returns, or both. But if the entity is classified as a voting interest, it is evaluated for consolidation based on voting power.[119]

The effects of FIN 46 and FIN 46(R) were expected to be substantial. Companies in the S&P 500 were expected to bring approximately $379 billion of assets and $377 billion of liabilities onto their balance sheets when FIN 46 first became effective. These adjustments would have increased total assets held by the S&P 500 by approximately two percent, to $19.2 trillion. Liabilities would have increased by about 2.4 percent, to $16.2 trillion. The bulk of the adjustments were expected to take place on the books of financial services companies.[120]

The expected large-scale adjustments tend to confirm that off-balance sheet activity has made a major contribution to the accounting scandals that began to unfold in the late 1990s and to the crisis in investor confidence that developed in their aftermath.[121] No doubt Enron's fraud took place in part because the company's management failed to

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[119] FIN 46, *supra* note 108, at 7; Scott Taylor & Daniel Volpi, *New FASB Guidelines for Consolidation of Variable Interest Entities Will Affect U.S. Energy Sector*, March 6, 2003 (available at http://www2.standardandpoors.com).

[120] FIN 46, *supra* note 108, at 6. *See also* Stephen Taub, *FIN 46 Costs Cisco $567 Million*, CFO Magazine, Feb. 5, 2004. Available at http://www.cfo.com. *But see* Robert Julavits, *Fewer SPE Assets Going to Sheet*, AMERICAN BANKER, Aug. 5, 2003, at Markets 1 (Citigroup Inc. is restoring $5 billion to its balance sheet, rather than the $55 billion originally estimated, by restructuring or winding-down SPEs). Available at http://www.americanbanker.com.

[121] *See* FIN 46, *supra* note 108, at 51. According to one survey, 19 of the 224 securities fraud class action suits filed in 2002 concerned the burying of liabilities, including transfers to SPEs. *See* Paul R. Besette, Michael J. Biles & Alfred Mcdaniel, *Accounting Fraud in 2002 – Lessons Learned*, 1377 PLI Corp 155, 161 (2003). *See also* Tony McAuley, *The Parmalat Archipelago*, CFO Magazine, Feb. 9, 2004 (massive accounting fraud at Parmalat was facilitated by company's use of hundreds of off-balance sheet SPEs). Available at http://www.cfo.com.

follow certain rules set forth in GAAP.[122] But the fraud also was facilitated and encouraged by such rules.[123] GAAP's historic failure to adequately account for off-balance sheet activity has been a hallmark of the deficiencies of U.S. accounting standards. Moreover, it is not at all clear that the FASB has solved the problem. FIN 46, adopted after two decades of discussion and study by the FASB, was widely criticized.[124] FIN 46(R) has fared somewhat better, but remains deficient. One example of the FASB's failure to solve the off-balance-sheet problem concerns operating lease commitments. Post-FIN 46(R), companies continue to be able to keep such commitments off their balance sheets. For the companies in the S&P 500, such commitments totaled $482 billion in 2004. This was equivalent to eight percent of the $6.25 trillion reported as debt on the companies' balance sheets. The FASB has done nothing to address this issue.[125]

Moreover, the 2005 SEC study concerning SPEs concluded that, in anticipation of the implementation of FIN 46 and FIN 46(R), a number of entities circumvented the rules by restructuring arrangements with potential VIEs such that they did not require consolidation. The SEC study concluded: "[A] new series of structures that straddle the

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[122] *See*, *e.g.*, William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1044 (2003).

[123] *See*, *e.g.*, Luppino, *supra* note 103, at 40 n.4, 141-42, and 153. Accounting scandals at Enron and Parmalat also prompted the European Union to require listed, non-exempt companies to disclose off-balance-sheet transactions, under riules adopted in 2005. *See* Stephen Taub, *EU Orders Off-Balance-Sheet Disclosures*, CFO Magazine, Dec. 16, 2005. Available at http://www.cfo.com.

[124] One of the Big Four accounting firms described FIN 46 as "severely non-operational." FIN 46, *supra* note 108, at 10. *See also* Christine Richard, *Wall Street Pros Are in an Uproar Over Commercial Paper Rules*, Wall St. J., May 5, 2003; Adam Temkin, *Is FIN 46 the Wrong Solution To the Right Problem? Securitization Professionals Share Their Views in Standard & Poor's SF Market Opinion Survey*, Apr. 11, 2003 (two-thirds of securitization professionals surveyed by S&P do not believe that FIN 46 solves the problem of corporate malfeasance) (available at http://www.standardandpoors.com).

[125] Jonathan Weil, *Open Secrets: How Leases Play A Shadowy Role in Accounting*, Wall St. J., Sept. 22, 2004, at A1. *But cf.* Tim Reason, *All in the Family*, CFO Magazine, Sept. 1, 2004 (sample of 300 quarterly reports shows that post-FIN 46R, companies are now claiming ownership of many assets and liabilities previously kept off-balance sheet). Available at http://www.cfo.com.

lines between consolidation approaches has sprung up, and various structures have been designed to work around the guidance in Interpretation No. 46(R)."[126]

(4) Intangible Assets

A fourth area where GAAP has been a dismal failure concerns accounting for intangible assets. In 1978 it was estimated that the book value of the tangible assets of publicly traded United States corporations accounted for more than 83 percent of the market value of those companies. By 2002 that figure had declined to an estimated 30-40 percent. Today, most of the value in United States corporations comes from intangible assets, such as patents, copyrights, brands, and customer lists.[127] Yet, pursuant to GAAP, these assets rarely appear on corporate balance sheets.[128]

One particular aspect of GAAP's failure is its requirement under FAS No. 2 ("Accounting for Research and Development Costs"), issued in October 1974, that expenditures on R&D -- one of the most concrete of intangibles -- be immediately expensed. GAAP requires expensing in the period in which the items are incurred and a

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[126] SEC Sec. 401(c) Report, *supra* note 94, at 109.

[127] Alan Murray, *Accounting Rules Should Adapt To New Economy*, Wall St. J., July 23, 2002, at A4. *Accord* Robert E. Litan & Peter J. Wallison, The GAAP Gap – Corporate Disclosure in the Internet Age 26 (2000) (intangible assets constitute approximately 80 percent of the value of the S&P 500); Ben McLannahan, *Hidden Treasures*, CFO Magazine, Dec. 30, 2003 (intangibles dwarf the tangible book assets of all sorts of companies in all sorts of industries) (available at http://www.cfo.com). *But see* Steven Liesman, *Deciphering the Black Box*, Wall St. J., Jan. 23, 2002, at C1 (study of 5,300 publicly traded companies shows that intangible assets account for nine percent of total assets). *See also* Leonard Nakamura, *A Trillion Dollars a Year in Intangible Investment and the New Economy*, *in* Intangible Assets 19, 27-28 (John R. M. Hand & Baruch Lev eds., 2003) (intangibles represent a third or more of the market value of U.S. domestic corporations and 6-10 percent of U.S. GDP is spent annually on intangibles).

[128] Neil Gross, *Commentary: Valuing "Intangibles" Is a Tough Job, But it Has to Be Done*, BusinessWeek Online, Aug. 6, 2001. Available at http://www.businessweek.com/magazine/content/01_32/b3744009.htm. *Accord* Louis K. C. Chan, Josef Lakonishhok & Theodore Sougiannis, *The Stock Market Valuation of Research and Development Expenditures* 387, 387 *in* Intangible Assets, *supra* note 127 ("Under generally accepted U.S. accounting principles, many types of intangible assets are not reported in firms' financial statements."); Peter J. Wallison, *Debating Sarbanes-Oxley: Give Us Disclosure, Not Audits*, Wall St. J., June 2, 2003, at A16 ("Intangible assets. . . do not appear on GAAP balance sheets.").

charge against current earnings.[129] Such an approach falsely implies that R&D expenditures do not create an asset that has future value.[130] The result is a serious distortion of the fundamental accounting principle that costs be matched with revenues and a "systematic decline in the usefulness of financial information to investors over the past twenty years."[131] Many other intangible investments are never identified in financial statements.[132]

The failure of the current reporting model to capture the value of intangibles has had a number of other specific adverse consequences. These consequences include diminished market liquidity,[133] increased insider trading by managers who are able to exploit the information asymmetry between them and outside investors,[134] an increased cost of capital, and the misallocation of resources.[135]

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[129] Robert F. Reilly, *Valuation of Technology Companies*, 22 AM. BANKR. INST. J. 42, 43 (July/August 2003) ("Under GAAP, R&D expenditures are normally expensed as incurred."). Likewise, FAS No. 86 ("Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed"), issued in August 1985, provides that costs incurred to establish the technological feasibility of a product are considered R&D under FAS No. 2 and charged to expenses as incurred. *See* Wayne S. Upton, Jr., *Business and Financial Reporting, Challenges from the New Economy* 66 (Apr. 2001) (hereafter *New Economy*). Available at http://www.fasb.org.

[130] Margaret Blair & Steven Wallman, *The Growing Intangibles Reporting Discrepancy* 449, 455 *in* Intangible Assets, *supra* note 127.

[131] Baruch Lev & Paul Zarowin, *The Boundaries of Financial Reporting and How To Extend Them* 487, 508, *in* Intangible Assets, *supra* note 127. *Accord* Juergen H. Daum, Intangible Assets and Value Creation 84 (2003) (many corporate crises would have been detected sooner if investors, creditors and management had been able to measure the value and development of intangible assets).

[132] Chandra Kanodia, *et al*., *Should Intangibles Be Measured? What Are the Economic Trade-Offs?*, 42 J. ACCT. RES. 89, 90 (2004).

[133] Jeff P. Boone & K. K. Raman, *Off-Balance Sheet R&D Assets and Market Liquidity* 335, 360 *in* Intangible Assets, *supra* note 127.

[134] David Aboody & Baruch Lev, *Information Asymmetry, R&D, and Insider Gains* 366, 382 *in* Intangible Assets, *supra* note 127.

[135] Blair & Wallman, *supra* note 130, at 460, 462.

To date, the FASB has shown no inclination to overhaul the accounting for intangible assets. Incremental reform was made in 2001, when the FASB adopted two rules that eliminate amortization of goodwill in the case of acquisitions. But neither standard addresses the reporting of internally developed intangible assets.[136] Further reform is not on the horizon, notwithstanding the conclusion of a 2001 FASB report that a basis for the recognition and measurement of internally generated intangible assets should be developed.[137] The FASB's failure to bridge the current gap in accounting for intangibles is a fourth significant problem.[138]

(5) Rules vs. Principles

A fifth infirmity in the current reporting model is GAAP's focus on specific bright-line rules, as opposed to general principles. The SEC has identified three major shortcomings of rules-based standards. Such standards: (1) can be misused by financial engineers, such as auditors, as a roadmap to comply with the letter but not the spirit of the standards; (2) contain numerous exceptions, resulting in inconsistencies in accounting

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[136] Benjamin P. Foster, Robin Fletcher & William D. Stout, *Valuing Intangible Assets*, CPA J., Oct. 2003. Available at http://www.cpajournal.com. *Accord* Bruce H. Nearon, *Intangible Assets: Framing the Debate*, CPA J., Jan. 2004 ("[W]ith few exceptions, we account for intangible assets in the same manner as we did 30 years ago.") Available at http://www.cpajournal.com.

[137] *See* New Economy, *supra* note 129, at 59.

[138] Even if the FASB decided to act, it would confront some serious obstacles. First, the current state of technology "does not allow for sufficiently reliable measurement of many intangibles." Samuel A. DiPiazza Jr. & Robert G. Eccles, Building Public Trust: The Future of Corporate Reporting 46 (2002). *Accord* New Economy, *supra* note 129, at 82 ("Measurement . . . is the big question that frustrates many attempts to incorporate intangible assets in financial statements."). *But see* Foster, *et al., supra* note 136 (objective external evidence of value of intangibles exists in form of insured values and use of intangibles as collateral). Second, few entities maintain comprehensive inventories of intangible assets beyond those required for tax and financial reporting or for protection of intellectual property. *New Economy, supra* note 129, at 99. Third, inclusion of intangibles in the balance sheet risks misleading investors. Arguably, corporations would have increased incentives to create flattering false numbers, which auditors might have difficulty recognizing. *See Touchy-Feely: Accountants Want To Start Measuring Intangible Assets and New Economy 'Value Drivers.' They Are Unlikely To Be Any Good at It*, Economist, May 17, 2001. Available at http://www.economist.com.

treatment by auditors of transactions and events with similar economic substance; and (3) create a need and demand by auditors for voluminous detailed implementation guidance on their application, thereby generating complexity and uncertainty.[139]

Four specific accounting topics are often described as overly rules-based: leases, derivatives and hedging, stock-based compensation, and de-recognition of assets and liabilities. With regard to derivatives, for example, FAS No. 133 lists nine exceptions to its scope, there are 15 Derivative Implementation Group issues related to the application of these scope exceptions, and more than 800 pages of GAAP apply to the topic.[140] Other bright-line GAAP tests historically have been applied to the consolidation of SPEs and the smoothing of gains or losses in pension plans.[141]

The primary alternative to a rules-based system such as GAAP is a principles-based system. The latter regime, which utilizes general accounting principles rather than bright-line rules,[142] has already been adopted, or is likely to be adopted, by many

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[139] Section 108(b) Study, *supra* note 25, at 11 and 47-48. *Accord Financial Reform: Relevance and Reality in Financial Reporting*, Speech by Cynthia A. Glassman (SEC Commissioner) 3, Sept. 16, 2003 (GAAP's detailed bright-line tests are vulnerable to financial engineering). Available at http://www.sec.gov/news/speech/spch091603cag.htm. *See also Accounting for Change: The Need for Radical Audit Reform in America Grows Ever More Pressing*, Economist, June 27, 2002 ("GAAP rules are still too detailed and prescriptive; they have lost sight of the aim that company accounts should present a true and fair picture."); *The Lessons From Enron: After the Energy Firm's Collapse, the Entire Auditing Regime Needs Radical Change*, Economist, Feb. 7, 2002 (Enron's behavior confirmed that GAAP is too rules-based) (both available at http://www.economist.com); and Frederick Gill, *Principles-Based Accounting Standards*, 28 N.C. J. INT'L L. & COM. REG. 967, 972, 980 (2003) (U.S. GAAP has become incredibly complex, with only small groups of specialists thoroughly understanding the accounting for common transactions).

[140] Section 108(b) Study, *supra* note 25, at 24. *See also* Rebecca Toppe Shortridge & Mark Myring, *Defining Principles-Based Accounting Standards*, CPA J., Aug. 2004 (U.S. GAAP related to lease accounting is addressed in 20 Statements, nine FASB Interpretations, 10 Technical Bulletins, and 39 EITF Abstracts). Available at http://www.nysscpa.org.

[141] Section 108(b) Study, *supra* note 25, at 25.

[142] *See*, *e.g.*, Bernhard Grossman, *Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards*, 28 N.C. J. INT'L L. & COM. REG. 847, 861 (2003) (principles-based system constitutes effort to limit bending of individual rules); Paul Hofheinz, *Battle of the*

countries around the globe. This trend is primarily attributable to efforts by the International Accounting Standards Board (IASB) and its predecessor, which have been striving for 30 years to achieve global convergence to principles-based accounting standards.[143] Prior to 2005, countries in Europe and Asia used at least 26 different accounting standards, none of which was quite the same as United States GAAP.[144] In 2002, however, the European Parliament and the European Council of Ministers voted to require the adoption of IASB standards. By 2005 all European Union (EU) listed companies were required to prepare their consolidated financial statements in accordance with IASB standards,[145] which are published in a series of pronouncements denominated as International Financial Reporting Standards (IFRSs).[146] This requirement applies to

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Accountants: Europe Tries To Win Over U.S., Wall St. J., July 16, 2002, at A12 (Enron would have encountered more difficulty moving debt to SPEs if auditors had followed international accounting rules).

[143] The IASB began operations in 2001. Its predecessor, the International Accounting Standards Committee (IASC), was established in 1973 and disbanded in 2001. The IASB is funded by contributions from the major accounting firms, private financial institutions and industrial companies, central and development banks, and other organizations. The IASB, which has 14 Board members (at least five of whom have a background as practicing auditors), has stated that its mission is to develop "a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements." *See* http://www.iasb.org. The United States, which does not follow international accounting standards, nevertheless has four seats on the IASB. Stephen Taub, *Who Determines International Standards?*, CFO Magazine, March 11, 2005 (available at http://www.cfo.com).

[144] Michael Maiello, *The International 500: Tower of Babel*, Forbes.com, July 22, 2002. Available at http://www.forbes.com. *See also* Josephina Fernandez McEvoy, *The Scourge of Sarbanes-Oxley*, 22 AM. BANKR. INST. J. 40, 40 (Dec./Jan. 2004) (Latin American countries have their own accounting standards).

[145] The European Parliament retains the power to disapprove of specific IASB standards. *Common Ground: A Move Toward Global Accounting Standards Is Proving Controversial*, Economist, Dec. 18, 2003. Available at http://www.economist.com. Also, European companies that report their results under U.S. GAAP are not required to switch to international standards until 2007. David Reilly, *Accounting Chief in Europe Vows To Resist Pressure*, Wall St. J., Oct. 17, 2003, at C9.

[146] The IASB has also adopted and sometimes amended the body of standards previously issued by the Board of the IASC. Those 41 pronouncements continue to be designated "International Accounting Standards (IASs)." The IASB amended 13 IASs in 2003. *Press Release -- International Accounting Standards Board Issues Wide-Ranging Improvements To Standards*, Dec. 18, 2003. Available at http://www.iasb.org.

approximately 7,000 listed companies in the EU,[147] representing about 25 percent of the world's total market capitalization.[148] Individual governments have the option of extending the requirement to all companies, of which there are approximately 5 million in Europe.[149]

Most non-EU nations also are likely to converge to IFRSs. A study conducted by six major accounting firms in 2002 disclosed that 95 percent of the 59 countries surveyed either have adopted, intend to adopt, or intend to converge with, IFRSs.[150] More recently, the IASB projected that 100 countries will be using IFRSs in 2006, and 150 countries by 2010.[151] These projections suggest the not too distant adoption of global accounting standards. Indeed, if the United States, with approximately 52 percent of the world's market capitalization, and Japan, accounting for another nine percent, took the EU's cue and adopted IFRSs, the standards would become global.[152] But Japan has not expressed an intention to converge with IFRSs, and the SEC has rejected the notion that

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[147] *So Far, So Good*, Economist, June 16, 2005. Available at http://www.cfo.com.

[148] Report by Sir David Tweedie (IASB Chairman) to IASC Foundation Trustees 8, Nov. 4, 2003 (available at http://www.iasb.org); DiPiazza & Eccles, *supra* note 134, at 50.

[149] Report by Sir David Tweedie, *supra* note 148, at 8.

[150] BDO, Deloitte Touche Tohmatsu, *et al., GAAP Convergence 2002: A Survey of National Efforts To Promote and Achieve Convergence with International Financial Reporting Standards* 4, 7 (2003). Available at http://www.pwcglobal.com. *See also* Cassell Bryan-Low, *Accounting's Global Rule Book*, Wall St. J., Nov. 28, 2003, at C1 (by 2005, as many as 91 countries will require or allow their companies to use international standards).

[151] *See* Tim Reason, *The Narrowing GAAP*, CFO Magazine, Dec. 1, 2005. Available at http://www.cfo.com.

[152] DiPiazza & Eccles, *supra* note 138, at 50.

IFRSs constitute a model for the principles-based accounting standards it believes the United States should adopt.[153]

Arguments in favor of worldwide convergence of accounting standards are compelling. Benefits resulting from convergence are likely to include reduced accounting fraud, increased movement of capital, greater transparency in transactions, increased comparability of financial statements, more informed investment choices, and increased coordination between accounting and taxation.[154] In recognition of the foregoing benefits, FASB and the IASB have agreed to work together toward convergence. In October 2002, the two boards issued a memorandum of understanding to formalize their commitment to the convergence of United States GAAP and international accounting standards.[155]

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[153] Section 108(b) Study, *supra* note 25, at 18. *See also* Natsuo Nishio, *Japan Is Hurt by Accounting Model*, Wall St. J., Feb. 17, 2004, at A6B; Mundstock, *supra* note 26, at 844 ("IFRS are inherently inferior to FASB's pronouncements. . . .")

[154] *See New World Order – IASB Chairman Sir David Tweedie Says Global Accounting Standards Are Within Reach*, CFO Magazine, March 1, 2004 (available at http://www.cfo.com); Sabine D. Selbach, *The Harmonization of Corporate Taxation & Accounting Standards in the European Community and Their Interrelationship*, 18 CONN. J. INT'L L. 523, 562 (2003).

[155] *See* Robert H. Herz & Kimberley R. Petrone, *International Convergence of Accounting Standards—Perspectives From the FASB on Challenges and Opportunities*, 25 NW. J. INT'L L. & BUS. 631, 643 (2005); *News Release -- FASB and IASB Agree To Work Together Toward Convergence of Global Accounting Standards*, Financial Accounting Standards Board (Oct. 29, 2002). Available at http://www.fasb.org/news/nr102902.shtml. International convergence and global adoption of principle-based standards are two distinct concepts, in theory. But since much of the world outside of the U.S. uses a principles-based system, convergence is likely to lead to such a system. Indeed, the SEC has concluded that the U.S. should move away from rules and toward what it calls an "objectives-oriented approach." *Section 108(b) Study, supra* note 25, at 8 ("[W]e conclude that the benefits of adopting objectives-oriented or principles-based standards in the U.S. justify the cost. . . ."). However, the same SEC study rejected the idea that IFRSs constitute a desirable model. *Id*. at 18. *Cf.* Remarks Before the IASB Meeting with World Standard-Setters, Donald T. Nicolaisen (chief accountant, SEC), Sept. 28, 2004, at 3 ("I am eager to embrace IFRS because I believe our investors in the U.S. will benefit."). Available at http://www.sec.gov/news/speech/spch092804dtn.htm.

The early announced goal was to remove most differences between the two sets of standards by 2005.[156] Given the wide disparities between the two systems, however, that objective was unrealistic.[157] Moreover, since the SEC has rejected the notion that IFRSs constitute a desirable model, while much of the rest of the world appears likely to adopt that model, convergence between the United States and other nations is likely to be a long-term project. The consequence is that rules-based GAAP will continue to be the United States model for the foreseeable future.[158] And that result entails the negative outcomes noted above, including the facilitation of accounting fraud. As GAAP has become increasingly rules-based, it has become "increasingly feasible for opportunistic managers to meet bright-line requirements in order to inflate reported net income."[159] Enron provides a stark example of the proposition that United States GAAP has been a

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[156] *U.S., EU Set 2005 To End Differences in Accounting Rules*, Wall. St. J., Oct. 30, 2002, at C9.

[157] *See A Review of FASB Action Post-Enron and WorldCom: Hearing Before House Subcomm. on Commerce, Trade, and Consumer Protection*, 108th Cong. 10 (2003) (statement of Robert H. Herz, FASB Chairman) ("Because there are literally hundreds of differences between U.S. and international standards, realistically this effort will still be ongoing well beyond 2005. . . ."); Lingling Wei, *FASB Moves To Converge Rules*, Wall St. J., Dec. 16, 2003, at C15 (FASB and IASB seek to reconcile hundreds of divergent standards). *But cf*. Stephen Taub, *European Group Seeks Accounting Changes*, CFO Magazine, May 2, 2005 (study by Committee of European Securities Regulators concludes that GAAP in U.S. Canada, and Japan is mostly equivalent to IFRS, with certain significant differences). Available at http://www.cfo.com.

[158] *See* Lori Calabro, *In the Same Language*, CFO Magazine, Jan. 28, 2005 (convergence between U.S. and international standards is now slated for 2007 or 2008) (available at http://www.cfo.com); Robert L. Bartley, *Debating Sarbanes-Oxley: Economic Profit vs. Accounting Profit*, Wall St. J., June 2, 2003, at A17 (Sarbanes-Oxley enshrined GAAP more firmly than ever); and Katherine Schipper, *Principles-Based Accounting Standards*, 17 Acct. Horizons 61, 71 (2003) (Sarbanes-Oxley is rules-based). *See also* Andrew Peple, *Moving the Market: Major Economies at Loggerheads Over Global Accounting Rules*, Wall St. J., Feb. 9, 2004, at C3 (drive for global accounting standards has stalled).

[159] Benston, *supra* note 42, at 1339-40.

substantial contributing factor in recent accounting fraud,[160] and it is certainly not the only example. GAAP facilitated many of the recent scandals.[161]

(6) Pro Forma Reports

A sixth weakness of the current financial reporting system in the United States is the permitted use of unaudited[162] pro forma reports. Such reports are designed to reflect the effects of applying significant assumptions to a company's financial statements or information. Historically, these assumptions concerned a proposed business combination, a change in capitalization, a change in form of business organization, a proposed sale or purchase, or the disposition of a significant segment of a business.[163] But in recent years pro forma reports have been used by numerous companies to reflect corporate earnings as if certain ordinary items, usually expenses, did not exist. The misleading exclusion of such expenses is often endorsed by management because it has the effect of artificially boosting corporate earnings.

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[160] G.J. Benston & A.L. Hartgraves, *Enron: What Happened and What Can We Learn From It*, 21 J. ACCT. & PUBLIC POLICY 105, 126 (2002) ("U.S. GAAP, as structured and administered by the SEC, the FASB, and the AICPA, are substantially responsible for the Enron accounting debacle.").

[161] *See*, *e.g.*, Markham, *supra* note 27, at 815-16 ("[T]he current financial accounting rules facilitated many of the recent accounting scandals."); Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 CONN. L. REV. 989, 1007 ("GAAP played a major role in the accounting abuses of the 1990s."); and Stephen Taub, *GAAP Faulted for Freddie Mac Woes*, CFO Magazine, Feb. 9, 2004 (available at http://www.cfo.com).

[162] Auditors have limited responsibilities for quarterly financial reports and other interim financial information. Auditors are engaged to review that information, but it is not subject to the same scrutiny as are the full year's audited financial statements. *Report and Recommendations*, Public Oversight Board – Panel on Audit Effectiveness 81, Aug. 16, 2000 (hereafter *Public Oversight Board*). Available at http://www.pobauditpanel.org/down/load.html. *Accord Out, by $100 Billion: Nasdaq Firms' Pro-Forma Alchemy*, Economist, Feb. 21, 2002 (pro forma numbers are neither audited nor subject to any controlling rules). Available at http://www.economist.com.

[163] Larry P. Bailey, 2003 Miller GAAS Guide: A Comprehensive Restatement of Standards for Auditing, Attestation, Compilation, and Review 622 (2003).

Pro forma reporting increased dramatically in the last 20 years.[164] It first became popular among Internet companies during the dot.com boom,[165] later expanded to nearly all industries,[166] and has been described as a "make-your-own-accounting-rules habit."[167] A survey released in 2002 by the National Investor Relations Institute (NIRI) disclosed that 57 percent of the 233 companies sampled used pro forma information in their quarterly earnings reports.[168] Another survey from 2002 found that more than 300 companies in the S&P 500 engaged in pro forma reporting.[169]

The permitted use of pro forma reports has the undesirable consequence of distorting to a substantial degree the actual performance of companies reporting on that basis. During the period 1988-2004, pro forma earnings were approximately 21 percent higher than GAAP earnings for S&P 500 companies.[170] These distortions are not readily apparent to many investors who read quarterly reports and are unaware, or fail to

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[164] Mark T. Bradshaw & Richard G. Sloan, *GAAP versus The Street: An Empirical Assessment of Two Alternative Definitions of Earnings*, 40 J. ACCT. RES. 41, 41 (2002).

[165] Gren Manuel, *European Interest Grows in Pro Forma Accounting*, Wall St. J., Jan. 8, 2002, at C9 (pro forma reporting became a hallmark of many U.S. Internet companies in the late 1990s).

[166] *Jonathan Weil, Moving Target: What's the P/E Ratio? Well, Depends on What Is Meant by Earnings,* Wall St. J., Aug. 21, 2001, at A1 (use of pro forma reporting can be found in companies in nearly every industry).

[167] Jonathan Weil, *'Pro Forma in Earnings Reports? . . . As If*, Wall St. J., Apr. 24, 2003, at C1. *See also Cautionary Advice Regarding the Use of "Pro Forma" Financial Advice in Earnings Releases*, Securities and Exchange Commission, Dec. 4, 2001 (Release Nos. 33-8039, 34-45124, FR-59) (pro forma financial information has no defined meaning and no uniform characteristics). Available at http://www.sec.gov/rules/other/33-8039.htm.

[168] Data reported at http://niri.org/publications/alerts/EA20020117.cfm.

[169] Edward Teach & Tim Reason, *Lies, Damn Lies, and Pro Forma*, CFO Magazine, Apr. 1, 2002. Available at http://www.cfo.com). *See also* Stephen Taub, *The Next Great Controversy? Pro Forma Earnings*, CFO Magazine, Jan. 22, 2002 (among publicly-traded corporations with a market capitalization exceeding $5 billion, more than 75 percent reported earnings on pro forma basis). Available at http://www.cfo.com.

[170] Stephen Taub, *How Good Are Those Earnings, Really?*, CFO Magazine, Nov. 9, 2004 (available at http://www.cfo.com); David Henry, *Cleaning Up the Numbers*, BusinessWeek, March 25, 2003, at 126.

understand, that data has been presented in such a format.[171] Small investors rely most heavily on pro forma reports.[172] Corporate executives engaged in fraud use the lack of sophistication of these small investors to their advantage. Many accounting frauds are initiated in quarterly reports, and then expanded to annual statements.[173] For example, the substantial accounting scandal involving Global Crossing, Ltd. was based on fraudulent pro formas.[174]

In January 2003 the SEC adopted a set of rules pursuant to Sarbanes-Oxley that is designed to regulate the use of pro forma reporting. The rules, which became effective in March 2003, restrict but do not bar the use of non-GAAP financial measures in SEC filings. They also regulate public disclosures outside of the context of such filings. Under Regulation S-K, whenever a company uses a non-GAAP financial measure in a document filed with the SEC, the filing must include: (1) a presentation with equal or greater prominence of the most directly comparable financial measure calculated and presented in accordance with GAAP; (2) a reconciliation of the non-GAAP financial measure to the most directly comparable GAAP financial measure; (3) a statement disclosing why management believes the presentation of the non-GAAP financial

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[171] *See* Dan L. Heitger & Brian Ballou, *Pro Forma Earnings: Adding Value or Distorting Perception?*, CPA J. (March 2003) ("[U]nregulated pro forma earnings serve only to confuse investors about a company's actual financial performance."). Available at http://nysscpa.org/cpajournal2003/2003/0309/dept/d034403.htm.

[172] Nilabhra Bhattacharya, *et al.*, *Who Trades on Pro Forma Earnings Information?* (July 2004) (study of 1,134 pro forma earnings releases finds that market segment that relies most heavily on pro forma earnings information is populated predominantly by small investors). Available at http://www.docs.cox.smu.edu/~research/nbhatta/BBCM704.pdf.

[173] *Public Oversight Board, supra* note 162, at 81 n.16.

[174] *See* Cunningham, *supra* note 36, at 930-32. Class action litigation involving Global Crossing was settled for $325 million in March 2004. That settlement did not cover Arthur Andersen, the former auditor for the fiber-optic company. Almar Latour & Dennis K. Berman, *Global Crossing, SEC Deal Expected*, Wall St. J., March 22, 2004, at A8.

measure provides useful information to investors; and (4) if material, a statement of the purpose, if any, for which management uses the non-GAAP financial measure. Regulation G imposes some of these same conditions on the use of non-GAAP financial measures outside the context of SEC filings.[175]

The foregoing rules have not induced many businesses to refrain from issuing pro forma reports. A 2004 NIRI survey of 360 companies found that 60 percent of them continued to report non-GAAP information in their earnings releases.[176] This is permitted, because Regulations S-K and G do not forbid the use of pro forma measures.[177] And because such measures have no defined standards, misleading and confusing earnings reports continue to be issued.[178] The issuance of such reports is not

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[175] The adopting release for these rules is set forth at http://www.sec.gov/rules/final/33-8176.htm. *See generally* Norman D. Slonaker, *Use of Non-GAAP Financial Measures*, 1454 PLI/Corp 117 (Nov. 10, 2004); N. Adele Hogan, *Non-GAAP Financial Measures and "Real-Time" Reporting: Final Rules Pursuant To Sections 401(b) and 409 of the Sarbanes-Oxley Act*, 1385 PLI/Corp 91 (Sept.-Dec. 2003);and Robert Bloom & David Schirm, *SEC Regulations G, S-B, and S-K: Reporting Non-GAAP Financial Measures*, CPA J., Dec. 2003 (available at http://www.cpajournal.com.). The rules were issued by the SEC, because FASB has no jurisdiction over pro forma reporting. *See* Jonathan Weil, *Accounting Board Responds To Use of Earnings on Pro-Forma Basis*, Wall St. J., Aug. 22, 2001, at A2.

[176] Alix Nyberg, *A Matter of Emphasis*, CFO Magazine, July 1, 2004 (available at http://www.cfo.com) ("Today, though, there's little evidence that Reg G has had much effect on pro forma reporting."). *See also* Stephen Taub, *Google to Report Pro-Forma Results*, CFO Magazine, Oct. 14, 2005 (issuance of pro forma numbers alongside GAAP numbers is very common practice on Wall Street) (available at http://www.cfo.com); Michael Rapoport, *Pro Forma Proves a Hard Habit To Break on Earnings Reports*, Wall St. J., Sept. 18, 2003 (numerous companies are still using pro forma metrics); and Stephen Taub, *Pro Forma Lives*, CFO Magazine, Aug. 13, 2003 ("The death of pro forma results has been greatly exaggerated.") Available at http://www.cfo.com. A trend that emerged in 2005 was for pro forma reports to exclude all charges for stock-based compensation, including stock options and restricted stock. *See* Craig Schnieder, *Stock Options, Meet Pro Formas*, CFO Magazine, Oct. 31, 2005. Available at http://www.cfo.com.

[177] David B.H. Martin, *Reporting Earnings – A New Model*, 1395 PLI/Corp 69, 75-78 (Nov. 2003).

[178] Cunningham, *supra* note 36, at 964 (new SEC rules are likely to permit continued manufacturing and use of pro forma data that remains misleading in practice); Stephen Bryan & Steven Lilien, *Managed Disclosure and Pro Forma Earnings*, CPA J., March 2004 (unaudited pro forma earnings vary widely) (available at http://www.cpajournal.com). . This is not mere theory. *See* Ian McDonald, *Ahead of the Tape: Lies, Damned Lies & Earnings*, Wall St. J., Nov. 26, 2004, at C1 (for the S&P 500 during the third and fourth quarters of 2004 there was an estimated 17-20% chasm between GAAP net income and pro forma earnings).

constrained by the risk of enforcement action. The SEC has initiated a single enforcement action in connection with the issuance of misleading pro forma data,[179] after investigating a mere handful of companies.[180]

D. Sources and Limits of GAAS

Pursuant to the Exchange Act, all public companies registered with the SEC are required to have their financial statements audited by an independent accountant.[181] Such statements disclose a company's financial position, stockholders' equity, results of operations, and cash flows. While management is responsible for the preparation and content of a public company's financial statements, the external auditor is responsible for auditing those statements in accordance with GAAS. The purpose of the audit is to provide reasonable assurance that the statements are fairly presented in all material respects in accordance with GAAP.[182] Certification of such fair presentation is based on

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[179] Cease and desist proceedings were initiated by the SEC against Trump Hotels & Casino Resorts Inc. for making misleading statements in the company's third-quarter 1999 pro forma earnings release. *See Press Release -- SEC Brings First Pro Forma Financial Reporting Case*, Securities and Exchange Commission, Jan. 16, 2002 (available at http://www.sec.gov/news/headlines/trumphotelsd.htm); Christina Binkley & Judith Burns, *Trump Hotels Gets Rebuke From SEC on Earnings Report*, Wall St. J., Jan. 17, 2002, at B4. Trump Hotels consented to the SEC's cease and desist order without admitting or denying the findings. Teach & Reason, *supra* note 169; David S. Ruder, et al., *The Securities and Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103, 1133-34 & n.172 (2005).

[180] Jonathan Weil, *SEC Threatens to Sue Companies for Misleading 'Pro Forma' Results*, Wall St. J., Dec. 5, 2001, at A2.

[181] In 2003, 17,988 public companies were registered with the SEC and subject to the federal securities laws. 15,847 of these companies were domestic and 2,141 were foreign. *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, Report by U.S. General Accounting Office to Senate Comm. on Banking, Housing, and Urban Affairs and House Comm. on Financial Services 15 (Nov. 2003) (GAO-04-216) (hereafter *Mandatory Audit Firm Rotation*). Available at http://www.gao.gov.

[182] United States v. Arthur Young & Co., 465 U.S. 805, 810 (1984).

the auditor's review of the company's records and verification of their accuracy through sampling, confirmation, or observation.[183]

Prior to Sarbanes-Oxley, auditing standards in the United States were the responsibility of the AICPA. Over the years the AICPA's Auditing Standards Board (ASB) issued a number of specific Statements on Auditing Standards (SAS) that generally comprise GAAS.[184] Approximately 100 SASs have been issued, and they were substantially codified in 2002.[185] Sarbanes-Oxley changed the auditing landscape by ousting AICPA from its standard-setting role and granting to the PCAOB the authority to set auditing standards to be used by registered public accounting firms in the preparation and issuance of required audit reports.[186] In April 2003 the PCAOB announced that it would not recognize any professional group of accountants to propose auditing standards. Instead, the PCAOB would develop "Professional Auditing Standards" that must be followed by registered public accounting firms for audits of public companies.[187] In the meantime, the PCAOB adopted as interim standards the ASB's auditing, attestation, and

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[183] For a judicial description of the audit process, *see* Bily v. Arthur Young & Co., 834 P.2d 745, 749-50 (1992).

[184] Larry P. Bailey, 2003 Miller GAAS Guide: A Comprehensive Restatement of Standards for Auditing, Attestation, Compilation, and Review 4-5 (2003). The ASB, a senior technical committee of the AICPA, was expanded in 2003 to include 19 members – most of whom are practicing CPAs. *News Release -- AICPA Expands Membership on Auditing Standards Board,* American Institute of Certified Public Accountants, Oct. 20, 2003. Available at http://www.aicpa.org. ASB members are not required to ever ties with their employers, and in this respect the ASB is even less independent than FASB. John E. McEnroe & Marshall K. Pitman, *An Analysis of the Accounting Profession's Oligarchy: The Auditing Standards Board*, *in* 16 RESEARCH IN ACCOUNTING REGULATION 29, 31 (Gary J. Previts ed., 2003).

[185] Lawrence A. Cunningham, *Private Standards in Public Law: Copyright, Lawmaking and the Case of Accounting*, 104 MICH. L. REV. 291, 312 (2005).

[186] David E. Hardesty, Corporate Governance and Accounting Under the Sarbanes-Oxley Act of 2002, at 107 (2002).

[187] *See PCAOB Release No. 2003-005 -- Statement Regarding the Establishment of Auditing and Other Professional Standards*, Public Company Accounting Oversight Board, Apr. 18, 2003. Available at http://www.pcaobus.org/rules/Release2003-005.pdf.

quality control standards, the AICPA's ethics and independence standards, and any relevant standards issued by the SEC, all as they existed on April 16, 2003.[188] These interim standards would ultimately be modified, repealed, replaced, or adopted permanently. The PCAOB adopted its first new auditing standard in December 2003.[189]

Currently, the primary SAS applicable to the detection of fraud during the conduct of an audit is SAS No. 99, "Consideration of Fraud in a Financial Statement Audit." This standard was approved by the AICPA in October 2002, and it is effective for audits of financial statements for periods beginning on or after December 15, 2002.[190] SAS No. 99, which has been adopted on an interim basis by the PCAOB, replaced SAS No. 82, which carried the same title.[191]

SAS No. 82, adopted in February 1997, was inadequate. An audit conducted pursuant to this standard was not a 'fraud audit' or a detailed forensic-style examination

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[188] *See PCAOB Release No. 2003-006 -- Establishment of Interim Professional Auditing Standards*, Public Company Accounting Oversight Board, Apr. 18, 2003. Available at http://www.pcobus.org/rules/Release2003-006.pdf. *See also* Kris Frieswick, *How Audits Must Change*, CFO Magazine, July 1, 2003 (AICPA holds the copyright for all of the auditing standards it has drafted since it began issuing them 60-plus years ago, so until the PCAOB writes its own standards, it must use the ones that AICPA wrote, possibly at cost). Available at http://www.cfo.com. *Cf.* Cunningham, *supra* note 185, at 293 (AICPA work retains copyright, subject to some qualifications).

[189] *See Press Release -- Board Adopts First Auditing Standard, Technical Amendments*, Public Company Accounting Oversight Board, Dec. 17, 2003. Available at http://www.pcaob.org/pcaob_news_12-17-03.asp. Meanwhile, the ASB continues to set auditing standards for non-public companies.

[190] Stephen Taub, *AICPA Unveils Anti-Fraud Standard*, CFO Magazine, Oct. 16, 2002. Available at http://www.cfo.com.

[191] Earlier, SAS No. 82 had replaced SAS No. 53, "The Auditor's Responsibility for the Detection of Errors and Irregularities." SAS No. 53, adopted by the AICPA in April 1988, required the auditor to design the audit to provide reasonable assurances of detecting material errors and irregularities. This standard had little effect on audit planning and testing, and it received limited acceptance from public users, the SEC, and the courts. *The Accounting Profession*, *supra* note 21, at 64. The original standard, SAS No. 16 ("Errors or Irregularities") was issued by the AICPA in 1977. Jeanne Calderon & Rachel Kowal, *Auditors Whistle an Unhappy Tune*, 75 DENV. U. L. REV. 419, 434 (1998).

of evidence.[192] SAS No. 82 also maintained the AICPA's position that an auditor had no obligation to disclose the existence of fraud to third parties, once discovered.[193] One study concluded that while the stated purpose of SAS No. 82 was to clarify auditors' responsibilities to detect fraud, the AICPA's actual intent was to lower public expectations concerning such obligations.[194] A separate study conducted by the PCAOB's predecessor -- the POB ---concluded that SAS No. 82 failed to effectively deter fraud or significantly increase the likelihood that the auditor would detect material fraud, primarily because the standard failed to direct auditing procedures toward fraud detection.[195]

SAS No. 99 superseded SAS No. 82 in October 2002, in the wake of Enron and other accounting scandals, but once again it did not alter the auditor's minimal responsibility to detect fraud. SAS No. 99 focused more on risk assessment than on forensic procedures.[196] It retained the mantra that the auditor's responsibility is merely to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatements.[197]

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[192] *Public Oversight Board*, *supra* note 162, at 76.

[193] Calderon & Kowal, *supra* note 191, at 437.

[194] *See* McEnroe & Pitman, *supra* note 184, at 39.

[195] *Public Oversight Board*, *supra* note 162, at 86. *See also* John H. Eickemeyer, *Audit Issues in Litigation*, SH057 ALI-ABA 87, 104 (2003) (SAS No. 82 provides little specific guidance for auditors in detecting fraud and imposes no requirement that auditors attempt such detection); Stephen T. Jakubowski, *et al*., *SAS 82's Effects on Fraud Discovery*, CPA J., Feb. 2002 (SAS 82 has not led to increase in discovery of fraudulent financial reporting) (available at http://www.cpajournal.com.

[196] Frieswick, *supra* note 188.

[197] See *The Sarbanes-Oxley Act of 2002 -- Understanding the Independent Auditor's Role in Building Public Trust*, PricewaterhouseCoopers 22-23 (2003). Available at http://pwcglobal.com/Extweb/NewCoAtWork.nsf. *Accord* Daniel D. Montgomery, Mark S. Beasley, Susan L. Menelaides & Zoe-Vonna Palmrose, *Auditors' New Procedures for Detecting Fraud*, J. ACCT. 63, 63 (May 2002) (successor to SAS No. 82 does not change auditor's responsibilities for fraud detection in a

Given that GAAS historically has not been concerned with fraud detection, it is not surprising that auditors uncover only a small amount of the corporate fraud that takes place in the United States. The cost of such fraud is estimated at $600 billion annually in this country,[198] but only a fraction of this huge sum is uncovered by auditors. A study by the Association of Fraud Examiners found that external auditors detect only 11.5 percent of all corporate fraud. A higher percentage is discovered by accident.[199] Of course, some fraud will be virtually impossible to detect.[200] But much of the remainder likely goes undetected at least in part because audits are not designed under GAAS to find fraud.

Numerous other indicia of audit failure in the United States are available. One is the extraordinary number of restatements of financial statements that have occurred in recent years. Restatements are significant, because they can be considered as a "proxy for fraud"[201] that was not uncovered in an initial audit. A 2005 study by the Huron

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financial statement audit); Joseph T. Wells, *New Approaches to Fraud Deterrence*, J. ACCT. 72, 74 (Feb. 2004) (auditors have historically attempted to avoid responsibility for fraud detection).

[198] 2002 Report to the Nation: Occupational Fraud and Abuse, Association of Certified Fraud Examiners 11 (2002).

[199] *Id.* (18.8% of fraud is discovered by accident). *See also* Stephen Taub, *Corporate Crime Increases*, CFO Magazine, Nov. 30, 2005 (2005 survey by PricewaterhouseCoopers of 3,634 companies in 34 countries finds that 34% of corporate fraud is discovered by accident, making chance the most common fraud detection tool) (available at http://www.cfo.com); *Lessons Learned from Enron's Collapse -- Auditing the Accounting Industry: Hearings Before House Comm. on Energy and Commerce*, 107th Cong. 78, 156 (2002) (statement of James S. Chanos) (no major financial fraud in the United States in the last ten years was uncovered by an outside accounting firm); Howard R. Davia, Patrick C. Coggins, John C. Wideman & Joseph T. Kastantin, ACCOUNTANT'S GUIDE TO FRAUD DETECTION AND CONTROL 37 (2d. ed. 2000) (auditors uncover 20 percent of fraud in the United States). The SEC's track record is no better. The SEC failed to spot almost every major financial scandal in recent years. Mark Maremont & Deborah Solomon, *Missed Chances: Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance*, Wall St. J., Dec. 24, 2003, at A1.

[200] *See*, *e.g*., Lance Levine, *Compliance with GAAP and GAAS: Its Proper Use as an Accountant's Defense in a Rule 10b-5 Suit*, 1993 COLUM. BUS. L. REV. 109, 125 (1993) ("It is clear that management, in most cases, will be perfectly capable of disguising a fraudulent scheme from its auditors if it wishes.").

[201] Coffee, *supra* note 4, at 1407; Warren, *supra* note 13, at 886. Not all restatements are attributable to fraud. For example, by mid-2003, nine of the 288 U.S.-listed companies electing to expense stock options had decided to restate results to reflect that accounting change. Jonathan Weil, *Microsoft's Reboot:*

Consulting Group found that restatements of quarterly and annual statements reached a record high of 414 in 2004, a 28 percent increase from the 323 total restatements in 2003. The number of restatements involving annual, audited financials rose to a record high of 253 in 2004.[202] An earlier study by the United States General Accounting Office confirmed the soaring numbers. According to the GAO study, the number of restatements due to accounting irregularities increased 145 percent from January 1997 to June 2002. The number of restatements rose from 92 in 1997 to 225 in 2001. The proportion of listed companies on the New York Stock Exchange, the American Stock Exchange, and NASDAQ restating their financial reports tripled from less than 0.89 percent in 1997 to about 2.5 percent in 2001. From January 1997 to June 2002, about ten percent of all listed companies announced at least one restatement. The restating companies lost about $100 billion in market capitalization.[203]

Decision To Restate Earnings Is Unusual, Wall St. J., July 10, 2003, at C1. Some restatements also result from new accounting methods required by the SEC. *See SEC Plans Initiative Tied To Restatements,* Wall St. J., Dec. 5, 2003 (available at 2003 WL-WSJ 68130109); Michael Schroeder, *SEC List of Accounting-Fraud Probes Grows*, Wall St. J., July 6, 2001, at C1 (study by Arthur Andersen finds that nine percent of restatements are explained by new accounting methods). More generally, while an estimated 61% of the 98 reported restatements of annual financial statements resulted in securities class action litigation in 2000, by 2004 that figure had declined to an estimated 17%. 2004 PWC Study, *supra* note 19, at 11. The occurrence of a restatement raises average settlement values 20 percent in securities fraud class actions, even in the absence of an auditor as a co-defendant. *Recent Trends*, *supra* note 10, at 10. *See also* John C. Coffee, Jr., *Limited Options*, LEGAL AFFAIRS 52, 52 (Nov./Dec. 2003) (in general, restatements are not mere technical accounting adjustments, as indicated by immediate market-adjusted average decline of ten percent in stock price of firms announcing restatements).

[202] *Summary: 2004 Annual Review of Financial Reporting Matters*, Huron Consulting Group (2005), available at http://www.huronconsultinggroup.com. *See also* Diya Gullapalli, *Tracking the Numbers/Outside Audit: Too Err Is Human, to Restate Financials, Divine*, Wall St. J., Jan. 20, 2005, at C3.

[203] *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges -- Report to the Senate Comm. on Banking, Housing and Urban Affairs,* U.S. General Accounting Office 4 (Oct. 2002) (GAO-03-138) (available at http://www.gao.gov). While the loss in market capitalization is significant, it represents less than 0.2 percent of the total market capitalization of the New York Stock Exchange, the American Stock Exchange, and Nasdaq. Rob Wells, *Restatements of Profits Prove Costly to Investors*, Wall St. J., Oct. 24, 2002, at D2. *See also* Nanette Byrnes, *Accounting in Crisis*, BusinessWeek, Jan. 28, 2002, at 44 (during the period 1996-2001, investors lost close to $200 billion in earnings restatements and lost market capitalization following audit failures); Coffee, *supra* note 201, at 52-53 (the ten percent of all listed companies that restated earnings represents only the proverbial

The foregoing numbers are especially significant when placed in historical context. Just three United States companies restated results in 1981.[204] Another apt comparison is with the number of restatements in other countries. Britain's equivalent to the SEC -- the Financial Reporting Review Panel -- demanded that a mere 15 companies restate results during the 12 years prior to 2003. Statistics for Europe as a whole are comparable to those for Britain. (Of course, these numbers could represent nothing more than lax enforcement overseas.)[205]

Improper revenue recognition was the leading cause of restatements during the period 2000-2004,[206] consistent with the most common allegation in securities class action suits and the most common explanation for SEC enforcement actions.[207] Some of the announced restatements have been extraordinarily large -- $9 billion for Fannie Mae, $6.4 billion for Xerox, $5 billion for Freddie Mac, $3.9 billion for AIG, at least $2.2 billion for Qwest Communications, $2 billion for Tyco, and $1.6 billion for Rite-Aid.[208]

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tip of the iceberg, "signaling a far larger concentration of companies that manipulated their earnings and got away with it."); and Coffee, *supra* note 14, at 282-85 ("During the 1990s, earnings restatements, long recognized as a proxy for fraud, suddenly soared. . . . [They] were increasingly issued by large, mature, publicly held firms, rather than by smaller, less experienced companies.").

[204] Ianthe Jeanne Dugan, *Depreciated: Did You Hear the One About the Accountant? It's Not Very Funny*, Wall St. J., March 14, 2002, at A1. *See also* Benston, *supra* note 42, at 1339 n.56 (search of databases for mentions of restatements due to irregularities or errors finds 274 in 1977-1989 (17 a year on average), 392 in 1990-1997 (49 a year), and 464 in 1998-2000 (155 a year)).

[205] *See* Floyd Norris, *Corporate Rules in Europe Have Been Flexible, but Change Is Coming*, N.Y. Times, Apr. 8, 2005, at C1; *Ahold Out: The Ahold Scandal Shows That Europe Is Not Immune from America's Corporate Ills,* Economist, Feb. 27, 2003; *and Holier Than Thou: European Sanctimony Over American Accounting Scandals Is Misplaced*, Economist, Feb. 6, 2003 (available at http://www.economist.com).

[206] Stephen Taub, *Record Number of Restatements in 2004*, CFO Magazine, Jan. 21, 2005. Available at http://www.cfo.com. *See also* Lynn Cowan, *The Economy: More Large-Cap U.S. Companies Restate Results Than Small Fry*, Wall St. J., Aug. 9, 2002, at A2.

[207] *See* n.14, *supra*.

[208] Stephen Taub, *AIG Finally Files 10-K, Restates*, CFO Magazine, May 31, 2005 (available at http://www.cfo.com); Stephen Taub, *Refunding Bonuses for Restated Earnings*, CFO Magazine, Jan. 7,

Another sign of widespread audit failure is the high percentage of corporations that file for bankruptcy subsequent to being audited and given a clean bill of health. Between January 1, 2001 and June 30, 2002, 307 publicly traded companies filed for Chapter 11 protection. 228 of these companies received an auditor's report within 366 days of filing for protection -- 85 percent of them from a Big Five accounting firm. But only 57.9 percent of these 228 reports for soon-to-be bankrupt companies included "going-concern" warnings,[209] which an auditor is required to provide under SAS No. 59 if substantial doubt exists about an audit client's ability to continue as a going concern and a disclaimer of opinion is not provided by the auditor.[210] Likewise, a 2002 study by Bloomberg News found that in 54 percent of the 673 largest bankruptcies of public

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2005 (available at http://www.cfo.com); Shawn Young, *Executives on Trial: Qwest Trial Shows That Rank Is No Protection*, Wall St. J., Apr. 2, 2004, at C1; *The Rest of the Fallen: Heads Rolled Over Bungled Launches, Loose Accounting, and Soured Deals*, BusinessWeek, Jan. 12, 2004, at 78, 79; Craig Schneider, *Xerox: New Lease on Life*, CFO Magazine, Oct. 24, 2003 (available at http://www.cfo.com); *Executives on Trial: Rite Aid Ex-Counsel Is Convicted*, Wall St. J., Oct. 20, 2003, at C8; Marcelo Prince & Christine Nuzum, *Qwest's Long-Awaited Revision of Results Shows Wider Losses*, Wall St. J., Oct. 17, 2003, at A8; and *Executives on Trial: Scandal Scorecard*, Wall St. J., Oct. 3, 2003, at B1.

[209] Martin D. Weiss, *The Worsening Crisis of Confidence on Wall Street: The Role of Auditing Firms* 7-8 (July 5, 2002). The same study (the Weiss Report), submitted to the United States Senate in connection with hearings on Sarbanes-Oxley, concluded that auditing firms gave a clean bill of health to 93.9 percent of public companies that were subsequently involved in accounting irregularities. *Id.* at 4. The Weiss Report, available at http://www.weissratings.com/worsening_crisis.pdf, has been criticized. *See* Michael D. Akers, *et al*., *Going-Concern Opinions: Broadening the Expectations Gap*, CPA J., Oct. 2003 ("The flaws of the Weiss Report – inadequate sample selection; the use of criteria not proved to predict bankruptcy; and the lack of statistical support – suggest that the study cannot be relied upon as an indicator of the success or failure of auditing firms to predict the bankruptcy or the going concern status of a company.") Available at http://www.cpajournal.com. However, other studies have confirmed that auditing firms frequently fail to issue going concern opinions to firms that shortly thereafter file for bankruptcy. *See* M. Geiger & K. Raghunandan, *Going Concern Opinions in the "New" Legal Environment*, 16 ACCT. HORIZONS 17 (2002); K. Raghunandan & K. Rama, *Audit Reports for Companies in Financial Distress Before and After SAS No. 59*, 14 AUDITING: J. PRACTICE & THEORY 50 (1995).

[210] J.V. Carcello, D.R. Hermanson & T.L. Neal, *Auditor Reporting Behavior When GAAS Lacks Specificity: The Case of SAS No. 59*, 22 J. ACCT. & PUB. POLICY 63 (2003); Bruce K. Behn, Kurt Pany & Richard Riley, *SAS No. 59: Going Concern Evidence*, CPA J. (July 1999). Available at http://www.nysscpa.org/cpajournal/1999. SAS No. 59 was amended by SAS No. 96 in January 2002 (effective for audits of financial statements for periods beginning on or after May 15, 2002), but the amendment did not alter the basic requirement. *See* http://aicpa.org/members/div/auditstd/riasai/sas96.htm.

companies since 1996, auditors provided no cautions in annual financial statements in the months before the bankruptcy filing. Auditors issued warnings in only 14 of the 50 largest bankruptcies.[211] More recently, a 2004 report found that 40-50 percent of all companies filing for bankruptcy since the effective date of SAS 59 failed to receive a going-concern paragraph in the audit opinion on their last financial statements issued prior to filing for bankruptcy.[212]

Still another measure of likely audit failure is provided by the limited reporting made by auditors under Section 10A of the Exchange Act. The PSLRA added Section 10A, which requires reporting to the SEC when, during the course of a financial audit, an auditor detects likely illegal acts that have a material impact on the financial statements and appropriate remedial action is not being taken by management or the board of directors.[213] Section 10A first became effective for most companies for fiscal years beginning on or after January 1, 1996. From the inception of the reporting requirement until May 15, 2003, a mere 29 Section 10A reports had been submitted to the SEC -- an average of fewer than four per year.[214] This is a remarkably low number, given the

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[211] Stephen Taub, *Teetering on the Brink -- But No Audit Warning*, CFO Magazine, Apr. 25, 2002. Available at http://www.cfo.com.

[212] Elizabeth K. Venuti, *The Going-Concern Assumption Revisited: Assessing A Company's Future Viability*, CPA J., May 2004 (arguing that one effect of PSLRA was to tip scales in favor of not issuing a going-concern opinion, because PSLRA protects auditors from lawsuits, whereas issuance of going – concern opinion could hasten demise of client and result in loss of audit fees). Available at http://www.nysscpa.org.

[213] 15 U.S.C. § 78j-1. *See generally* Daniel J. Kramer & James McBride, *Section 10A of the Securities Exchange Act of 1934: Auditors' Duty to Detect and Disclose Fraud Under the Federal Securities Laws*, 1309 PLI/Corp 307 (May – June 2002); Jamie A. Barber, Note, *Congressional Oversight: Interpreting the Phrase "Financial Statements" Within Section 10A of the Securities Exchange Act of 1934*, 31 HOFSTRA L. REV. 849 (2003).

[214] *Securities Exchange Act: Review of Reporting Under Section 10A*, Report by U.S. General Accounting Office to House Comm. on Energy and Commerce 5 (Sept. 3, 2003) (GAO-03-982R) (hereafter *Section 10A*). Available at http://www.gao.gov. *See also* John Connor, *Auditors File 29 Cases of Likely Illegal Activity*, Wall St. J., Oct. 7, 2003, at A14. By comparison, during the same time period (1996-2003), the

18,000 or so financial statement audits that take place annually in the United States and the high tide of accounting scandals that swept over corporate America beginning in the late 1990s.[215]

Yet another indication is that material weakness reports have sharply increased in the Sarbanes-Oxley environment. Section 404 of the the Act, which requires an independent auditor to attest to a company's internal controls, became effective for many public companies beginning with their first fiscal year ending after November 15, 2004. Materal weakness reports skyrocketed in 2005, compared with 2004, in the aftermath of Section 404's implementation. It is more likely that this upturn represents more stringent scrutiny by auditors, post-Section 404, than it does an actual increase in deficiencies.[216]

The foregoing evidence collectively suggests widespread historical audit failure in the United States.[217] While the list of explanations for audit failure is long, a significant part of the problem lies with GAAS itself. As indicated above, GAAS does not require auditors to look for fraud. Auditors are not required to conduct forensic audits, which are

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SEC filed seven actions against auditors for alleged violations of Section 10A for failing to file the required reports. Six of the cases had settled by September 2003, with the majority of auditors agreeing to suspensions from practice before the SEC for periods ranging from one to ten years. *Section 10A*, at 1-2. The task of the SEC is made easier in these cases by the absence of a scienter requirement in Section 10A. SEC v. Solucorp Indus., Ltd., 197 F. Supp. 2d 4, 10-111 (S.D.N.Y. 2002).

[215] *But see* Thomas L. Riesenberg, *Trying To Hear the Whistle Blowing: The Widely Misunderstood "Illegal Act" Reporting Requirements of Exchange Act Section 10A*, 56 BUS. LAW. 1417, 1458 (2001) (10A reports should be rare, because few boards of directors will refuse to respond to findings of fraud presented by external auditors). *Cf. PWC 2004 Study, supra* note 19, at 10 (predicting significant increase in Section 10A matters, from 2005 onward).

[216] Helen Shaw, *Material-Weakness Reports Skyrocket*, CFO Magazine, July 18, 2005. Available at http://www.cfo.com.

[217] *See*, *e.g.*, Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 419 (2004) (late 1990s and early 2000s saw numerous and sizable audit failures). *But see* Stephen Barr, *Breaking Up the Big 5*, CFO Magazine, May 1, 2000 (only 1 in 10,000 audits is deemed substandard by regulators, and only three-tenths of one percent of all audits result in a legal claim). Available at http://www.cfo.com.

designed to uncover fraudulent conduct. In 2000, PCAOB's predecessor -- the POB -- issued a comprehensive report recommending that auditors use forensic techniques in every audit.[218] While SAS No. 99, adopted in 2002, does not mandate the use of such techniques, the Big Four and other firms were aggressively expanding their forensic accounting practices in 2004.[219] No doubt the auditing industry has determined that this can be a lucrative practice area. Fees for outside auditors tripled in 2003 for companies with at least $3 billion in sales -- in part because forensic techniques are time-consuming and expensive. In 2004, audit fees paid to Big Four firms more than doubled.[220] But forensic auditing remains the clear exception, even after Sarbanes-Oxley and the SEC rules adopted in its aftermath. Moreover, the adoption of Sarbanes-Oxley has caused

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[218] *Public Oversight Board*, *supra* note 162, at 88.

[219] Diya Gullapalli, *Andersen Survivors Aim to Benefit From Scandals*, Wall St. J., Sept. 14, 2004, at C1. *See also* Vinita Ramaswamy, *Corporate Governance and the Forensic Accountant*, CPA J., March 2005 (available at http://www.nysscpa.org).

[220] Stephen Taub, *Audit Fees Double Due to Sarbox*, CFO Magazine, Feb. 11, 2005 (available at http://www.cfo.com); Jill M. D'Aquila, *Tallying the Cost of the Sarbanes-Oxley Act*, CPA J., Nov. 2004 (available at http://www.nysscpa.org). Some of this audit fee increase is attributable to compliance with Section 404 of Sarbanes-Oxley. Section 404 requires that management assess the effectiveness of a company's internal control over financial reporting and that external auditors attest to, and report on, that assessment. The number of controls that major companies must test and document can run into the tens of thousands. *404 Tonnes of Paper*, Economist, Dec. 16, 2004 (available at http://www.economist.com). Section 404's reporting requirements became applicable to large public companies in the 2004 audit cycle, and companies representing over 95% of total U.S. market capitalization are now obligated to comply with the requirements. Section 404 helps explain the recent increase in audit fees. According to one study, the net private costs associated with Section 404 compliance are $1.4 trillion. *See Sarbanes-Oxley: A Price Worth Paying?*, Economist, May 19, 2005 (available at http://www.economist.com). *See also* Stephen Taub, *404 Costs to Drop, Big Four Maintain*, CFO Magazine, Dec. 9, 2005 (study of 96 members of Fortune 1,000 finds that audit fees account for just one-fourth of total Section 404 costs for larger companies and about one-third of 404 costs for smaller companies) (available at http://www.cfo.com); Donna Fuscaldo, *For Tech Firms, Sarbanes-Oxley Provides Revenue Opportunities*, Wall St. J., Dec. 1, 2004 (public companies expected to spend $5.5 billion in 2004 and $5.8 billion in 2005 to become Sarbanes-Oxley compliant, but only a portion of these sums are attributable to audit fees). Companies disclosing control weaknesses are fairly likely to change auditors. A 2005 survey found that 44% of 329 companies disclosing control weaknesses changed auditors. Stephen Taub, *Auditor Changes Accompany Controls Woes*, CFO Magazine, May 24, 2005 (available at http://www.cfo.com).

some accounting firms to sell their forensic accounting practices, in order to avoid potential conflicts of interest.[221]

Another obstacle to success is that most of the forensic auditing that does occur is targeted at the employee level, thereby ignoring the much more significant fraud undertaken by senior members of management.[222] A study of 276 corporate frauds perpetrated during the period 1987-1999 found that the company's chief executive officer was involved approximately 70 percent of the time.[223] Similarly, the SEC has reported that the majority of enforcement actions it brought during the period 1997-2002 regarding fraudulent financial reporting stemmed from misconduct by top-level executives. 157 of the 227 enforcement actions brought by the SEC during this time period involved charges against at least one senior manager. Charges were brought against 75 Chairmen of the Board, 111 Chief Executive Officers, 111 Presidents, 115 Chief Financial Officers, 21 Chief Operating Officers, 16 Chief Accounting Officers, and 27 Vice Presidents of Finance.[224] Forensic auditing techniques currently employed by the Big Four firms are not generally geared toward uncovering such high-level fraud,[225] and thus it usually escapes undetected.

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[221] Marie Beaudette, *Some Firms Profit by Sarbanes-Oxley*, Wall St. J., Nov. 10, 2004, at B12C.

[222] Frieswick, *supra* note 188.

[223] Ken Brown, *Auditors' Methods Make it Hard To Catch Fraud by Executives*, Wall St. J., July 8, 2002, at C1. *See also* David M. Brodsky, *The Role of Forensic Accounting in Identifying and Reacting to Allegations of Financial Fraud and Employee Misconduct*, 1491 PLI/Corp 39, 44 (Feb. 2005) (90% of financial reporting frauds are committed at the senior executive level).

[224] *Section 704 Report*, *supra* note 14, at 32. *See also* Michael Schroeder, Jerry Guidera & Mark Maremont, *Accounting Crackdown Focuses Increasingly on Top Executives*, Wall St. J., Apr. 4, 2002, at A1.

[225] *See* Charles P. Cullinan & Steve G. Sutton, *Defrauding the Public Interest: A Critical Examination of Reengineered Audit Processes and the Likelihood of Detecting Fraud*, 13 CRIT. PERSPEC. ACCT. 297 (2002). *See also* Judith Burns, *Corporate Governance (A Special Report)*, Wall St. J., June 21, 2004, at R8

IV.
THE SCIENTER STANDARD: THE CIRCUIT SPLIT

Almost 90 percent of the securities class action suits filed in 2004 involved claims made under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act).[226] In 1976, the United States Supreme Court held in *Ernst & Ernst v. Hochfelder* that merely negligent misstatements will not establish liability under Section 10(b). Rather, plaintiffs are required to establish that defendants acted with scienter, defined by the Court as misconduct that is "knowing or intentional."[227] The Court did not foreclose the possibility that "recklessness" would satisfy the scienter requirement,[228] and every federal court of appeals to later consider the issue has held that recklessness does suffice.[229] However, even prior to the enactment of the PSLRA the courts disagreed about what was required to plead recklessness.[230]

(statement of former SEC Chairman Richard Breeden that post-Sarbanes-Oxley, "the area that is most broken is the audit profession, in its ability to detect fraud and abuse").

[226] *2004: A Year in Review*, *supra* note 9, at 16. Section 10(b) of the Exchange Act and companion SEC Rule 10b-5 make it illegal to commit a manipulative or deceptive act in connection with the purchase or sale of securities. Section 10(b) states, in relevant part: "It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78(b). SEC Rule 10b-5 is similar. *See* 17 C.F.R. § 240.10b-5 (2003). The elements of a Rule 10b-5 claim are: (1) a misrepresentation or omission of a material fact, (2) scienter, (3) causation, (4) reliance, and (5) damages. The causation element requires a showing of both actual cause and proximate cause. *See, e.g.*, In re Daou Systems, Inc. Sec. Litig., 397 F.3d 704, 710 (9th Cir. 2005).

[227] 425 U.S. 185, 197 (1976).

[228] *Id.* at 193 n.12.

[229] Ottman v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 343-44 (4th Cir. 2003); Joseph Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 651 (2002); and Bruce Cannon Gibney, Comment, *The End of the Unbearable Lightness of Pleading: Scienter After Silicon Graphics*, 48 UCLA L. REV. 973, 1001-02 (2001).

[230] Matthew Roskoski, Note, *A Case-by-Case Approach to Pleading Scienter Under the Private Securities Litigation Reform Act of 1995*, 97 MICH. L. REV. 2265, 2267 (1999); Michael B. Dunn, Note, *Pleading*

The debate intensified after the PSLRA became law in 1995. That statute requires that private plaintiffs, in addition to satisfying the specificity requirements of Rule 9(b) of the Federal Rules of Civil Procedure, "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind."[231] Subsequent to the enactment of the PSLRA, federal courts of appeal in ten different circuits issued opinions interpreting the "strong inference" standard. These opinions conflict, primarily as to whether allegations of motive and opportunity to commit fraud satisfy the PSLRA's pleading requirement for scienter.[232] The circuit split emerged in large measure because the legislative history of the PSLRA provides little concrete guidance concerning the appropriate interpretation.[233]

The appellate opinions are frequently divided into three camps for analysis: (1) Second and Third Circuits; (2) Ninth Circuit; and (3) First, Fourth, Fifth, Sixth, Eighth, Tenth, and Eleventh Circuits. The Seventh and D.C. Circuits had not issued controlling opinions by December 2005, but several district courts in those circuits have addressed the scienter standard since the PSLRA was enacted. The next section of this Article

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Scienter After the Private Securities Litigation Reform Act: Or, A Textualist Revenge, 84 CORNELL L. REV. 193, 199 (1998).

[231] 15 U.S.C. § 78(u)-4(b)(2) (2000).

[232] Gregory A. Markel, *Pleading Scienter Under the Private Securities Litigation Reform Act of 1995*, 1396 PLI/Corp 1339, 1342-43 (Nov. 2003).

[233] *See* Grundfest & Pritchard, *supra* note 229, at 665-66 ("The authors find it difficult to draw any conclusion from the mélange of legislative history about Congress' intent in adopting the 'strong inference' pleading standard. . . . We suggest that Congress was content to enact an ambiguous statute.") *Accord* Chuan Li, Note, *Gauging the Hurdle to Strike Suits: Reconciling the Circuit Split Over the Proper Interpretation of the Heightened Pleading Standard Under the Private Securities Litigation Reform Act*, 26 J. CORP. LAW 435, 439 (2001) ("[T]he legislative history is confusing and has not been helpful. . . ."). *But see* Michael R. Dube, Note, *Motive and Opportunity Test Survives Congressional Death Knell in Private Securities Litigation Reform Act*, 42 B.C. L. REV. 619, 642-43 (2001) ("[I]t is difficult to view the legislative history of the PSLRA as anything other than Congressional rejection of the motive and opportunity test.")

briefly examines key appellate decisions from the three camps, as well as district court opinions from the undecided circuits.

A. Second and Third Circuits

The Second Circuit test arguably has had three different post-PSLRA manifestations.[234] These manifestations have been the product of different Second Circuit panels, which issued a series of conflicting opinions during the period 1999 – 2001. The series of cases included *Press v. Chemical Investment Services Corp*. (PSLRA was a codification of the Second Circuit's own pre-Act jurisprudence, and scienter could be pled by showing either motive and opportunity to commit fraud, or strong circumstantial evidence denoting recklessness or conscious misbehavior);[235] *Novak v. Kasaks* (courts are not wedded to the motive and opportunity test, and plaintiffs are required to plead conscious recklessness or actual intent);[236] *Rothman v. Gregor*[237] and *Ganino v. Citizens Utilities Co.*[238] (both retreating from *Novak*); and *Kalnit v. Eichler* (making strict application of motive and opportunity test).[239] Overall, for a period of time there was a material disagreement within the Second Circuit concerning the proper interpretation of that Circuit's own standard.[240] Now, however, Second Circuit courts generally agree that plaintiffs must allege facts showing (a) both motive and opportunity,

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[234] Grundfest & Pritchard, *supra* note 229, at 653-54.

[235] 166 F.3d 529, 538 (2d Cir. 1999).

[236] 216 F.3d 300, 309-12 (2d Cir. 2000).

[237] 220 F.3d 81, 90 (2d Cir. 2000).

[238] 228 F.3d 154, 168-70 (2d Cir. 2000).

[239] 264 F.3d 131, 139-41 (2d Cir. 2001).

[240] Grundfest & Pritchard, *supra* note 229, at 673.

or (b) strong circumstantial evidence of conscious misbehavior or recklessness.[241] This is the most pro-plaintiff standard in the country,[242] and the Third Circuit is in accord.[243]

B. Ninth Circuit – At The Edge

The Ninth Circuit has made the strictest interpretation of the scienter pleading standard. The leading case is *In re Silicon Graphics Inc. Securities Litigation*,[244] which held that plaintiffs must plead, at a minimum, "particular facts giving rise to a strong inference of deliberate or conscious recklessness."[245] While adopting what has been described as a "super-recklessness" standard,[246] the Ninth Circuit rejected the Second Circuit focus on pleading motive and opportunity.[247] Despite criticism that its standard

241 *See*, *e.g*., Rombach v. Chang, 355 F.3d 164, 176 (2d Cir. 2004); In re BISYS Sec. Litig., 2005 WL 2844792, *6 (S.D.N.Y., Oct. 28, 2005); In re Geopharma, Inc. Sec. Litig., 2005 WL 2431518, *5 (S.D.N.Y., Sept. 30, 2005). *See also* In re Worldcom, Inc. Sec. Litig., 2003 WL 21219049, *16 (S.D.N.Y., May 19, 2003) (noting Second Circuit retreat from *Novak*).

242 Grundfest & Pritchard, *supra* note 229, at 674. *See also* Ryan G. Miest, Note, *Would the Real Scienter Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud*, 82 MINN. L. REV. 1103, 1135 (1998) ("[E]mploying the motive and opportunity test fails to further the PSLRA's interest in reducing abusive securities litigation. . . .").

243 The leading Third Circuit case is In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999), which held that plaintiffs may plead scienter by alleging facts establishing motive and opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior. In addition, all allegations must be supported by particular facts and such allegations must give rise to a strong inference of scienter. *Id.* at 534-35. *Accord* Klein v. Autek Corp., 2005 WL 2106622, *5 (3d Cir. Sept. 1, 2005); In re: Alpharma Inc. Sec. Litig., 372 F.3d 137, 148 (3d Cir. 2004). *See also* James V. Fazio, *The Motive and Opportunity Test for Pleading Scienter Under the Federal Securities Laws: Where Is it Now?*, 50 FED. LAW. 51, 52 (May 2003) ("In short, the Second and Third Circuits appear to be the only two circuits in which allegations of motive and opportunity may be sufficient in themselves to show scienter.").

244 183 F.3d 970 (9th Cir. 1999).

245 *Id*. at 979. *Accord* Gompper v. VISX, Inc., 298 F.3d 893, 895 (9th Cir. 2002); DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 388-89 (9th Cir. 2002).

246 Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1284 n.21 (11th Cir. 1999). *See* Joseph T. Phillips, Comment, *A New Pleading Standard Under the Private Securities Litigation Reform Act?*, 69 U. CINN. L. REV. 969, 988 (2001).

247 183 F.3d at 979. *See* Brent Wilson, Comment, *Pleading Versus Proving Scienter Under the Private Securities Litigation Reform Act of 1995 in the Ninth Circuit After In re Silicon Graphics and Howard v. Everex: Meet the Pleading Standard and the Fat Lady Has Already Sung*, 38 WILLAMETTE L. REV. 321,

is too restrictive,[248] the Ninth Circuit has not retreated. Cases decided in 2005 continued to adhere to *Silicon Graphics*.[249]

C. The Intermediate Standard

If the Second and Third Circuits, on the one hand, and the Ninth Circuit, on the other hand, represent the respective endpoints of the scienter pleading spectrum, then the broad center is occupied by seven of the remaining Circuits. The center is not monolithic, but the fundamental perspective is the same -- merely pleading motive and opportunity generally will not suffice to demonstrate scienter, and facts sufficient to support a strong inference of recklessness are necessary. The First,[250] Fourth,[251] Fifth,[252] Sixth,[253] Eighth,[254] Tenth,[255] and Eleventh[256] Circuits all have adopted the centrist view.

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365 (2002) and Dube, *supra* note 225, at 645 ("Only the Ninth Circuit interpreted the PSLRA as an outright rejection of the motive and opportunity test."). *But see* Ann Morales Olazabel, *The Search for "Middle Ground": Towards a Harmonized Interpretation of the Private Securities Litigation Reform Act's New Pleading Standard*, 6 STAN. J.L. BUS. & FIN. 153, 173 (2001) ("Nothing in the opinion expressly rejects the consideration of motive and opportunity allegations. . . .").

[248] *See*, *e.g.*, Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1284 n.21 (11th Cir. 1999) ("To the extent that the effort in Silicon Graphics is an attempt to import into the law a new and uncertain super-recklessness, . . . we believe that the attempt is inconsistent with the plain statutory language. Further, we doubt that the attempt would be worth the additional uncertainty that would be introduced.").

[249] *See*, *e.g.*, In re Saxton, Inc. Sec. Litig., 2005 WL 3271342, *1 (9th Cir. Dec. 2, 2005); Livid Holdings Ltd. v. Salomon Smith Barney, Inc., 403 F.3d 1050, 1057 (9th Cir. 2005); and In re Daou Systems, Inc. Sec. Litig., 397 F.3d 704, 711, 718 (9th Cir. 2005). The Ninth Circuit scienter standard has received some academic support. *See*, *e.g.*, Aron Hansen, Comment, *The Aftermath of Silicon Graphics: Pleading Scienter in Securities Fraud Litigation*, 34 U.C. DAVIS L. REV. 769, 808 (2001) ("[T]he Ninth Circuit's deliberate recklessness standard is supported by case law, legislative history, and public policy considerations."); Marilyn F. Johnson, Karen K. Nelson & A.C. Pritchard, *In re Silicon Graphics Inc.: Shareholder Wealth Effects Resulting From the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard*, 73 S. CAL. L. REV. 773 (2000) (arguing that the *Silicon Graphics* interpretation of scienter enhances shareholder wealth).

[250] *See* In re Cabletron Systems, Inc. 311 F.3d 11 (1st Cir. 2002) (showing motive and opportunity does not suffice, but pleading combination of facts and circumstances indicating fraudulent intent does suffice); Aldridge v. A.T. Cross Corp., 284 F.3d 72 (1st Cir. 2002); Geffon v. Micron Corp., 249 F.3d 29 (1st Cir. 2001); and Greebel v. FTP Software, Inc., 194 F.3d 185 (1st Cir. 1999).

[251] *See* Ottman v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 345-46 (4th Cir. 2003) (courts should not restrict their scienter inquiry by focusing on specific categories of facts, such as those relating to motive and opportunity, but instead should examine all of the allegations in a case to determine whether they collectively establish a strong inference of scienter). The Fourth Circuit had ducked prior opportunities in

D. The Undecided Circuits

The Seventh and D.C. Circuits both failed to issue opinions on the scienter issue by December 2005. While the Seventh Circuit has not yet staked out a position, a number of district courts in the Circuit -- primarily in the Northern District of Illinois -- have chosen to apply the Second Circuit standard. These courts sometimes assert that while they are adopting the Second Circuit standard, they are not bound by that Circuit's

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2003 and 1999 to select a test, concluding on both occasions that even under the relatively lenient Second Circuit standard, plaintiffs' allegations failed to meet the PSLRA requirements. *See* Svezzese v. Duratek, Inc., 2003 WL 21357313, *4 (4th Cir., June 12, 2003) (*per curiam*) and Phillips v. LCI, Int'l, Inc., 190 F.3d 609, 621 (4th Cir. 1999).

252 *See* Goldstein v. MCI WorldCom, 2003 WL 21738963, *6 (5th Cir., July 28, 2003) ("[A]llegations of motive and opportunity, without more, will *not* fulfill the pleading requirements of the PSLRA.") (emphasis in original); Nathenson v. Zonagen Inc., 267 F.3d 400 (5th Cir. 2001). *Accord* Abrams v. Baker Hughes, Inc., 292 F.3d 424, 430 (5th Cir. 2002) ("Allegations of motive and opportunity, standing alone, are no longer sufficient to plead a strong inference of scienter, although appropriate allegations of motive and opportunity may enhance other allegations of scienter.").

253 *See* In re Ford Motor Co. Sec. Litig., 2004 WL 1873808, *2 (6th Cir., Aug. 23, 2004); Helwig v. Vencor, Inc., 251 F.3d 540, 550 (6th Cir. 2001) (while motive and opportunity are not substitutes for a showing of recklessness, "they can be catalysts to fraud and thus serve as external markers to the required state of mind."); In re: Comshare, Inc. Sec. Litig., 183 F.3d 542, 549 (6th Cir. 1999).

254 *See* In re: Navarre Corp. Sec. Litig., 299 F.3d 735, 745 (8th Cir. 2002) (scienter standard is "not satisfied by any one particular method, such as the motive-and-opportunity formulation adopted by the Second Circuit. . . but rather through various criteria developed throughout the circuits that look for badges of fraud."); Florida State Board of Administration v. Green Tree Financial Corp., 270 F.3d 645, 660 (8th Cir. 2001) (allegations of motive and opportunity are relevant, but when they are missing, other allegations tending to show scienter would have to be particularly strong). *Accord* Kushner v. Beverly Enterprises, Inc., 317 F.3d 820, 827 (8th Cir. 2003).

255 *See* Caprin v. Simon Transp. Services, Inc., 2004 WL 326995, *8 (10th Cir., Feb. 23, 2004); City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1261-62 (10th Cir. 2001) (courts must look to the totality of the pleadings to determine whether the plaintiffs' allegations permit a strong inference of fraudulent intent, and while allegations of motive and opportunity may be important to that totality, typically they are not sufficient in themselves to establish a strong inference of scienter). *See generally* Charles F. Hart, *Interpreting the Heightened Pleading of the Scienter Requirement in Private Securities Fraud Litigation: The Tenth Circuit Takes the Middle Ground*, 80 DENV. U. L. REV. 577 (2003).

256 *See* Bryant v. Avado Brands, Inc., 187 F.3d 1271 (11th Cir. 1999). The Tenth Circuit noted in *City of Philadelphia* that *Bryant* is internally inconsistent. 264 F.3d at 1261 n.19. On the one hand, *Bryant* concluded that the PSLRA did not codify the motive and opportunity analysis. On the other hand, *Bryant* asserted that such allegations may be relevant to a showing of severe recklessness, but without more are insufficient to demonstrate scienter. 187 F.3d at 1285-86. The *Bryant* analysis, which relies heavily on the Sixth Circuit discussion in *Comshare*, was later criticized by the Sixth Circuit. *See* Helwig v. Vencor, Inc. 251 F.3d 540, 550 (6th Cir. 2001) (Eleventh Circuit reading of *Comshare* is unduly rigid).

specific interpretations.[257] The D.C. Circuit also has been silent. One district court case from 2000 cited *Bryant*, *Comshare*, *Advanta*, and *Silicon Graphics*, but did not choose between them.[258] The opinion rejected the idea that general allegations of motive suffice.[259] Subsequent opinions, in 2004 and 2005, also failed to select a standard.[260]

E. Observations About The Circuit Split

A number of summary observations may be made about the circuit split described above. First, it is even more profound than suggested by the different formulations adopted by the courts of appeal. The split is "compounded by evidence of inconsistent interpretations among panels within the same circuit [and] inconsistent applications of a common standard to a common set of facts. . . ."[261] The situation is no less chaotic at the district court level. A study of 167 district court rulings addressing the PSLRA's "strong inference" standard, published in 2002 by law professors Joseph Grundfest and A.C. Pritchard, found "aggregate patterns of behavior that are, to a remarkable degree, statistically indistinguishable from a 'coin-toss' model of judicial behavior."[262] Second,

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[257] *See, e.g.,* Davis v. SPSS, Inc., 2005 WL 1126550, *12 (N.D. Ill., May 10, 2005); Lindelow v. Hill, 2001 WL 830956, *6 (N.D. Ill., July 20, 2001) ("The overwhelming majority of courts, particularly in this District, have applied the Second Circuit's formulation for alleging scienter."). *But see* Premier Capital Mgt., LLC v. Cohen, 2003 WL 21960357, *7 (N.D. Ill., Aug. 15, 2003) (agreeing with Eighth Circuit that "having the motive and opportunity to do wrong are certainly not the same as having the intent to do it"); Wafra Leasing Corp. 1999-A-1 v. Prime Capital Corp., 2002 WL 31664480, *8 (N.D. Ill., Nov. 26, 2002) (declining to adopt Second Circuit standard and holding that scienter can be established with evidence of motive and opportunity or with circumstantial evidence).

[258] *See* In re: Baan Co. Sec. Litig., 103 F. Supp.2d 1, 19-20 (D.D.C. 2000).

[259] *Id*. at 20.

[260] Burman v. Phoenix Worldwide Indus., Inc., 384 F. Supp.2d 316, 331-32 (D.D.C. 2005); In re Interbank Funding Corp. Sec. Litig., 329 F. Supp.2d 84, 90 (D.D.C. 2004); and In re U.S. Office Products Sec. Litig., 2004 WL 1607694 (D.D.C., July 16, 2004).

[261] Grundfest & Pritchard, *supra* note 229, at 678.

[262] *Id.*

while the situation would appear ripe for Supreme Court review,[263] such review, in 2005, is not imminent. The plaintiffs' bar has generally declined to file petitions for certiorari because it does not expect the Supreme Court, as currently configured, to adopt a pro-plaintiff interpretation of the "strong inference" standard.[264] A petition was filed in *Novak*, but it was denied in November 2000.[265]

Third, the selection by a circuit of a particular interpretation of the scienter standard is not outcome-determinative. Nationally, dismissal rates for federal securities class actions have almost doubled since the passage of the PSLRA.[266] Dismissal rates vary substantially by circuit, but those circuits adopting stricter interpretations of the scienter standard do not invariably have higher dismissal rates. District courts in the Second Circuit, which has the most lenient standard, dismissed within two years 25 percent of cases filed between 1996 and 2002. Ninth Circuit courts, which apply the strictest standard, also dismissed 25 percent. Tenth Circuit courts, occupying the middle ground of the pleading spectrum, dismissed eight percent.[267] The outcome is different at

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[263] *Id.* at 676 ("Silicon Graphics presented a pure question of law with a clear circuit split, making it an ideal vehicle for Supreme Court review."). *Accord* Jonathan C. Dickey, *Current Trends in Federal Securities Litigation*, SK027 ALI-ABA 241, 246-47 (Aug. 2004) (Supreme Court has chosen not to resolve "clear conflict among the circuits").

[264] *Id*. *Accord* Ray J. Grzebielski & Brian O. O'Mara, *Whether Alleging "Motive and Opportunity" Can Satisfy the Heightened Pleading Standards of the Private Securities Litigation Reform Act of 1995: Much Ado About Nothing*, 1 DEPAUL BUS. & COM. L.J. 313, 337 (2003) (concluding that a Supreme Court decision adopting the *Silicon Graphics* scienter standard would devastate the rights of shareholders and destroy the plaintiffs' securities bar).

[265] Kasaks v. Novak, 531 U.S. 1012 (2000). *See* Harold S. Bloomenthal, 2 Securities Law Handbook 1964 (2002) (speculating that the petition may have been denied because the Supreme Court was preoccupied with the petition filed in the 2000 Bush-Gore presidential election).

[266] Elaine Buckberg, Todd Foster & Ronald I. Miller, *Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?* (July 2005) at 3. Available at http://www.nera.com.

[267] *Id*. at 3. The two highest dismissal rates for securities class actions are in the Fourth Circuit (44 percent) and the Eighth Circuit (32 percent). *Id*. But these rates are based on relatively few filings, so their

the appellate level. The study by professors Grundfest and Pritchard of 33 post-PSLRA appellate court decisions reported that almost all plaintiff victories on appeal (nine of eleven) occurred in circuits applying the Second Circuit's pro-plaintiff standard.[268]

V. GROUP PLEADING – THE DISTRICT COURTS SPLIT

The "group pleading" or "group-published" doctrine may be considered against the landscape of the foregoing circuit split. Pursuant to this doctrine, a plaintiff in a securities fraud action treats individual defendants as part of a group for pleading purposes. The identification of individual sources of allegedly fraudulent statements is unnecessary when group pleading is utilized. Such statements in annual reports, prospectuses, registration statements, press releases, or other group-published information are attributable to a narrow range of individual defendants.[269] Three key issues pertaining to group pleading are addressed in the next section of this Article. Does the doctrine: (1) survive subsequent to the adoption of the PSLRA; (2) apply generally to the scienter of defendants; and (3) apply specifically to the conduct of auditors? Each of the three issues has generated substantial disagreement.

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significance is debatable. In 2004, the Ninth (64 filings), Second (45 filings), and Eleventh (20 filings) Circuits were the most active, in terms of traditional class action filings. These rankings are consistent with historical rankings for the period 1996-2003. *2004: A Year in Review*, *supra* note 9, at 13. *But cf.* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 942 (2003) (study of 1,449 securities class actions filed in federal court from January 1, 1996 through December 31, 2001 finds strong correlation between adoption of stringent *Silicon Graphics* standard and significant decrease in securities litigation commenced in Ninth Circuit); Paul R. Bessette, *et a*l., *Accounting Fraud in 2002 – Lessons Learned,* 1386 PLI/Corp 153, 162 (Sept-Oct. 2003) (adoption of different pleading standards means that plaintiff's decision where to file suit greatly affects whether the complaint will survive a motion to dismiss).

[268] Grundfest & Pritchard, *supra* note 2219 at 674.

[269] *See*, *e.g.*, In re GlenFed Sec. Litig., 60 F.3d 591, 593 (9th Cir. 1995).

The federal courts are sharply divided as to whether the group-published doctrine survives subsequent to the enactment of the PSLRA. Dozens of federal district courts addressed this issue during the period 1997-2005, with a majority holding in favor of survival. Prior to the passage of the PSLRA, the Second[270] and Ninth[271] Circuits were the only federal appellate courts to apply the doctrine. Post-PSLRA, only one federal circuit court has expressly recognized group pleading in securities cases. In *Schwartz v. Celestial Seasonings, Inc.*,[272] decided in 1997, the Tenth Circuit recognized the viability of the doctrine, although it did not specifically address the issue of post-PSLRA survival. Since 1997, district courts in Colorado and Kansas have applied *Celestial Seasonings* on the assumption that the doctrine does survive in the Tenth Circuit.[273] Only one other circuit court had addressed the issue by December 2005. In 2004, the Fifth Circuit held that group pleading has not survived the PSLRA.[274]

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[270] *See* Ouaknine v. MacFarlane, 897 F.2d 75, 80 (2d Cir. 1990); DiVittorio v. Equidyne Extractive Indus., Inc., 822 F.2d 1242, 1248-49 (2d Cir. 1987); and Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986).

[271] *See* In re GlenFed Sec. Litig., 60 F.3d 591 (9th Cir. 1995) and Wool v. Tandem Computers, Inc., 818 F.2d 1433 (9th Cir. 1987).

[272] 124 F.3d 1246, 1254 (10th Cir. 1997).

[273] *See, e.g.*, In re Rhythms Sec. Litig., 2004 WL 180398, *3 (D. Colo., Jan. 29, 2004).

[274] *See* Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 363-65 (5th Cir. 2004). *Accord* Barrie v. Intervoice-Brite, Inc., 409 F.3d 653, 655 (5th Cir. 2005). The Fifth Circuit position is discussed in Jeremy T. Grabill, Recent Developments, *Southland Securities Corp. v. INSpire Insurance Solutions: The Fifth Circuit Brusquely Rejects the Group Pleading Doctrine in Light of the Private Securities Litigation Reform Act*, 79 TULANE L. REV. 1101 (2005). The First Circuit ducked the issue in 2002, after noting the on-going "great debate." *See* In re: Cabletron Systems, Inc., 311 F.3d 11, 40 (1st Cir. 2002). The Second ircuit assumed arguendo that the doctrine survived, in 2005. *See* Yung v. Lee, 2005 WL 3453820, *4 (2d Cir. Dec. 15, 2005). The Fourth Circuit ducked the issue in 2004. *See* Dunn v. Borta, 369 F.3d 421, 434 (4th Cir. 2004). The Sixth Circuit ducked the issue in 2005. *See* City of Monroe Employees Ret. System v. Bridgestone Corp., 2005 WL 264130, *31 (6th Cir., Feb. 4, 2005). The Ninth Circuit apparently assumed the continued viability of the doctrine in Berry v. Valence Tech., Inc., 175 F.3d 699, 706 (9th Cir. 1999) and In re Stac Electronics Sec. Litig., 89 F.3d 1399, 1411 (9th Cir. 1996). The Eleventh Circuit ducked the issue in 2004. *See* Phillips v. Scientific-Atlanta, Inc., 374 F.3d 1015, 1019 (11th Cir. 2004).

District courts stating (usually in holdings but sometimes in dicta) that the doctrine does not survive the enactment of the PSLRA include courts in the Central[275] and Southern[276] Districts of California; the District of Delaware;[277] the Northern District of Georgia;[278] the Northern District of Illinois;[279] the Eastern District of Louisiana;[280] the District of Maryland;[281] the Eastern District of Michigan;[282] the District of New Jersey;[283] the Middle[284] and Western[285] Districts of North Carolina; the Southern District of New York;[286] the Eastern District of Pennsylvania;[287] and the Western District of Washington.[288]

District courts stating or assuming (usually in holdings but sometimes in dicta) that the doctrine does survive the enactment of the PSLRA include courts in the District

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275 In re Syncor Intl Corp. Sec. Litig., 327 F. Supp.2d 1149, 1171-72 (C.D. Cal. 2004).

276 In re Ligand Pharm., Inc. Sec. Litig., 2005 WL 2461151, *15 (S.D. Cal., Sept. 27, 2005).

277 In re Digital Island Sec. Litig., 223 F. Supp.2d 546, 553 (D. Del. 2002).

278 In re Premiere Technologies, Inc. Sec. Litig., 2000 WL 33231639, *11 (N.D. Ga., Dec. 8, 2000).

279 Johnson v. Tellabs, Inc., 2004 WL 324752, *9 (N.D. Ill., Feb. 19, 2004).

280 Thompson v. Avondale Indus., Inc., 2000 WL 310382, *1 (E.D. La., March 24, 2000).

281 In re Acterna Corp. Sec. Litig., 378 F. Supp.2d 561, 572-73 (D. Md. 2005).

282 D.E. & J Limited Partnership v. Conaway, 2003 WL 22207640, *7 (E.D. Mich., Sept. 19, 2003).

283 In re Cambrex Corp. Sec. Litig., 2005 WL 2840336, *15 (D.N.J., Oct. 27, 2005).

284 In re Cree, Inc. Sec. Litig., 2004 WL 1950308, *9 (M.D.N.C., Aug. 27, 2004).

285 In re First Union Corp. Sec. Litig., 128 F. Supp.2d 871, 888 (W.D.N.C. 2001).

286 Endovasc Ltd. v. J.P. Turner & Co., LLC, 2004 WL 634171, *6 (S.D.N.Y., March 30, 2004).

287 In re American Bus. Fin. Services, Inc. Sec. Litig., 2005 WL 1324880, *13 (E.D. Pa. June 2, 2005).

288 South Ferry LP #2 v. Killinger, 2005 WL 3077222, *18 n.8 (W.D. Wash., Nov. 17, 2005).

of Arizona;[289] the Central,[290] Northern,[291] and Southern[292] Districts of California; the District of Colorado;[293] the District of Columbia;[294] the Middle[295] and Southern[296] Districts of Florida; the Northern District of Georgia;[297] the Northern District of Illinois;[298] the Southern District of Iowa;[299] the District of Kansas;[300] the District of Massachusetts;[301] the Western District of Michigan;[302] the District of Minnesota;[303] the Eastern District of Missouri;[304] the District of Nevada;[305] the Eastern[306] and Southern[307]

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[289] In re PETsMART Sec. Litig., 61 F. Supp.2d 982, 997 (D. Ariz. 1999).

[290] In re Real Estate Assocs. Ltd. Partnership Litig., 223 F. Supp.2d 1142, 1151 (C.D. Cal. 2002) (applying doctrine after stating that court need not resolve issue of continued viability).

[291] In re Harmonic, Inc., 2002 WL 31974384, *10 (N.D. Cal., Nov. 13, 2002).

[292] Stanley v. Safeskin Corp., 2000 WL 33115908, *4 (S.D. Cal., Sept. 15, 2000).

[293] In re Quest Comm. Int'l, Inc. Sec. Litig., 387 F. Supp.2d 1130, 1145 (D. Colo. 2005).

[294] In re Baan Co. Sec. Litig., 103 F. Supp.2d 1, 17 (D.D.C. 2000).

[295] Reina v. Tropical Sportwear Int'l, 2005 WL 846170, *4 (M.D. Fla., Apr. 4, 2005) (court assumes continued viability of doctrine).

[296] In re: Sensormatic Elec. Sec. Litig., 2002 WL 1352427, *4 (S.D. Fla., June 10, 2002).

[297] In re Friedman's, Inc. Sec. Litig., 385 F. Supp.2d 1345, 1362 n.17 (N.D. Ga. 2005).

[298] Selbst v. McDonald's Corp., 2005 WL 2319936, *5 (N.D. Ill. Sept. 21, 2005).

[299] Martino-Catt v. E.I. DuPont de Nemours, 213 F.R.D. 308, 315 (S.D. Iowa 2003).

[300] In re Sprint Corp. Sec. Litig., 232 F. Supp.2d 1193, 1225 (D. Kan. 2002) (citing *Celestial Seasonings*).

[301] In re Allaire Corp. Sec. Litig., 224 F. Supp.2d 319, 340 (D. Mass. 2002).

[302] Krieger v. Gast, 2000 WL 288442, *8-9 (W.D. Mich., Jan. 21, 2000) (court assumes that doctrine has survived).

[303] In re Digi Int'l Inc. Sec. Litig., 6 F. Supp.2d 1089, 1101 (D. Minn. 1998), *aff'd*, 2001 WL 753869 (8th Cir., July 5, 2001).

[304] In re BankAmerica Corp. Sec. Litig., 78 F. Supp.2d 976, 988 (E.D. Mo. 1999).

[305] In re Agribiotech Sec. Litig., 2000 WL 1277603, *3 (D. Nev., March 2, 2000).

[306] In re KeySpan Corp. Sec. Litig., 2003 WL 21981806, *13 n.3 (E.D.N.Y., July 30, 2003).

Districts of New York; the Northern[308] and Southern[309] Districts of Ohio; the Eastern District of Pennsylvania;[310] and the Western District of Wisconsin.[311] Other district courts have ducked the issue.[312]

As indicated by the foregoing, the district court split on this issue is so sharp that numerous courts located in the same judicial districts in California, Georgia, Illinois, New York, and Pennsylvania have drawn diametrically opposite conclusions, while the circuit courts of appeal have provided virtually no guidance. Which perspective is more defensible?

The primary argument supporting the view that group pleading has not survived is that the doctrine is inconsistent with the strict pleading requirements of both the PSLRA and Rule 9(b) of the Federal Rules of Civil Procedure. Inconsistency results because group allegations enable plaintiffs to avoid pleading fraud with the requisite particularity.[313] A second argument is that the doctrine is inconsistent with the discovery stay imposed by the PSLRA at the outset of a case.[314] The stay is designed to deny

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[307] In re Van Der Moolen Holding, N.V. Sec. Litig., 2005 WL 3410763, *9 (S.D.N.Y., Dec. 13, 2005).

[308] In re: First Energy Corp. Sec. Litig., 2004 WL 938440, *11 (N.D. Ohio, May 3, 2004).

[309] In re Smartalk Teleservices, Inc. Sec. Litig., 124 F. Supp.2d 527, 545 (S.D. Ohio, Nov. 1, 2000).

[310] In re: U.S. Interactive, Inc. Sec. Litig., 2002 WL 1971252, *4 (E.D. Pa., Aug. 23, 2002) (court assumes continued viability of doctrine).

[311] Friedman v. Rayovac Corp., 295 F. Supp.2d 957, 991-93 (W.D. Wis. 2003).

[312] *See*, *e.g.*, In re Trex Co. Sec. Litig., 212 F. Supp.2d 596, 604 n.3 (W.D. Va. 2002) ("The parties disagree as to whether the group pleading doctrine applies in the Fourth Circuit. . . . [T]he court finds it unnecessary to resolve the issue.").

[313] *See*, *e.g.*, In re PDI Sec. Litig., 2005 WL 2009892, *24 (D.N.J. Aug. 17, 2005).

[314] Under the PSLRA, the filing of a motion to dismiss automatically stays all discovery and other proceedings, unless a stay would create undue prejudice or particularized discovery is necessary to preserve evidence. 15 U.S.C. § 78u-4(b)(3)(B) (2000) Attempts to limit the effect of the discovery stay have

plaintiffs the opportunity to sue when they lack a factual basis for their complaint. Group pleading arguably undermines that objective because it enables plaintiffs to name individual defendants without knowing whether such defendants made any misrepresentations.[315] A third argument is that group pleading is inconsistent with the Supreme Court's abolition in *Central Bank*[316] of aiding and abetting liability under Section 10(b) of the Exchange Act and companion Rule 10b-5.[317]

The counter-arguments, which seem more persuasive, are at least four-fold. First, no language in the PSLRA expressly abolishes group pleading.[318] If Congress desired to abolish the doctrine, it could have used specific language in the PSLRA to do so. Likewise, no subsequent federal legislation is preclusive. Second, because the doctrine merely sets up a rebuttable presumption, there is no inherent tension between group pleading and the PSLRA.[319] Tension would result only if the presumption had conclusive effect. Third, abolishing the doctrine sets the pleading bar too high, and thus defeats the remedial goals of the federal securities laws.[320] Absent the availability of group pleading,

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generally been unsuccessful, except in egregious cases. Sherrie R. Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff's Perspective*, 1505 PLI/Corp. 17, 43 (Sept. 2005).

[315] William O. Fisher, *Don't Call Me a Securities Law Groupie: The Rise and Possible Demise of the "Group Pleading" Protocol in 10b-5 Cases*, 56 BUS. LAW. 991, 1053 (2001).

[316] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

[317] *Id.* at 183-84. *See*, *e.g*., D.E. & J Limited Partnership v. Conaway, 2003 WL 22207640, *6 (E.D. Mich., Sept. 19, 2003) (group pleading runs afoul of *Central Bank*).

[318] *See* In re Sunbeam Sec. Litig., 89 F. Supp.2d 1326, 1341 (S.D. Fla. 1999) (group pleading doctrine is consistent with language of PSLRA). *Accord* In re BISYS Sec. Litig., 2005 WL 2844792, *5 (S.D.N.Y., Oct. 28, 2005) (nothing in statutory text or legislative history of PSLRA addresses group pleading).

[319] *See* In re El Paso Elec. Co. Sec. Litig., 2004 WL 377555, *8 (W.D. Tex., Feb. 23, 2004); In re JDN Realty Corp. Sec. Litig., 182 F. Supp.2d 1230, 1251 (N.D. Ga. 2002); and In re BankAmerica Corp. Sec. Litig., 78 F. Supp.2d 976, 988 (E.D. Mo. 1999).

[320] *See* In re PETsMART, Inc. Sec. Litig., 61 F. Supp.2d 982, 988 (D. Ariz. 1999).

numerous meritorious securities fraud cases could be dismissed at the onset of litigation, before discovery is undertaken.

Fourth, group pleading is not inconsistent with *Central Bank*, because attribution of a statement under the doctrine does not impermissibly seek to establish liability for aiding and abetting. *Central Bank*, decided in 1994 on a 5-4 split, abrogated 25 years of judicial recognition of the aiding and abetting doctrine in securities cases, and overruled the prior holdings of all eleven federal courts of appeal that had considered the issue.[321] But even after *Central Bank*, secondary actors such as auditors can be primarily liable for violations of Section 10(b) and Rule 10b-5, and such primary liability is not limited to those actors actually making false statements. Pursuant to the "substantial participation" test adopted by a number of courts, liability can be imposed upon auditors and other professionals who substantially participate in the disclosure process, even if such actors have not made the statements at issue.[322] The only requirement is that "the alleged violator play a significant role in, or be intricately involved with, the alleged scheme to

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[321] In re Leslie Fay Cos. Sec. Litig., 871 F. Supp. 686, 689 (S.D.N.Y. 1995). *See generally* Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293 (1999); Lewis D. Lowenfels & Alan R. Bromberg, *Liabilities of Lawyers and Accountants Under Rule 10b-5*, 53 BUS. LAW. 1157, 1158 (1998); and Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691 (1997). A number of commentators have argued for the reinstatement of aiding and abetting liability. *See, e.g.*, Assaf Hamdani, *Gatekeeper Liability*, 77 SO. CAL. L. REV. 53, 116 (2003).

[322] *See*, *e.g.*, In re Software Toolworks, Inc. Sec. Litig., 50 F.3d 615, 628 n.3 (9th Cir. 1994) (accounting firm's substantial participation in drafting and editing misleading letters to SEC suffices to support claim of primary liability); Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995) (plaintiffs could allege primary liability against accountant based upon various statements and reports issued by company); Cashman v. Coopers & Lybrand, 877 F. Supp. 425, 433 (N.D. Ill. 1995) (primary liability can be based on accounting firm's central role in drafting misleading statements); and In re ZZZZ Best Sec. Litig., 864 F. Supp. 960, 970 (C.D. Cal. 1994) (auditor may be primarily liable for securities fraud even if false statements could not be reasonably attributed to it). *See also* Sanford P. Dumain, *Class Action Suits and the Effect of the Private Securities Litigation Reform Act of 1995*, SH057 ALI-ABA 361, 366 (Feb. 2003).

defraud."[323] Given the application of this test,[324] the group-published doctrine is not inherently inconsistent with *Central Bank*.[325]

A second major issue associated with the doctrine is whether it applies to scienter, or instead is limited to pleading the source of fraudulent statements. Again, the courts are split. For example, in *In re JDN Realty Corp. Securities Litigation*, the federal district court concluded that the group pleading doctrine "allows a court to presume scienter."[326] Conversely, in *Holmes v. Baker*, the federal district court asserted that the group pleading

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[323] Jay B. Kasner & Scott G. Horton, *Secondary Liability After Enron*, 1386 PLI/Corp 51, 62 (Sept. – Oct. 2003).

[324] The "substantial participation" test has been rejected by many courts. *See, e.g.*, Gariety v. Grant Thornton, LLP, 368 F.3d 356 (4th Cir. 2004); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226-27 (10th Cir. 1996). Under the alternative "bright line" test, in order for the conduct of a secondary actor to constitute a primary violation of Section 10(b), the plaintiff must show that the actor: (1) made a false or misleading statement, (2) knew or should have known that the statement would be communicated to investors, and (3) was publicly identified with such statement. *See* Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001); Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (secondary actors such as accountants may not be held primarily liable unless they have made a material misstatement on which a plaintiff relies); Shapiro v. Cantor, 123 F.3d 717, 721 (2d Cir. 1997); and In re DVI, Inc. Sec. Litig., 2005 WL 1307959, *8 (E.D. Pa. May 31, 2005) (most courts have adopted the bright line test). *See also* In re Ikon Office Solutions, Inc., 277 F.3d 658, 667 n.8 (3d Cir. 2002) (declining to choose a test); In re Lernout & Hauspie Sec. Litig., 230 F. Supp.2d 152 (D. Mass. 2002) (applying both bright line and substantial participation tests to determine whether various affiliates of accounting firm were primarily liable in securities class action). In In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp.2d 549 (S.D. Tex. 2002), the court criticized the two prevailing tests and then adopted an alternative test, pursuant to which an accounting firm could be found to be a primary violator, even if it were not publicly identified, if it made actionable statements with knowledge and intent, and third parties such as investors relied upon the statements. *Id*. at 581, *et seq*.; Scott Siamas, Comment, *Primary Securities Fraud Liability for Secondary Actors: Revisiting Central Bank of Denver in the Wake of Enron, WorldCom, and Arthur Andersen*, 37 U.C. DAVIS L. REV. 895, 921 (2004). *See also* In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp.2d 319, 331 n.12 (S.D.N.Y. 2004) (rejecting application of *Enron* test to conduct of accounting firm); Tricontinental Indus., Ltd. v. Anixter, 256 F. Supp.2d 806, 807 (N.D. Ill. 2003) (same). The court in In re Global Crossing formulated a modified version of the bright line test. 322 F. Supp.2d at 332-34. *Accord* In re Parmalat Sec. Litig., 383 F. Supp.2d 616, 623 n.35 (S.D.N.Y. 2005).

[325] *See, e.g.*, Schnall v. Annuity and Life Re (Holdings), Ltd., XL, 2004 WL 515150, *4 (D.D.C., March 9, 2004) (*Central Bank* and its progeny do not affect vitality of group pleading doctrine).

[326] 182 F. Supp.2d 1230, 1250 (N.D. Ga. 2002). *Accord* In re Stellant, Inc. Sec. Litig., 2004 WL 1646500, *8 (D. Minn., July 23, 2004) (under group pleading, inference of scienter is attributable to each defendant); Martino-Catt v. E.I. DuPont de Nemours & Co., 213 F.R.D. 308, 317 n.7 (S.D. Iowa 2003) ("The Court notes that the group pleading doctrine is generally argued to show scienter. . . ."). *See also* Sheehan v. Switzerland, 136 F. Supp.2d 301, 313 (D. Del. 2001) (if group pleading survives PSLRA, then plaintiffs need not allege scienter as to each defendant); P. Schoenfeld Asset Mgt. LLC v. Cendant Corp., 142 F. Supp.2d 589, 620 (D.N.J. 2001) (same).

doctrine "does not apply to the [PSLRA's] scienter requirement."[327] The latter view is the clear majority view.[328]

An argument can be made that the group-published doctrine should indeed apply to scienter. Such an application should be made because some information about operations or transactions of a corporation is so vital that it is reasonable to make a rebuttable presumption attributing knowledge of that information to a range of individuals connected with the company.[329] A rebuttable presumption of this sort is not inherently contrary to the PSLRA's requirement that scienter be pleaded with particularity. A number of federal courts have so held.[330] Another reason to apply the doctrine to scienter is that falsity and scienter are generally inferred from the same set of facts. The Ninth Circuit, for example, has incorporated the falsity and scienter requirements into a single inquiry.[331] Since the same set of facts serves to establish both

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[327] 166 F. Supp.2d 1362, 1376 (S.D. Fla. 2001).

[328] *See, e.g.,* Phillips v. Scientific-Atlanta, Inc., 374 F.3d 1015, 1017 (11th Cir. 2004); Reina v. Tropical Sportswear Int'l, 2005 WL 846170*5 (M.D. Fla., Apr. 4, 2005); DH2, Inc. v. Athanassiades, 2005 WL 589004 (N.D. Ill., March 10, 2005); In re Lockheed Martin Corp. Sec. Litig., 2002 WL 32081398, *5 (C.D. Cal., July 22, 2002) ("Under no circumstances does the group-published information doctrine relieve plaintiffs of their burden to plead scienter. . . ."); and In re BankAmerica Corp. Sec. Litig., 78 F. Supp.2d 976, 988 (E.D. Mo. 1999) ("[T]he doctrine has nothing to do with scienter."). *See also* Fisher, *supra* note 315, at 1029-30 (courts applying group pleading to scienter are simply mistaken).

[329] *See*, *e.g.*, Epstein v. Itron, Inc., 993 F. Supp. 1314, 1326 (E.D. Wash. 1998) ("[F]acts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers.")

[330] *See*, *e.g.*, In re Ramp Networks, Inc. Sec. Litig., 210 F. Supp.2d 1051, 1075-76 (N.D. Cal. 2002); Danis v. USN Communications, 73 F. Supp.2d 923, 938 (N.D. Ill. 1999); In re Peoplesoft, Inc., 2000 WL 1737936 (N.D. Cal., May 25, 2000); Chalverus v. Pegasystems, Inc., 59 F. Supp.2d 226, 235 (D. Mass. 1999); In re Aetna, Inc. Sec. Litig., 34 F. Supp.2d 935, 953 (E.D. Pa. 1999); Spitzer v. Abdelhak, 1999 WL 1204352, *6 (E.D. Pa., Dec. 15, 1999); and Schlagel v. Learning Tree, Int'l 1998 WL 114581, *18 (C.D. Cal., Dec. 23, 1998).

[331] *See, e.g.,* In re Daou Systems, Inc. Sec. Litig., 397 F.3d 704, 711 (9th Cir. 2005); Ronconi v. Larkin, 253 F.3d 423, 429 (9th Cir. 2001). However, the Ninth Circuit has disapproved of district court decisions suggesting that some form of group scienter is permissible under the PSLRA. *See* In re Read-Rite Corp. Sec. Litig., 335 F.3d 843 (9th Cir. 2003).

pleading elements, both must be pleaded with particularity, and group pleading is sufficiently particular to show falsity, there is no compelling reason why group pleading should not also suffice to establish scienter.

A third key issue associated with the group-published doctrine concerns the universe of defendants to whom it applies. The specific question addressed herein is whether the doctrine applies, or should be applied, to external auditors. Many courts currently limit application of the doctrine to "clearly cognizable corporate insiders with active daily roles in the relevant companies or transactions."[332] Other courts extend the doctrine to outside directors. The Ninth Circuit extends the doctrine to outside directors who either participated in day-to-day corporate activities, or had a "special relationship" with the company.[333] District courts elsewhere agree.[334] At least one court has held that group pleading may be applied to outside directors who were members of a company's audit committee.[335]

The justification for requiring plaintiffs to allege more specific involvement by outside directors in the preparation and dissemination of allegedly fraudulent materials before the doctrine applies is that these individuals are less connected to the company's day-to-day operations than are corporate employees, and presumably had less knowledge

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[332] Dresner v. Utility.com, Inc., 2005 WL 1185636, *13 (S.D.N.Y., May 18, 2005). *Accord* In re Neopharm, Inc. Sec. Litig., 2003 WL 262369, *14 (N.D. Ill., Feb. 7, 2003) (group-published doctrine applies to "those high-level individuals with direct involvement in the everyday business of the company.") and In re Raytheon Sec. Litig., 157 F. Supp.2d 131, 152 (D. Mass. 2001).

[333] Berry v. Valence Tech., Inc., 173 F.3d 699, 706 (9th Cir. 1999) and GlenFed Inc. Sec. Litig., 60 F.3d 591, 593 (9th Cir. 1995). Participation in an audit committee does not constitute such a special circumstance. In re Sensormatic Elec. Corp. Sec. Litig., 2002 WL 1352427, *5 (S.D. Fla., June 10, 2002).

[334] *See*, *e.g*., In re GeoPharma, Inc. Sec. Litig., 2005 WL 2431518, *7 (S.D.N.Y., Sept. 30, 2005).

[335] Mitzner v. Hastings, 2005 WL 88966, *6 (N.D. Cal., Jan. 14, 2005). *But see* Wojunik v. Kealy, 2005 WL 2573435, *9 (D. Ariz., Sept. 26, 2005) (numerous district courts in Ninth Circuit have held that audit committee membership is insufficient to make an outside director liable under the group pleading doctrine).

of fraud that occurred. However, the doctrine has been applied to outside directors even absent such allegations, in the case of a merger. The court in this case reasoned that the board of directors, including outside members, was "intimately involved" in the merger.[336]

Should external auditors, like outside directors, be subject to the group pleading doctrine? To date there are divergent holdings about this issue,[337] but most courts reject such an application. In *Yadlowsky v. Grant Thornton, L.L.P.* the district court rejected application of the doctrine to auditors because plaintiffs failed to allege facts supporting an inference that the auditors exercised operational involvement in the company they audited.[338] Likewise, in *In re Lernout & Hauspie Securities Litigation* the district court rejected application of the doctrine to KPMG because plaintiffs failed to allege facts showing that the auditors played an active role in managing the company they audited or in handling the questionable transactions. [339]

While courts have been reluctant to extend the doctrine to auditors, this general reluctance is not always warranted. Arguably, an external auditor does have a "special relationship" to the company it audits. This is particularly true because, as shown below,

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[336] Krieger v. Gast, 2000 WL 288442, *9 (W.D. Mich., Jan. 21, 2000).

[337] In re Enron Corp. Sec., Derivative & ERISA Litig., 2003 WL 230688, *6 (S.D. Tex., Jan. 28, 2003). *See also* Swanson & Roberts, *supra* note 5, at 422 (permissibility of group pleading under PSLRA is significant issue for accountants).

[338] 120 F. Supp.2d 622, 632 (E.D. Mich. 2000).

[339] 2002 WL 31961469, *14 (D. Mass., Nov. 18, 2002). KPMG ultimately paid $115 million to settle the Lernout & Hauspie litigation. Stephen Taub, *KPMG Pays $115 Million to Settle Suit*, CFO Magazine, Oct. 12, 2004. Available at http://www.cfo.com. *See also* Yung v. Lee, 2005 WL 3453820, *4 (2d Cir. Dec. 15, 2005) (declining to apply group pleading doctrine to auditor BDO Seidman).

in many instances auditors are not truly independent of their corporate clients.[340] The lack of independence is a function of several factors, including economic incentives to deliver favorable audit reports. Such incentives stem in part from the desire to obtain lucrative non-audit work, in the form of consulting or tax services. As demonstrated in Part VI of this Article, in recent years such services have out-paced audit services as profit centers for large accounting firms. Other key factors include the lack of competition in the audit industry, the absence of auditor rotation, and the revolving-door phenomenon, whereby auditors ultimately work directly for their former clients.[341] The lack of independence has resulted on many occasions in acquiescence or participation by auditors in aggressive and even fraudulent accounting policies devised by corporate management.[342]

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[340] *See generally* Peter K.M. Chan, *Breaking the Market's Dependence on Independence: An Alternative to the "Independent" Outside Auditor*, 9 FORDHAM J. CORP. & FIN. L. 347, 362 (2004) ("[L]ack of independence is a widespread and systemic problem in the accounting industry, despite the existence of independence rules."). As one example, in April 2004 an SEC administrative law judge barred Ernst & Young from accepting new audit clients in the U.S. for six months, because it violated SEC rules on auditor independence. Stephen Taub, *More Questions on E&Y Independence*, CFO Magazine, June 8, 2004. Available at http://www.cfo.com.

[341] *See* Cassell Bryan-Low, *Accounting Firms Seek To Dispel Cloud of Corporate Fraud*, Wall St. J., May 27, 2003, at C1 (in many of the large accounting frauds, auditors knew what was happening but were willing to look the other way) (statement of Charles Niemeier, former chief accountant at the SEC's enforcement division); McCoy, *supra* note 161, at 1008 ("Any truly meaningful reform of the accounting industry must reverse the incentive structure that impels auditors to curry favor with company management."); and Max H. Bazerman, George Loewenstein & Don A. Moore, *Why Good Accountants Do Bad Audits*, HARV. BUS. REV. 96, 99 (Nov. 2002) ("Auditors have strong business reasons to remain in clients' good graces and thus are highly motivated to approve their clients' accounts.")

[342] *See Called to Account – The Future of Auditing*, Economist, Nov. 19, 2004 ("Auditors have been implicated in fraud after fraud."). Available at http://www.economist.com. *See also* Kate O'Sullivan, *Are Auditors and CFOs Growing Apart?*, CFO Magazine, Oct. 8, 2004 (auditors can be involved in companies' day-to-day business) (available at http://www.cfo.com).

VI.
PLEADING SCIENTER OF AUDITORS – THE COURTS SET THE BAR UNJUSTIFIABLY HIGH

The foregoing discussion demonstrates that GAAP is a poor tool for measuring accounting fraud, and even encourages such fraud. Moreover, GAAS fails to deter fraud or significantly increase the likelihood that material fraud will be detected. The result has been widespread audit failure. This Article now considers the scienter of external auditors against the backdrop of the rocky GAAP/GAAS landscape. As will be seen, as a general rule federal courts have been extremely demanding in terms of the pleading requirements applicable to auditors. Many of the cases decided in the last decade or so cannot be reconciled with the reality of auditing practice or the scienter standards applicable to non-auditor defendants. This section begins with an analysis of the line of cases that originated in *DiLeo v. Ernst & Young*, decided in 1990 by the Seventh Circuit.[343]

A. The *DiLeo* Line of Cases

In *DiLeo,* the Seventh Circuit upheld the dismissal of a securities fraud class action filed against accounting firm Ernst & Whinney (E&W).[344] The dismissal was upheld in large part because the plaintiffs failed to adequately allege scienter, according to the Seventh Circuit. The court explained that auditors, behaving as rational economic actors, would not sacrifice their professional reputations in order to derive additional audit revenue from participating in the fraud of their clients. The court stated: "An accountant's greatest asset is its reputation for honesty, followed closely by its reputation

[343] 901 F.2d 624 (7th Cir. 1990).

[344] Following one of many mergers in the accounting industry, E&W became Ernst & Young.

for careful work. Fees for two years' audits could not approach the losses E&W would suffer from a perception that it would muffle a client's fraud. . . . E&W's partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with [their audit client]."[345]

The foregoing reasoning, which focuses on the motive prong of the motive and opportunity test discussed in Part IV of this Article, has been endorsed by numerous courts in subsequent opinions, both before and after the PSLRA was enacted. During the period 1990-2005, the Seventh Circuit's reasoning in *DiLeo* was adopted by the Fifth[346] and Ninth Circuits,[347] as well as by federal district courts in California,[348] Colorado,[349] Illinois,[350] Indiana,[351] Maryland,[352] New York,[353] Ohio,[354] Pennsylvania,[355] Virginia,[356]

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[345] 901 F.2d at 629. *Accord* Robin v. Arthur Young & Co., 915 F.2d 1120, 1127 (7th Cir. 1990).

[346] Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994). *See also* Umstead v. Andersen LLP, 2003 WL 222621, *4 (N.D. Tex., Jan. 28, 2003) (citing *Melder*).

[347] In re Worlds of Wonder Securities Litigation, 35 F.3d 1407, 1427 n.7 (9th Cir. 1994).

[348] In re Van Wagoner Funds, Inc., 2004 WL 2623972, *7 (N.D. Cal. July 27, 2004) ("A large independent accountant will rarely, if ever, have any rational economic incentive to participate in its client's fraud."); Reiger v. PricewaterhouseCoopers LLP, 117 F. Supp.2d 1003, 1007-08 (S.D. Cal. 2000) (same); Reiger v. Altris Software, Inc., 1999 WL 540893, *3 (S.D. Cal., Apr. 30, 1999) ("[A]llegations that a large accounting firm such as Price Waterhouse would align itself with one of its clients to perpetuate a fraud on investors are irrational."); Adam v. Silicon Valley Bancshares, 1994 WL 619300, *4 (N.D. Cal., Feb. 8, 1994); and In re Software Toolworks Sec. Litig., 789 F. Supp. 1489, 1499 n.16 (N.D. Cal. 1992), *aff'd in part, rev'd in part*, 38 F.3d 1078 (9th Cir.), *as amended*, 50 F.3d 615 (9th Cir. 1994).

[349] Queen Uno Ltd. Partnership v. Coeur D'Alene Mines Corp., 2 F. Supp.2d 1345, 1360 (D. Colo. 1998) (citing *DiLeo* approvingly).

[350] In re Spiegel, Inc. Sec. Litig., 2004 WL 1535844, *39 (N.D. Ill. July 8, 2004); Danis v. USN Communications, Inc., 121 F. Supp.2d 1183, 1195-96 (N.D. Ill. 2000); In re First Merchants Acceptance Corp., Sec. Litig., 1998 WL 781118, *9 n.4 (N.D. Ill., Nov. 4, 1998); Retsky Family L.P. v. Price Waterhouse LLP, 1998 WL 774678, *9 (N.D. Ill., Oct. 21, 1998); and In re VMS Sec. Litig., 1373, 1401 (N.D. Ill. 1990).

[351] Stamatio v. Hurco Cos., 885 F. Supp. 1180, 1185 (S.D. Ind. 1995).

[352] In re Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp.2d 334, 390 (D. Md. 2004).

[353] In re Philip Services Corp. Sec. Litig., 2004 WL 1152501, *5-6 (S.D.N.Y. May 24, 2004) (auditor's participation in a client's fraud is even more economically irrational at the individual level than at the firm

and Wisconsin.[357] Some of the district court opinions have all but foreclosed the possibility that plaintiffs could ever successfully plead scienter of an external auditor. A post-PSLRA opinion from Illinois asserted: "In the absence of evidence that an outside accountant has become an insider in the subject company, e.g., by purchasing stock whose value is then inflated by the misstatements, it appears unlikely for any plaintiff ever to demonstrate sufficient motive to provide a strong inference pursuant to the motive and opportunity test that an outside accountant or accounting firm committed fraud."[358]

While the influence of *DiLeo* has been pervasive,[359] both the case and its progeny are subject to attack on multiple fronts. First, such cases erroneously posit that a fraudulent audit would almost always be irrational, because the loss to reputation caused by the discovery of such fraud could not be counter-balanced by the fees earned from audit services. Such an assumption is invalid, because it fails to consider the substantial fees derived by the major accounting firms from non-audit services such as consulting

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level); AUSA Life Ins. Co. v. Ernst & Young, 991 F. Supp. 234, 247 (S.D.N.Y. 1997); In re Health Management, Inc. Sec. Litig., 970 F. Supp. 192, 202 (E.D.N.Y. 1997); Duncan v. Pencer, 1996 WL 19043, *9-10 (S.D.N.Y., Jan. 18, 1996); and SEC v. Price Waterhouse, Inc., 797 F. Supp. 1217, 1242 (S.D.N.Y. 1992). *See also* In re Merrill Lynch & Co. Research Reports Sec. Litig., 272 F. Supp.2d 243, 263 (S.D.N.Y. 2003) (citing *DiLeo* approvingly).

[354] In re SmarTalk Teleservices, Inc. Sec. Litig., 124 F. Supp.2d 505, 518 (S.D. Ohio 2000) (citing *DiLeo* approvingly).

[355] In re Ikon Office Solutions, Inc. Sec. Litig., 66 F. Supp.2d 622, 629 (E.D. Pa. 1999); In re Healthcare Serv. Group, Inc. Sec. Litig., 1993 WL 54437, *5 (E.D. Pa., Mar. 1, 1993).

[356] In re MicroStrategy, Inc. Sec. Litig., 115 F. Supp.2d 620, 655 & n.66 (E.D. Va. 2000).

[357] Grove Holding Corp. v. First Wis. Nat'l Bank, 803 F. Supp. 1486, 1502 (E.D. Wis. 1992).

[358] Retsky Family L.P. v. Price Waterhouse LLP, 1998 WL 774678, *9 (N.D. Ill., Oct. 21, 1998).

[359] *See* Steven O. Sidener, *Partners in Crime*, TRIAL 27, 27 (Apr. 2003) ("DiLeo heavily influenced judicial thinking throughout the 1990s, with many courts adopting its logic in dismissing accounting firms from securities cases, at both the pleading and summary judgment stages."); Coffee, *supra* note 4, at 1406 (during the 1990s, many courts accepted the *DiLeo* logic "hook, line and sinker"). *See also* In re: Rural Cellular Corp. Sec. Litig., 2004 WL 1278725, *4 (D. Minn. 2004) (allegation that Arthur Andersen performed both auditing and consulting functions insufficient to support inference of scienter).

and tax. The next section of this Article examines the significance of those fees and the likelihood that they impair auditor independence.

(1) Non-Audit Services Expand Dramatically

The phenomenon of accounting firms as one-stop shops providing a full range of services is fairly recent, dating back only a couple of decades. Fees derived from consulting services by the largest accounting firms increased dramatically between 1975 and 1998. In 1975, on average, management consulting services comprised only 11 percent of the Big 8's total revenues, ranging from 5 percent to 16 percent by firm.[360] By 1990, when *DiLeo* was decided, Arthur Andersen derived 40 percent of its worldwide revenue from consulting work. For most other large United States accounting firms, consulting work accounted for 15-25 percent of overall revenues in 1990.[361] By 1998, revenues from consulting services had jumped to an average of 45 percent, ranging from 34 to 70 percent of the Big Five's revenues for that year.[362]

By 2000, the consulting trend had reversed. That year average revenue from consulting services decreased to about 30 percent of the Big Five's total revenues.[363] The

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[360] *Public Accounting Firms: Mandated Study on Consolidation and Competition*, Report by U.S. General Accounting Office to Senate Comm. on Banking, Housing, and Urban Affairs and House Comm. on Financial Services 8 (July 2003) (GAO-03-864) (hereinafter *Public Accounting Firms*). Available at http://www.gao.gov. *See also* Coffee, *supra* note 14, at 291 ("Prior to the mid-1990s, few auditing firms provided significant consulting services to audit clients.").

[361] Stephen A. Zeff, *How the U.S. Accounting Profession Got Where It Is Today: Part II*, 17 ACCT. HORIZONS 267, 269 (2003) (noting that Arthur Andersen was number one on the list of top U.S. consulting firms as early as 1983); Robin Goldwyn Blumenthal, *SEC Staff Ruling Gives Accounting Firms More Leeway to Consult for Audit Clients*, Wall St. J., July 6, 1990, at A2.

[362] *Public Accounting Firms*, *supra* note 360, at 8. *See also Public Oversight Board, supra* note 162, at 112 (between 1990 and 1999, the ratio of accounting and auditing revenues for the SEC clients of Big Five auditing firms plunged from 6 to 1 to 1.5 to 1); Jonathan Weil, *Behind Wave of Corporate Fraud: A Change in How Auditors Work*, Wall St. J., March 25, 2004, at A1 (by 1990s, audit had become mere foot in the door for consultants).

[363] Weil, *supra* note 362.

downward trend accelerated after 2000 as the large accounting firms began to sell or divest portions of their consulting practices. In May 2000 Cap Gemini Group S.A. acquired Ernst & Young Consulting. In February 2001 KPMG Consulting split from its former parent KPMG LLP and subsequently renamed itself BearingPoint, Inc. In August 2002 IBM acquired PricewaterhouseCoopers Consulting.[364] Deloitte & Touche LLP, the remaining member of the Big Four,[365] broke from the auditing pack and voted in March 2003 to retain its consulting arm, after initially deciding to divest.[366] But while fees from

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[364] *Deals and Deal Makers: Mergers Snapshot/Big-Five Consulting Firms*, Wall St. J., Aug. 7, 2002, at C5. Ernst & Young was reported to be returning to the consulting business in 2005. *See* Stephen Taub, *More Consulting for Ernst & Young?*, CFO Magazine, June 21, 2004. Available at http://www.cfo.com.

[365] Arthur Andersen, the former fifth member of the Big Five, ceased to exist as a U.S. accounting firm in the fall of 2002, having surrendered all of its state licenses after the firm was found guilty of obstruction of justice in connection with the Enron accounting scandal. *See generally* Stephan Landsman, *Death of an Accountant: The Jury Convicts Arthur Andersen of Obstruction of Justice*, 78 CHI.-KENT L. REV. 1203 (2003). Earlier, Andersen Consulting (renamed Accenture) had split from Arthur Andersen, after arbitration of a bitter dispute. Arthur Andersen, once the world's largest professional services firm, had 85,000 worldwide employees and generated $9.3 billion in revenues in 2001. Following the criminal conviction, some of Andersen's operations were purchased by competitors, while many of its overseas partnerships spun off and continue to operate. By 2005, the company was a mere shell with fewer than 200 employees, mostly administrative staff and attorneys. Stephen Taub, *Arthur Andersen Settles WorldCom Suit*, CFO Magazine, Apr. 26, 2005 (available at http://www.cfo.com); Jeffrey Zaslow, *How the Former Staff of Arthur Andersen Is Faring Two Years After Its Collapse*, Wall St. J., Apr. 8, 2004, at D1; Ken Brown & Ianthe Jeanne Dugan, *Sad Account: Andersen's Fall from Grace Is a Tale of Greed and Miscues*, Wall St. J., June 7, 2002, at A1; and *Andersen's Android Wars*, Economist, Aug. 10, 2000 (available at http://www.economist.com). *See also* Cassell Bryan-Low, *Who Are Winners at Andersen's Yard Sale?*, Wall St. J., May 30, 2002, at C1 (Arthur Andersen could not be sold intact, so up for grabs in mid-2002 were roughly 2,300 public U.S. auditing clients, 32,000 smaller private ones, 1,750 partners in the U.S., and more than 80 overseas affiliates with their own partners). In May 2005 the United States Supreme Court reversed Andersen's conviction (which had been upheld by the Fifth Circuit), on the basis that the trial judge gave incorrect jury instructions, but the reversal did nothing to restore the firm. *See* Arthur Andersen LLP v. United States, 125 S. Ct. 2129 (2005); Bruce D. Fisher, *Andersen v. U.S.: A Shift in the Legal Winds for Public Auditors?,* 41 TENN. B.J. 22 (2005); Stephen Taub, *Supreme Court Reverses Andersen Verdict*, CFO Magazine, June 1, 2005 (available at http://www.cfo.com); and Linda Greenhouse, *The Andersen Decision: The Overview, Justices Reject Auditor Verdict in Enron Scandal*, N.Y. Times, June 1, 2005, at A1.

[366] Cassell Bryan-Low, *Deloitte Yearly Revenue Rose 21% Even with Consulting Issues*, Wall St. J., Oct. 1, 2003, at A8 (Deloitte derives two-thirds of its revenue from consulting and tax services); Cassell Bryan-Low, *Deloitte Chief Wrestles To Get Consultants Back in Firm*, Wall St. J., Aug. 15, 2003, at C1; and Robert Frank & Deborah Solomon, *Deloitte Touche Cancels Plan To Split Off Its Consulting Arm*, Wall St. J., March 31, 2003, at C10. In 2003, Deloitte spun off its tax and consulting businesses in France, in response to a new French financial security law banning accounting firms from providing consulting services to their audit clients. Andrew Parker, *Deloitte Plans To Spin Off French Consulting*, Financial Times, Oct. 21, 2003. Available at http://www.FT.com

consulting began to slide for most large accounting firms, total fees from non-audit services remained substantial.[367] In 2002, accounting firms still obtained more than 50 percent of their revenues from non-audit services,[368] which included both consulting and tax work. Non-audit fees paid by large corporations to audit firms often outweighed audit fees by a ratio of nearly 3 to 1.[369] In many cases auditing firms low-balled the prices on their audits (even to the point of taking a loss), in order to obtain lucrative consulting work.[370]

The landscape changed in January 2003, when the SEC adopted final rules to implement Title II of Sarbanes-Oxley, which pertains to auditor independence. The new rules, effective in May 2003, implement Section 201, which specifies nine non-audit services that a public accounting firm, serving as an auditor of a client, cannot simultaneously provide to that client. Those services are: bookkeeping, financial information system design or implementation, appraisal and valuation, actuarial, internal

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[367] *War of Independence: Auditors Should be Auditors, Not the Advance-Guard of an Army of Consultants*, Economist, Aug. 10, 2000 (all five members of the Big Five make most of their money from non-audit services). Available at http://www.economist.com. *See also* Arthur R. Wyatt, *Accountants' Responsibilities and Morality*, CPA J., March 2004 (accounting firms that have divested their consulting practices continue to expand range of services offered within their auditing and tax divisions) (available at http://www.cpajournal.com); Laura J. Kornish & Carolyn B. Levine, *Discipline with Common Agency: The Case of Audit and Nonaudit Services*, 79 ACCT. REV. 173, 195 (2004) (Arthur Andersen "regrew" nonaudit services after it split with Andersen Consulting).

[368] Cassell-Bryan Low, *Accounting Firms Are Still Consulting*, Wall St. J., Sept. 23, 2002, at C1. *See also* Cassell Bryan-Low, *Accounting Firms Earn More from Consulting*, Wall St. J., Apr. 16, 2003, at C9 (62.2 percent of the $811.8 million of fees paid to auditors in 2002 by most of the 30 companies in the Dow Jones Industrial Average was for services other than auditing).

[369] Jonathan Weil & Michael Rapoport, *New SEC Definition May Cloud 'Audit Fees*,' Wall St. J., Jan. 22, 2003, at C1.

[370] Janice Revell, *The Fires That Won't Go Out*, Fortune, Oct. 13, 2003, at 139. *Accord* Frieswick, *supra* note 188 ("The audit function became a commodity service -- a loss leader accounting firms offered in conjunction with vastly more lucrative consulting fees."); Coffee, *supra* note 4, at 1411 (during the 1990s, auditing firms began to compete based on a strategy of low-balling, in which auditing services were offered at rates that were marginal to arguably below cost).

audit outsourcing, management and human resources functions, investment advising, legal, and expert.[371]

While the foregoing list might appear to be comprehensive, it is not. The most significant omission is the provision of tax services. Section 201 of Sarbanes-Oxley specifically provides that a registered public accounting firm may engage in any non-audit service, including tax, that is not expressly prohibited, after audit committee pre-approval. Accordingly, accountants remain free to give tax advice to their audit clients, and provide tax compliance and planning services, subject to audit committee pre-approval requirements.[372] This freedom resulted from successful lobbying of Congress by the accounting industry when Sarbanes-Oxley was under consideration.[373]

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[371] *See Press Release -- Commission Adopts Rules Strengthening Auditor Independence*, Securities and Exchange Commission, Jan. 22, 2003. Available at http://www.sec.gov/news/press/2003-9.htm. Sarbanes-Oxley has impacted the provision of legal services by the major accounting firms. By 2001, the Big Five accounting firms had more lawyers than the five largest law firms in the world. Subsequently, the environment changed. In November 2003 KPMG International announced that it would sever ties with KLegal International, its network of 3,000 lawyers in 60 countries that, during its three years of operation, often catered to companies listed on U.S. stock exchanges. Sarbanes-Oxley and similar legislation passed by France in 2003 were factors offered by KPMG to explain its decision. The other Big Four accounting firms have denied plans to follow KPMG's lead, but those plans may change. PricewaterhouseCoopers has a network of 2,850 lawyers that operates in more than 40 countries through Landwell, its legal affiliate. Ernst & Young offers legal services through EY Law, a network that includes 2,000 lawyers in 30 countries. Deloitte & Touche also has a global law network. Geanne Rosenberg, *Big Changes in Offing for Big Four*, National L.J., Dec. 22, 2003, at 8; *Back To Basics: The Aspirations of Accountancy Firms in the Law Are Faltering*, Economist, Nov. 13, 2003 (available at http://www.economist.com); and *KPMG To End Legal Services*, Wall St. J., Nov. 7, 2003, at B6.

[372] Sanford P. Dumain, *Class Action Suits, Auditor Liability, and the Effect of the Private Securities Litigation Reform Act of 1995*, SK086 ALI-ABA 501, 512 (Feb. 2005) ("Tax services and some other non-audit services may be provided if preapproved by the audit committee."); Weil & Rapoport, *supra* note 369.

[373] Michael Schroeder, *SEC Clears Rules Limiting Auditors from Offering Consulting Services*, Wall St. J., Jan. 23, 2003, at C9. *See also* Thomas J. Purcell III & David Lifson, *Tax Services After Sarbanes-Oxley*, J. ACCT. 32, 35 (Nov. 2003) (SEC rules implementing Sarbanes-Oxley substantially adopted AICPA recommendation concerning provision of tax shelter services, pursuant to which such services could still be rendered). New accounting rules adopted by the European Commission in March 2004 similarly do not bar European auditors from providing tax services. Stephen Taub, *Tough New Accounting Rules for Europe*, CFO Magazine, March 15, 2004. Available at http://www.cfo.com.

The requirement that audit committees approve all assignments given to external auditors is unlikely to significantly curtail the assignment of tax work. Many publicly traded companies began to create audit committees in the 1970s. The objective was to assure the integrity of external audits by requiring auditors to report to independent committees, rather than to management. But the expected independence rarely materialized.[374] Indeed, the general abdication of responsibility by audit committees was a contributing factor in a number of the recent accounting scandals.[375] SEC rules enacted pursuant to Sarbanes-Oxley[376] are supposed to ensure audit committee independence, but the requirement that committees pre-approve assignments to external auditors is unlikely to have a correlative effect on auditor independence. The SEC rules specifically allow committees to pre-approve such work in their written policies, as opposed to making

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[374] *Corporate Governance (A Special Report) -- The Hot Seat: These Days, All Eyes Are on the Chairman of the Audit Committee*, Wall St. J., Feb. 24, 2003, at R4; *An Analysis of the Securities and Exchange Commission's Implementation of Key Audit Reform Provisions of Recently Enacted Corporate Reform Legislation* 4-5, Consumer Federation of America, Jan. 29, 2003 ("Audit committees have time and again demonstrated their reluctance to accept responsibility for protecting the independence of the audit.") (available at http://www.consumerfed.org/auditreformeval.pdf). *See also* Stephen Taub, *Best Practices Elude Most Audit Committees*, CFO Magazine, Apr. 2, 2004 (survey of 758 audit committee chairs and 900 CFOs finds that just 20 percent of audit committees have adopted best practices for financial audit process). Available at http://www.cfo.com.

[375] *See* Jonathan Weil & Dennis Berman, *Auditing the Audit Committee*, Wall St. J., Dec. 9, 2002, at C1. *But cf*. Stephen Taub, *More Board Independence, Less Fraud?*, CFO Magazine, June 29, 2004 (study of 133 companies accused of fraud between 1978 and 2001 finds that boards of companies accused of fraud were less likely to have an audit committee). Available at http://www.cfo.com.

[376] *See Press Release -- SEC Requires Exchange Listing Standards for Audit Committees*, Securities and Exchange Commission, Apr. 1, 2003. Available at http://www.sec.gov/news/press/2003-43.htm. The new rules implement the requirements of Section 10(A)(m)(1) of the Exchange Act, as added by Section 301 of Sarbanes-Oxley, by creating new Exchange Act Rule 240.10A-3. The rules require that each member of an audit committee be independent according to criteria specified in Section 10(A)(m). Two specific criteria must be met. One, the audit committee member may not accept directly or indirectly any consulting, advisory or other compensatory fee from the listed issuer or any subsidiary of the issuer, other than in the member's capacity as a member of the board of directors or any board committee. Two, the audit committee member may not, other than in his or her capacity as a member of the board of directors or any board committee, be affiliated with the listed issuer or any subsidiary of the issuer. Steve Bochner, *Audit Committee Responsibilities*, 1395 PLI/Corp 611, 615-26 (Nov. 2003).

fresh determinations.[377] The result is that tax work continues to be performed for audit clients by their external auditors.[378]

The SEC rules also expand the definition of an audit service. Services that previously had been regarded as non-audit are now classified as audit and therefore are permissible. These include statutory audits, reviews of documents filed with the SEC, and tax and accounting consultations to the extent that such services are necessary to comply with GAAS.[379] This expansive definition of audit services also was the result of

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[377] Tim Reason, *Did the SEC Gut Sarbanes-Oxley?*, CFO Magazine, March 1, 2003 (SEC rules permit audit committees to pre-approve, in their written policies, certain non-audit services) (available at http://www.cfo.com).

[378] Cassell-Bryan-Low, *Questioning the Books: Keeping the Accountants from Flying High*, Wall St. J., May 6, 2003, at C1 (statement of Barbara Roper, director of investor protection at Consumer Federation of America). *See also Press Release -- Consumer Groups Charge Audit Firm with Undermining Key Auditor Independence Reform, Urge SEC To Investigate*, Consumer Federation of America, June 11, 2003 (Ernst & Young is advising audit clients on how to undermine audit committee pre-approval requirement) (available at http://www.consumerfed.org/E&Yletter_release.html). More recently, in December 2004, the PCAOB proposed new rules designed to strengthen the pre-approval requirement. *See* Stephen Taub, *Audit Board Proposes New Ethics Rules*, CFO Magazine, Dec. 15, 2004 (available at http://www.cfo.com).

[379] Cassell Bryan-Low, *Accounting Firms Earn More from Consulting*, Wall St. J., Apr. 16, 2003, at C9.

industry lobbying,[380] and the effect has been to re-characterize many millions of dollars worth of services to make them permissible under Sarbanes-Oxley.[381]

The exclusion of tax from the list of non-audit services prohibited by Sarbanes-Oxley is especially significant, because tax work comprises such a high percentage of total revenues for the Big Four. In 2002, tax revenue (much of it from audit clients)[382] accounted for 21%, 38%, 23%, and 37%, respectively, of the total revenues derived by Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers, and KPMG.[383] More recently, a 2004 survey of 1,652 companies, including most of the S&P 500, found that

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[380] Weil & Rapoport, *supra* note 369. Apart from its highly effective lobbying, the auditing industry exerts political clout by making significant campaign contributions. The Big Five and the AICPA donated nearly $39 million through individuals, political action committees, and soft-money contributions from 1989 to 2001. Ianthe Jeanne Dugan, *Depreciated: Did You Hear the One About the Accountant? It's Not Very Funny*, Wall St. J., March 14, 2002, at A1. In 1996, the year after the PSLRA was enacted, a grateful accounting industry donated more than $1 million to Congressional members responsible for the new law. Elizabeth McDonald, *Auditors Are Ending Up Between a Rock and a Hard Place Over Securities Law*, Wall St. J., Dec. 24, 1996, at C1. *See also* Johan von Brachel, *CPAs on Capitol Hill: A Behind-the-Scenes Look at the Passage of Securities Litigation Reform*, J. ACCT. 15 (June 1996). Each of the Big Five accounting firms was among the top 20 contributors to George W. Bush's 2000 presidential campaign. And 212 of the 248 Senate and House members who sat on congressional committees involved in the investigations prompted by the financial scandals of 2002 received campaign contributions from one or more of the Big Five accounting firms. James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L.Q. 301, 316 (2003); R.W. Roberts, P.D. Dwyer & J.T. Sweeney, *Political Strategies Used by the U.S. Public Accounting Profession During Auditor Liability Reform: The Case of the Private Securities Litigation Reform Act of 1995*, 22 J. ACCT. & PUB. POLICY 433, 434 n.2 (2003).

[381] While audit fees rose by 40 percent in 2004 for 23 of the 30 companies in the Dow Jones Industrial Average, much of this increase was attributable to a recharacterization of fees. Stephen Taub, *Audit Fees Surged in 2004*, CFO Magazine, March 28, 2005. Available at http://www.cfo.com.

[382] Revell, *supra* note 370, at 139 ("The mother lode of these 'other' fees comes from tax consulting, which observers estimate accounts for anywhere between 30% and 40% of the Big Four's overall revenue in the United States -- much of that from audit clients.").

[383] *Public Accounting Firms*, *supra* note 360, at 17. *See also* Phyllis Plitch, *Tracking the Numbers/Outside Audit: Auditor Independence Gets Focus*, Wall St. J., July 14, 2004, at C3 (tax work remains major revenue source for accounting firms); McCoy, *supra* note 161, at 1007 (exclusion by Sarbanes-Oxley of tax services from list of prohibited services is gigantic loophole).

42% of the total fees paid by the companies to their auditors went toward non-audit services. The biggest chunk of the non-audit fees (23 percent) was spent on tax work.[384]

Much of this lucrative tax work concerns tax shelters,[385] which are widely used and annually result in the loss of billions of dollars of revenue. Hundreds of thousands of United States taxpayers have utilized tax shelters in the last decade,[386] many of them to avoid paying taxes on stock options,[387] and in recent years the practice has spread from larger corporations to smaller businesses.[388] Tax shelters cost the United States Treasury

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384 Phyllis Plitch & Michael Rapoport, *Moving the Market: Nonaudit Fees Fell Below Half of Auditor Payment*, Wall St. J., July 8, 2004, at C3. *See also* Diya Gullapalli, *After the Scandals: More Work, More Money*, Wall St. J., Jan. 31, 2005, at R6 (survey of S&P companies in December 2004 finds that 2004 non-audit fees have increased 28 percent over 2003); Stephen Taub, *Audit Firms Focusing on Audit Fees*, CFO Magazine, July 7, 2004. Available at http://www.cfo.com.

385 *See generally* Ben Wang, Note, *Supplying the Tax Shelter Industry: Contingent Fee Compensation for Accountants Spurs Production*, 76 S. CAL. L. REV. 1237 (2003).

386 John D. McKinnon & John Harwood, *Tax Shelters Come Under Fire*, Wall St. J., June 6, 2003, at A4. *See also Internal Revenue Service: Challenges Remain in Combating Abusive Tax Schemes*, Report by U.S. General Accounting Office to Senate Comm. on Finance 2, 6 (Nov. 2003) (GAO-04-50) (131,000 participants were linked to abusive tax schemes, including tax shelters, during the period October 2001 - August 2003) (available at http://www.gao.gov); John D. McKinnon & Cassell Bryan-Low, *Tax Shelters of '90s May Have Returned*, Wall St. J., Oct. 21, 2003, at A2.

387 John D. McKinnon & Cassell Bryan-Low, *Leading the News: IRS Targets Shelters for Stock Options*, Wall St. J., July 2, 2003, at A3. In 2003, Sprint Corp. replaced Ernst & Young, its auditor since 1966, following a scandal concerning tax shelters devised by the auditor. The tax shelters protected more than $100 million in stock option gains realized by Sprint's CEO and President, both of whom were forced out of the company. Shawn Young, *Sprint Replaces Ernst & Young As Its Auditor*, Wall St. J., Oct. 15, 2003, at B9.

388 *Tax Shelters Target Small Businesses*, Wall St. J., Sept. 17, 2003.

an estimated $10-20 billion in annual revenue[389] and state governments an additional $8-12 billion.[390]

Many accounting firms are deeply involved in creating these tax shelters and aggressively marketing them to audit clients.[391] One such client of Arthur Andersen was Enron. Enron's extensive use of tax shelters enabled the company to report no taxable income during the period 1996-99, while it was claiming $2.3 billion in book profits.[392] These shelters were facilitated by Enron's creation, with Andersen's assistance, of 881 offshore subsidiaries.[393] KPMG and Ernst & Young also heavily promoted tax shelters during the late 1990s.[394] A Senate report released in 2003 concluded that KPMG had devoted substantial resources to, and obtained significant fees from, developing, marketing, and implementing potentially illegal and abusive tax shelters that had cost the

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[389] Don Durfee, *Shelter Fallout*, CFO Magazine, Nov. 1, 2004 (available at http://www.cfo.com); Raquel Meyer Alexander, et al., *Tax Shelters Under Attack*, CPA J., Aug. 2003. Available at http://www.cpajournal.com. *Cf. Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters*, Testimony of Michael Brostek (Director, Tax Issues, U.S. General Accounting Office) Before Senate Comm. on Finance, Oct. 21, 2003 (GAO-04-104T) (abusive tax shelters totaled tens of billions of dollars over the last decade). Available at http://www.gao.gov.

[390] Glenn R. Simpson, *The Economy: California, Other States to Join IRS in Tax-Shelter Crackdown*, Wall St. J., July 16, 2003, at A2.

[391] Cassell Bryan-Low, *Senate Panel Seeks Accounting Firms' Tax Shelter Data*, Wall St. J., Apr. 22, 2003, at A2 (statement of Sen. Carl Levin). *See also Developments in the Law – Governmental Attempts to Stem the Rising Tide of Corporate Tax Shelters*, 117 HARV. L. REV. 2249, 2253 (2004) (accounting firms command the lion's share of the tax shelter market and produce the most aggressive shelters).

[392] *Many Happy Returns?: Why a Low Corporate Tax Bill Is Often Not the Good News It Seems to Be*, Economist, May 8, 2003. Available at http://www.economist.com.

[393] Alexander, *et al., supra* note 389. Andersen was not the only member of the Big Five whose work facilitated the Enron accounting scandal. The work of PricewaterhouseCoopers and KPMG was described as grossly negligent and negligent, respectively, by Enron examiner Harrison Goldin. *See* Stephen Taub, *Enron Examiner Cites Auditors, Banks*, CFO Magazine, Dec. 8, 2003. Available at http://www.cfo.com.

[394] *See* Cassell Bryan-Low, *KPMG Insiders Questioned Shelter*, Wall St. J., Nov. 19, 2003, at A2; Cassell Bryan-Low, *KPMG Didn't Register Strategy*, Wall St. J., Nov. 17, 2003, at C1 (during 1990s, sales of tax shelters boomed as large accounting firms stepped up their marketing efforts).

United States Treasury billions of dollars in lost tax revenues.[395] Many of these tax shelters were marketed to KPMG's audit clients, creating inherent conflicts of interest. Conflicts arose when KPMG auditors were required to examine their clients' tax returns and use of shelters. In these situations, KPMG was, in effect, auditing its own work.[396] In 2005 KPMG agreed to pay $456 million in fines and accepted a list of other conditions to settle a criminal action initiated by the Department of Justice in connection with the creation and sale of these abusive tax shelters.[397]

But KPMG is not alone. The 2003 Senate report concluded that accounting firms in general have become key participants in the thriving tax shelter industry.[398] A subsequent GAO report, released in 2005, concluded that more than 12 percent of the Fortune 500 – 61 companies in all – obtained tax shelter services from their external auditors during the period 1998 – 2003.[399]

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[395] *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals* -- Report by Minority Staff of Senate Permanent Subcomm. on Investigations 4 (Nov. 2003) (herafter *U.S. Tax Shelter Industry*). KPMG reaped $128 million in fees for tax shelters that permitted clients to evade $2.5 billion in taxes by claiming false losses of $11 billion. *See* Floyd Norris, *When Auditors Go Astray, What Director Dares Say So?*, N.Y. Times, Sept. 6, 2005.

[396] U.S. Tax Shelter Industry, *supra* note 395, at 15-16.

[397] Stephen Taub, *Ex-CFO of KPMG Among 10 Newly Indicted*, CFO Magazine, Oct. 18, 2005. Available at http://www.cfo.com.

[398] U.S. Tax Shelter Industry, *supra* note 395, at 22.

[399] *Tax Shelters: Services Provided by External Auditors*, Report by General Accounting Office to Ranking Minority Member, Permanent Senate Subcomm. on Investigations, Comm. on Homeland Security and Governmental Affairs (Feb. 2005) (GAO-05-171); Stephen Taub, *Tapping the Auditor to Avoid Taxes*, CFO Magazine, March 2, 2005. Available at http://www.cfo.com. The PCAOB has recognized the tax shelter problem. In December 2004, the board proposed rules that would treat a registered public accounting firm as not independent of an audit client, if, *inter alia*, the firm provided tax advice on certain types of potentially abusive tax transactions. *See Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, Release No. 2004-015*, 1482 PLI/Corp 143, 143 (May 2005). Those rules were finally adopted in July 2005. Craig Schneider, *PCAOB Toughens Independence Rules*, CFO Magazine, July 26, 2005. Available at http://www.cfo.com.

The provision by auditing firms of numerous non-auditing services directly undercuts the assumption of *DiLeo* and its progeny that accountants have no economic incentive to engage in fraudulent audits. In fact, they have a powerful incentive, which is to encourage their audit clients to generate additional tax and consulting work.[400] While the empirical evidence is mixed, a fair amount of research does support the hypothesis that the provision of non-audit services impairs audit quality.

In 1996, the United States General Accounting Office reported findings of the accounting profession and the SEC that "there is no conclusive evidence that providing traditional management consulting services compromises auditor independence."[401] Four years later, in 2000, the POB echoed the GAO: "The Panel is not aware of any instances of non-audit services having caused or contributed to an audit failure or the actual loss of auditor independence."[402]

One likely reason why such evidence did not surface is that prior to 2000 the SEC did not require companies to disaggregate fees they paid for audit and non-audit services. Hence, researchers were handicapped by a lack of usable data.[403] In November 2000 the SEC imposed such a reporting requirement, applicable to proxy statements and annual reports of all public companies.[404] Corporations were required to disclose fees

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[400] *See*, *e.g.*, Larry E. Ribstein, *Market v. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 30 (2002) ("[A]uditing firms have proven willing to cast aside valuable reputations for short-term profits.").

[401] Accounting Profession, *supra* note 21, at 8.

[402] Public Oversight Board, *supra* note 162, at 110.

[403] *Keeping Auditors Independent: The SEC's Deal with the Big Accountancy Firms May Not Restrain Them Enough*, Economist, Nov. 16, 2000 ("[A]lthough the firms publish aggregate revenues, they do not break them down by clients. So it has been hard even to see where conflicts might lie."). Available at http://www.economist.com.

[404] Regulation S-X, Rule 2-01, 17 C.F.R. § 210.2-01.

paid and services performed during the two most recent fiscal years, split into four fee categories: audit, audit-related, tax, and all other.[405] This mandate was the result of a compromise, brokered after the auditing industry staged a massive public relations and lobbying campaign against an SEC proposal to prohibit auditors from providing consulting services.[406] Thereafter, empirical research began to proliferate.

A study released in 2002 by accounting professors at Stanford, MIT, and Michigan State concerning 4,200 SEC filings found that corporations with the least independent auditors (those which paid the most in consulting fees, as a percentage of the total fee paid to the audit firm) were the most likely to meet or surpass earnings benchmarks such as analysts' forecasts.[407] The authors concluded: "Taken together, our results suggest that the provision of non-audit services impairs independence and reduces the quality of earnings."[408] Another study of 2,295 firms, released in 2003 by researchers at the Wharton School, found that the provision of non-audit services was associated with

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[405] *The Sarbanes-Oxley Act of 2002 -- Understanding the Independent Auditor's Role in Building Public Trust: A White Paper 13*, PricewaterhouseCoopers (2003). Available at http://www.pwcglobal.com/extweb/NewCoAtWork.nsf.

[406] Arthur Levitt, Jr., the former head of the SEC, later described this campaign as a total war. *See* Arthur Levitt, Jr. & Paula Dwyer, Take on the Street 133-39 (2002). *See also* McCoy*, supra* note 161, at 1000 (accountants battled to the death efforts to curb their consulting powers); *Ceasefire*, Economist, Nov. 16, 2000 (after heavy lobbying, the Big Five firms foiled an effort by the SEC to prohibit consulting and auditing services from operating under the same roof); *The Ties That Bind Auditors*, Economist, Aug. 10, 2000 (major accounting firms, lobbying against the SEC, cited failure of POB to offer examples of audit failures that resulted from the sale of non-audit services) (available at http://ww.economist.com). The SEC has described its resolution of the dispute as "a pragmatic approach to a difficult issue." *See* William T. Allen & Arthur Siegel, *Threats and Safeguards in the Determination of Auditor Independence*, 80 WASH. U. L.Q. 519, 534 (2002).

[407] Richard M. Frankel, Marilyn F. Johnson & Karen K. Nelson, *The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality*, 77 ACCT. REV. 71 (2002).

[408] This conclusion is reported at http://www.gsb.stanford.edu/news/reasearch/acctg_auditconflict.shtml. *See also* Aaron Elstein, *Deals & Deal Makers: Study Faults Work of Auditors Who Consult*, Wall St. J., Aug. 1, 2001, at C18.

earnings deterioration for a sub-group of firms with weak corporate governance.[409] A third study, also released in 2003, found that audit partners' going-concern judgments were influenced by whether the client offered significant future opportunities for non-audit fees.[410]

While other studies are to the contrary,[411] a fair amount of empirical evidence supports the hypothesis that the provision of non-auditing services impairs audit quality. Such evidence tends to confirm the common perception, set forth in media reports, that consulting fees can and do skew audit results.[412] The Enron example also supports the hypothesis. In 2000, Arthur Andersen earned $25 million in auditing fees and $27 million for consulting and tax work performed for the energy trader.[413] Much of the consulting work was performed in connection with structuring Enron's thousands of off-

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[409] David F. Larcker & Scott Richardson, *Corporate Governance, Fees for Non-Audit Services and Accrual Choices* (Apr. 2003). Available at http://accounting.wharton.penn.edu/faculty/richardson/NAS.pdf.

[410] The results are reported in Mark W. Nelson, *A Review of Empirical Conflicts-of-Interest Research in Auditing* 16 (Sept. 2003). Available at http://conflictofinterest.info/papers/Nelson.pdf.

[411] *See*, *e.g*., William R. Kinney, Jr., Zoe-Vonna Palmrose & Susan Scholz, *Auditor Independence and Non-audit Services: What Do Restatements Suggest?* (Apr. 2003) (finding a consistent negative association between tax service fees and earnings restatements). Available at http://www.thecorporatelibrary.com/special/misc/KPS_04-17-03.pdf. *See also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1535-36 (2005) (19 of 25 studies find no connection between the provision of non-audit services and audit quality); K. Raghunandan, *et al., Initial Evidence on the Association Between Nonaudit Fees and Restated Financial Statements*, 17 ACCT. HORIZONS 223 (2003) (study of 110 firms restating earnings finds no link between non-audit fees and incidence of restatement); and Mark L. DeFond, et al., *Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions*, 40 J. ACCT. RES. 1247 (2002) (study of 1,158 firms finds (a) no significant association between non-audit service fees and impaired auditor independence, and (b) no association between going concern opinions and either total fees or audit fees).

[412] *See*, *e.g*., Cassell Bryan-Low, *More Ernst Nonaudit Services Under Fire*, Wall St J., March 10, 2003, at C1 (accounting firms that sell millions of dollars of consulting and other services to their auditing clients could be compromised and cave on tough auditing calls for fear of losing non-audit business).

[413] Cassell Bryan-Low, *Accounting Firms Are Still Consulting*, Wall St. J., Sept. 23, 2002, at C1. This fee distribution generally characterized Arthur Andersen during the late 1990s. Consultants generated 58 percent of Andersen's overall revenues during this period. Ken Brown & Ianthe Jeanne Dugan, *Sad Account: Andersen's Fall from Grace Is A Tale of Greed and Miscues*, Wall St. J., June 7, 2002, at A1.

balance sheet transactions. A year later, Enron collapsed when its complex accounting fraud was uncovered. The lesson, according to many commentators, was clear. One wrote: "The Enron disaster, with its combination of sham transactions and antecedent (and lucrative) auditor consultation in the sham transactions' structure, demonstrated that consulting relationships can indeed contribute to catastrophic audit failures."[414] This conclusion is reinforced by Arthur Andersen's participation in an extended sequence of accounting scandals prior to its demise.[415]

In sum, the *DiLeo* analysis is flawed because it fails to consider that the lure of significant non-audit fees can provide the necessary economic motive for an external auditor to engage in fraudulent conduct.[416] Sarbanes-Oxley has not fundamentally

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[414] Bratton, *supra* note 122, at 1030. *Accord* McCoy, *supra* note 161, at 992, 1000 ("All too often, accounting firms felt compelled to pay the piper by signing off on doctored financial statements. . . . As consulting revenues skyrocketed and surpassed fees from audits, retaining consulting business became the overriding goal, even at the risk of compromising audits."). *See also Why Good Accountants Do Bad Audits, supra* note 341, at 102 ("True auditor independence requires, as a start, full divestiture of consulting and tax services.").

[415] *See* Christine E. Early, Kate Odabashian & Michael Willenborg*, Some Thoughts on the Audit Failure at Enron, the Demise of Andersen, and the Ethical Climate of Public Accounting Firms*, 35 CONN. L. REV. 1013, 1024 (2003) ("At the end of the day, the spate of audit failures that consumed Andersen (Sunbeam, Waste Management, Baptist Foundation of Arizona, Enron, Worldcom, Global Crossing, and Qwest) seem inextricably linked to the audit firm's longstanding cohabitation with a highly profitable consulting culture."); Ken Brown & Jonathan Weil, *Questioning the Books: How Andersen's Embrace of Consulting Altered the Culture of the Auditing Firm*, Wall St. J., March 12, 2002, at C1.

[416] *See, e.g.*, In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp.2d 319, 345-46 (S.D.N.Y. 2004) (allegation that Arthur Andersen had dual role as auditor and consultant sufficient to survive motion to dismiss); In re Complete Mgt. Inc. Sec. Litig., 153 F. Supp.2d 314, 335 (S.D.N.Y. 2001) (Arthur Andersen's receipt of consulting fees from audit client, in combination with other factors, supported inference that Andersen had motive to engage in fraudulent audit); and In re Microstrategy, Inc. Sec. Litig., 115 F. Supp.2d 620, 654-56 (E.D. Va. 2000). *See also* Stephen Taub, *PwC Probed on Auditor Independence*, CFO Magazine, June 2, 2004 (PricewaterhouseCoopers pays $50 million to settle class action alleging that its independence was compromised by lucrative contract for non-audit consulting work that it was seeking from client Raytheon Co. shortly before issuance of clean audit opinion). Available at http://www.cfo.com. *But see* In re Stone & Webster, Inc. Sec. Litig., 414 F.3d 187, 215 (1st Cir. 2005) (auditor's motivation to continue a profitable business relationship insufficient by itself to support a strong inference of scienter); In re Royal Dutch/Shell Transport Sec. Litig., 380 F. Supp.2d 509, 568-69 (D.N.J. 2005) (auditor's motivation to increase fees from non-auditing services insufficient to constitute evidence of scienter).

changed the equation.[417] The analysis is infirm for a number of additional reasons, which are discussed below.

(2) The Auditing Industry Operates As An Oligopoly

DilLeo and similar cases are wrongly decided for a second reason. The absence of effective competition in the accounting industry means that auditors are not constrained by the possible loss of market share if their fraudulent audits are uncovered. The non-competitive nature of the auditing industry was underscored in a comprehensive report mandated by Sarbanes-Oxley and released in 2003 by the United States General Accounting Office. The GAO report noted that the number of firms capable of providing audit services to large national and multinational companies decreased from eight in the 1980s to four in 2003.[418] The reduction was the result of mergers involving six of the top

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[417] *See*, *e.g.*, Joseph Nocera, *Auditors: Too Few to Fail*, N.Y. Times, June 25, 2005, at C1 ("Accounting firms are no longrt allowed to sell consulting services to companies they audit, but all still do lots of consulting., and that is still an important revenue generator for them.").

[418] Public Accounting Firms, *supra* note 360, at 1-2. The Big Eight were Arthur Andersen LLP, Arthur Young LLP, Coopers & Lybrand LLP, Deloitte Haskins & Sells LLP, Ernst & Whinney LLP, Peat Marwick Mitchell LLP, Price Waterhouse LLP, and Touche Ross LLP. The Big Four are Deloitte & Touche LLP (the U.S. national practice of Deloitte Touche Tohmatsu), Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP. *Id.* at 1 n.2. The Big Four are structured as loose alliances of independent partnerships that belong to global membership organizations. Jonathan Weil, *KPMG Opens Its Books (a Bit), Offering Glimpse of U.S. Results*, Wall St. J., Jan. 26, 2005, at C4. The alliances are not so loose that affiliates of one organization can never be held liable for misconduct of other affiliates. *See* In re Parmalat Sec. Litig., 377 F. Supp.2d 390, 404 (S.D.N.Y. 2005); In re Parmalat Sec. Litig., 375 F. Supp.2d 278, 294-96 (S.D.N.Y. 2005); and Stephen Taub, *One Lawsuit, One Deloitte*, CFO Magazine, June 30, 2005 (available at http://www.cfo.com). But more frequently courts have rejected application of "one-firm" theories and dismissed claims against international accounting enterprises absent specific allegations that the international auditor controlled the activities of the member firm. *See*, *e.g.*, Newby v. Enron Corp., 394 F.3d 296, 308-09 (5th Cir. 2004) (fact that Andersen Worldwide SC promulgated and enforced professional standards insufficient to hold it liable for actions of U.S. member firm Arthur Andersen); In re Royal Dutch/Shell Transport Sec. Litig., 380 F. Supp.2d 509, 571-72 (D.N.J. 2005) (dismissing claims against KPMG International and PricewaterhouseCoopers International); Rocker Mgt. v. Lernout & Hauspie Speech Prods., 2005 WL 1365772 (D.N.J. June 8, 2005) (rejecting application of one-firm theory to accounting firms); In re Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp.2d 334, 385 n.41 (D. Md. 2004) ("Deloitte U.S. and Deloitte Netherlands are legally distinct, autonomous firms and will be treated as such."); Skidmore v. KPMG, 2004 WL 3019097, *4 (N.D. Tex. Dec. 28, 2004) (allegation that KPMG acted as worldwide organization insufficient to state claim against KPMG LLP for acts of KPMG member firm in Morocco); Nuevo Mundo Holdings v. PricewaterhouseCoopers LLP, 2004 WL 112948, *3 (S.D.N.Y. Jan. 22, 2004) (member firms in an international accounting association are not

eight firms since the late 1980s[419] and the dissolution of Arthur Andersen in 2002. Some of these mega-mergers were specifically designed to boost the auditors' consulting practices.[420] In 2002, the Big Four audited over 78 percent of all U.S. public companies, 97 percent of all public companies with sales over $250 million, and 99 percent of all public company annual sales.[421] Moreover, these concentration ratios have continuously increased. In 1988 the top four firms audited 63 percent of total public company sales. By 1997 that number had increased to 71 percent, and by 2002 it was 99 percent.[422]

Of course, the Big Four firms do not operate alone. By 2000 there were approximately 45,000 local and regional accounting firms in this country, generally organized as partnerships or sole proprietorships.[423] A tier of firms below the Big Four,

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part of a single firm and are neither agents nor partners of other member firms simply by virtue of using the same brand name); and In re Worldcom, Inc. Sec. Litig., 2003 WL 21488087 (S.D.N.Y. June 25, 2003) (dismissing securities claims against Andersen Worldwide SC, the umbrella organization for the former Arthur Andersen firms). *Cf.* In re Lernout & Hauspie Sec. Litig., 230 F. Supp.2d 152, 173 (D. Mass. 2002) (court finds that each member firm of KPMG International is a separate and independent legal entity, but refuses to dismiss certain claims).

[419] *See Too Few Accountants: Two Proposed Mergers Among Accountancy Firms Add Up to Serious Restraints on Competition*, Economist, Jan. 29, 1998; *Bean-Counters Unite*, Economist, Oct. 23, 1997 (available at http://www.economist.com); Elizabeth MacDonald, *Levitt Says Wave of Accounting Mergers Could Affect Independence of Auditors*, Wall St. J., Oct. 21, 1997, at A2; and Elizabeth MacDonald, *Ernst & Young to Merge with KPMG*, Wall St. J., Oct. 20, 1997, at A3.

[420] *Double Entries*, Economist, Dec. 11, 1997. Available at http://www.economist.com. *See also* Ford Harding, *Manager's Journal: Cross-Selling Will Outlast Enron and Andersen*, Wall St. J., Aug. 13, 2002, at B2 ("The big accounting firms grew to prominence by cross-selling services to their clients.").

[421] Public Accounting Firms, *supra* note 360, at 1-2, 16. The Big Four also audit more than 80% of public companies in Japan, two-thirds of those in Canada, and all of Britain's 100 largest public companies. They also hold over 70 percent of the European market as measured by fee income. *Called to Account – The Future of Auditing*, Economist, Nov. 19, 2004. Available at http://www.economist.com.

[422] Public Accounting Firms, *supra* note 360, at 20-21.

[423] Public Oversight Board, *supra* note 162, at 184. *Cf.* Louis Grumet, *State Legislative Power Supercedes Federal Laws in Accounting Reform*, 76 N.Y. ST. B.J. 54, 54 (2004) (of the nearly 30,000 members of the New York State Society of CPAs, merely 6 percent are affiliated with Big Four accounting firms).

known in the industry as Group B, has hundreds of members.[424] But these firms are much smaller than the Big Four. Grant Thornton, ranked fifth on the list of top 100 accounting firms in the United States, had annual revenues of $400 million in 2002, and its professional staff numbered about 2,100. By comparison, with respect to their United States operations, each member of the Big Four has annual revenues exceeding $3 billion and a professional staff that exceeds 10,000.[425] Even a merger of the five largest members of Group B might not create a firm capable of competing with the Big Four.[426] Moreover, hundreds of the smaller accounting firms have been predicted to fold before 2010. The predicted result would be a contraction from 1,200 to around 400 of the AICPA's SECPS, which generally consists of accounting firms that collectively audit the financial statements of more than 99 percent of the approximately 18,000 public corporations that file reports with the SEC.[427]

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[424] Joseph Radigan, *Sussing Out the Second Six*, CFO Magazine, Oct. 2, 2002. Available at http://www.cfo.com. Sarbanes-Oxley requires the registration of all public accounting firms (including foreign auditors) that issue or prepare audit reports on U.S. public companies, or that play a substantial role in the preparation of such audit reports. By November 23, 2005, 1,580 accounting firms had registered with the PCAOB. *See* http://www.pcaobus.org/Registration/index.asp.

[425] Public Accounting Firms, *supra* note 360, at 17. The gap is likewise huge if global operations are considered. In 2003, each member of the Big Four had global revenues that exceeded $10 billion and a professional staff that exceeded 60,000. But BDO Seidman, ranked fifth on the list of U.S.-based firms with global operations, lagged with global revenues of approximately $2.4 billion and a professional staff of less than 20,000. Grant Thornton ranked sixth. Joseph McCafferty, *Break Up the Big Four?*, CFO Magazine, June 2, 2004. Available at http://www.cfo.com.

[426] *Still Counting the Cost: The Auditing Profession Has Not Yet Put Its Problems Behind It*, Economist, Oct. 16, 2003. Available at http://www.economist.com. *Accord Crime and Punishment*, Economist, June 23, 2005 (mergers among second-tier firms would make little difference, given vast gap in size between KPMG, the smallest of the Big Four, and those companies below it). Available at http://www.economist.com.

[427] Joseph Radigan, *Coming: Auditor Cataclysm?* CFO Magazine, Oct. 2, 2002. Available at http://www.cfo.com. Since 1990, AICPA member firms auditing one or more companies registered with the SEC have been required to join the SECPS. Sally S. Spielvogel, Note, *Exploring the Sarbanes-Oxley Act: Will Government Intervention in the Public Accounting Profession Prevent Another Enron?*, 92 KY. L.J. 339, 351 (2003-04); Paul R. Brown, Jeanne A. Calderon & Baruch Lev, *Administrative and Judicial Approaches to Auditor Independence*, 30 SETON HALL L. REV. 443, 449 (2000).

Because Group B firms are so much smaller than the Big Four, and thus often lack (or are perceived to lack) technical skills and relevant knowledge of the industry, a reputation for quality work, capacity, and global offices,[428] major corporations generally shun them.[429] The GAO found that 88 percent of public companies responding to its survey would not consider using a non-Big Four firm for audit and attest services. The GAO concluded: "For most large public companies, the maximum number of choices has gone from eight in 1988 to four in 2003."[430]

But the maximum number of choices is even more limited. Additional constraints are imposed by industry specialization, potential conflicts of interest, and new SEC independence rules. The GAO found that specialization often limits the number of audit choices to two. For example, in 2002, 94.6 percent of assets in the petroleum and coal products industry were audited by two companies (Ernst & Young and PricewaterhouseCoopers). Similarly, in 2002, 86.1 percent of assets in the air

[428] *See Accounting Firm Consolidation: Selected Large Public Company Views on Audit Fees, Quality, Independence, and Choice*, Report by U.S. General Accounting Office to Senate Comm. on Banking, Housing and Urban Affairs and House Comm. on Financial Services 14-15 (Sept. 2003) (GAO-03-1158) (hereafter *Selected Large Public Company Views*) (available at http://www.gao.gov). An SEC study suggests that the reputation of the larger firms for higher quality work is not necessarily warranted. The SEC reviewed all 227 of the enforcement matters it pursued during the period July 31, 1997 to July 30, 2002, and determined that in 140 of those cases, the issuer was audited by a Big Five firm. Section 704 Report, *supra* note 14, at 39.

[429] Second-tier accounting firms gained 193 new clients from Big Four firms in 2004, but many of these were small clients cut loose by the Big Four. John Goff, *Fractured Fraternity*, CFO Magazine, Sept. 1, 2005. Available at http://www.cfo.com.

[430] Public Accounting Firms, *supra* note 360, at 26. *Accord* Lingling Wei, *Alliances Among Accounting Firms in Popularity Due to Necessity*, Wall St. J., Feb. 11, 2004 (Big Four firms have a virtual lock on market for auditing large public companies) (available at 2004 WL-WSJ 56919825); Jonathan Weil, *Tracking the Numbers/Outside Audit: Fannie Dismissal of KPMG Shows Dwindling Choices Among Big Four*, Wall St. J., Dec. 23, 2004, at C1. *See also* Alix Nyberg, *Audit Fees on the Rise*, CFO Magazine, Oct. 1, 2002 (during the period 1999-2002, only two to four percent of companies changing auditors switched from a Big Five firm to a smaller firm). Available at http://www.cfo.com. This outcome is not entirely a function of client choice. Many smaller accounting firms have no interest in competing for the audit work of multinationals, given the downside of possible securities litigation, high insurance costs, and the incumbent advantage enjoyed by the Big Four. *Still Counting the Cost: The Auditing Profession Has Not Yet Put Its Problems Behind It*, Economist, Oct. 16, 2003. Available at http://www.economist.com.

transportation industry were audited by two companies (Ernst & Young and Deloitte & Touche). These ratios became much more pronounced from 1997 to 2002, following the demise of Arthur Andersen and the merger of Price Waterhouse with Coopers & Lybrand. As a result of specialization it has become increasingly difficult for a large company to find an auditing firm with the requisite industry-specific expertise and staff capacity.[431]

The problem is exacerbated by the requirement, imposed by Sarbanes-Oxley and SEC rules adopted in 2003, that a company's auditor refrain from providing various non-audit services. The GAO concluded that, as a consequence of the foregoing factors, there are scenarios in which a company "would have no viable alternatives for its global audit and attest needs."[432] Another adverse consequence is that corporations selecting new auditors sometimes hire an accounting firm that has been fired from another major account on the ground of impropriety.[433]

The absence of effective competition in the auditing industry further undercuts the assumption of *DiLeo* and similar cases that auditors would never engage in fraud,

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[431] Public Accounting Firms, *supra* note 360, at 26-30. *See also Called to Account – The Future of Auditing*, Economist, Nov. 19, 2004 (just two firms audited 88.2% of the casino industry in 2004, and similar concentrations exist in other industries) (available at http://www.economist.com); Cassell Bryan-Low & Jonathan Weil, *GAO Warns on Future Problems from Audit-Industry Mergers*, Wall St. J., July 31, 2003, at C11; and *Mandatory Audit Firm Rotation, supra* note 181, at 41 (auditor choices are restricted because accounting profession has become segmented by industry and firms lack industry-specific knowledge).

[432] Public Accounting Firms, *supra* note 360, at 30. *See also The Future of the Accounting Profession*, American Assembly Report (Feb. 2004) at 15 (as result of Sarbanes-Oxley, multinational companies typically engage two of the Big Four, and thus have only two choices if they wish to change auditors). Available at http://www.hypermediative-dev1.net/programs.dir/prog_display_ind_pdf; *Half Measures: The Auditing Industry Still Needs More Reform*, Economist, Nov. 18, 2004 ("Each of the Big Four accountancy firms and many of the second-tier ones have been sullied by accounting scandals, and yet they continue to attract business because there are no other options, particularly for large, international companies."). Available at http://www.economist.com.

[433] Scot J. Paltrow, *Companies Swap Fired Auditors*, Wall St. J., July 1, 2002, at C1.

because the financial consequences would be devastating. In this industry, which effectively operates as an oligopoly, the constraints on fraudulent activity are thinner than might otherwise be expected.[434] Moreover, because a Big Three would certainly be too few to provide a sufficient degree of competition in Fortune 500 audits, the Department of Justice is constrained to act as aggressively now in cases of auditor fraud as it did in the case of Arthur Andersen. The industry cannot tolerate the demise of another huge auditor.[435] It is widely assumed that the Justice Department's 2005 deferred prosecution agreement with KPMG in connection with the firm's marketing of illegal tax shelters was prompted by concerns that an indictment would cause the Big Four to shrink to the Big Three.[436]

(3) Audit Firm Rotation and Accountants Who Switch Sides

The *DiLeo* analysis also should be rejected because it fails to consider that (a) major corporations have no obligation to rotate their audit firms (and therefore rarely do so), and (b) many corporations hire their former auditors to work in-house at the

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[434] *See* Coffee, *supra* note 4, at 1414-15 (in a concentrated market of four auditing firms, it becomes less likely that one of the firms will market itself as distinctive for its integrity); McCoy, *supra* note 161, at 1003 (oligopoly power permits major accounting firms to sustain repeated payouts in litigation with their reputations unscathed).

[435] *See, e.g., Called to Account – The Future of Auditing*, Economist, Nov. 19, 2004. Available at http://www.economist.com.

[436] *See*, *e.g.*, Stephen Taub, *Regulators Clueless on Big Four Failure*, CFO Magazine, Sept. 28, 2005 (available at http://www.cfo.com); *Taxed*, Economist, Sept. 1, 2005 ("Had the Big Four become a Big Three, there would have been one firm fewer in an industry that is already highly concentrated.") (available at http://www.cfo.com); and Joseph Nocera, *Auditors: Too Few to Fail*, N.Y. Times, June 25, 2005, at C1 (Justice Department failed to indict KPMG in connection with its sales of illegal tax shelters in part because government feared indictment would cause KPMG to fold). This concern was shared by European regulators. *See* Craig Schneider, *Concern for KPMG Extends to Europe*, CFO Magazine, July 11, 2005. Available at http://www.cfo.com. *See also* Robert Bloom & David C. Schirm, *Consolidation and Competition in Public Accounting: An Analysis of the GAO Report*, CPA J., June 2005 (speculating that SEC gave Ernst & Young a mere six-month suspension from accepting new public company audit engagements in 2004 -- due to violations of auditor independence rules -- because of limited competition in audit industry) (available at http://www.nysscpa.org).

management level. The absence of rotation and the phenomenon of revolving door hiring have impaired the independence that auditors are required to exhibit, because auditors in these situations are motivated to curry favor with management.

In a study mandated by Sarbanes-Oxley and released in 2003, the GAO estimated that 99 percent of Fortune 1000 public companies and their audit committees have no audit firm rotation policy.[437] Because mandatory rotation has not been imposed by the SEC or PCAOB,[438] and it is so rarely implemented on a voluntary basis, auditing relationships typically last a long time. The relationships between Fortune 1000 companies and their auditors average 22 years.[439] The absence of rotation has potentially serious detrimental effects. If an auditing firm knows that it can remain employed by its client indefinitely, as long as it remains in management's good graces, it has a powerful incentive to approve the client's accounting decisions, even if that accounting is fraudulent. Thus, almost all of the largest accounting scandals in recent years, including those at Enron, WorldCom, and HealthSouth, occurred on the watch of auditors who had been on the job for at least a decade.[440]

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[437] Mandatory Audit Firm Rotation, *supra* note 181.

[438] Neither body has taken a position on the merits of mandatory audit firm rotation. *Id.* at 40 n.45.

[439] *Id.* at 16-17. This statistic is shaped by two contrasting factors. First, there was a substantially increased rate of auditor change during the period 2001-03, attributable to the collapse of Arthur Andersen. More than 80% of Fortune 1000 companies that changed auditors during this period did so to replace Andersen. Second, approximately 10% of Fortune 1000 companies have had the same auditor for more than 75 years. Exclusion of this latter group of companies reduces the average auditor tenure to 19 years. *Id*. Audit relationships are shorter in other countries that impose mandatory rotation. Since 1975 Italy has required audit firm rotation for listed companies every nine years. Since 1999 Brazil has required financial institutions to change auditors every four years and all other listed companies to change every five years. Silvia Ascarelli, *One Size Doesn't Fit All: In Europe, Corporate Governance Rules Are Not in the Details*, Wall St. J., Feb. 24, 2003, at R6; *Mandatory Audit Reform Rotation, supra* note 181, at 83-84.

[440] *Still Counting the Cost: The Auditing Profession Has Yet To Put Its Problems Behind It,* Economist, Oct. 16, 2003. Available at http://www.economist.com). *Accord* Floyd Norris, *The Auditors Never Noticed*, N.Y. Times, Dec. 24, 2003 ("On all the major debacles, including Tyco, Ahold, Enron, Rite Aid, Xerox, Cendent, HealthSouth, WorldCom, Microstrategy, W.R. Grace, Sunbeam, Lucent, Oxford Health,

Likewise, an individual auditor who knows that ultimately he is likely to be offered a top management position with his client may be motivated to approve improper accounting.[441] Enron is a classic example. A revolving door connected Enron and Arthur Andersen, its external auditor since 1985.[442] The door revolved for numerous individuals, including the former chief accounting officer of Enron's North American operations, who joined the company after managing Enron's account at Arthur Andersen in Houston.[443] In 2003 this officer settled accounting fraud charges filed against him by the SEC, by agreeing to pay $500,000 in penalties, and he was later indicted on six felony counts.[444] But he was not alone. As many as three hundred accounting and finance positions at Enron, many in mid-level and senior management, may have been filled by former Andersen personnel.[445]

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and Adelphia, the auditor had a longtime relationship and should have had boat loads of knowledge.") (statement of Lynn Turner, former SEC chief accountant). Available at http://www.nytimes.com. *See also* Thomas C. Wooten, *Research About Audit Quality*, CPA J., Jan. 2003 (audit failure is more common in very long audit relationships, as well as in short tenures). Available at http://www.cpajournal.com.

[441] Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1178 (2003).

[442] *Why Good Accountants Do Bad Audits, supra* note 341, at 102; Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 867 (2003). Andersen also served as Enron's internal auditor.

[443] Craig Schneider, *When Accountants Switch Sides: Is it Time for the SEC To Prohibit Corporations from Offering Jobs To Their External Auditors?*, CFO Magazine, Apr. 3, 2002. Available at http://www.cfo.com.

[444] Kurt Eichenwald, *Ex-Accounting Chief at Enron Is Indicted on 6 Felony Charges*, N.Y. Times, Jan. 23, 2004 (available at http://www.nytimes.com); Dan Ackman, *Causey May Put GAAP on Trial*, forbes.com, Jan. 23, 2004 (available at http://www.forbes.com); and John R. Emshwiller, *U.S. Investigators Open New Front in Enron Case*, Wall St. J., Oct. 10, 2003, at A3.

[445] *See* In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp.2d 549, 674 (S.D. Tex. 2002). *Cf.* Landsman, *supra* note 365, at 1209 ("Enron hired away no fewer than 125 Andersen accountants. . . . The steady stream of hirings. . . appeared to hold out the promise of lucrative future employment to those Andersen accountants who could ingratiate themselves to Enron officials.").

Waste Management, Inc. is another classic example. From 1971 until 1997, every CFO and chief accounting officer hired by Waste Management previously worked for Arthur Andersen, its external auditor.[446] A total of 14 former Andersen employees ultimately worked for Waste Management during the 1990s, most of whom took jobs in key financial and accounting positions.[447] Each time the door revolved, Waste Management's fraud multiplied.[448] In 1997, the company had the largest earnings restatement to that date in United States history, wiping out $1.7 billion in profits that had been generated in the 1990s.[449] Subsequently, Waste Management settled class action litigation arising from this accounting fraud for $457 million and Andersen settled a related suit for $20 million.[450] Andersen also entered into a consent decree with the SEC regarding charges that the auditor failed to maintain its independence and issued

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[446] Roper, *supra* note 33, at 4.

[447] Schneider, *supra* note 443.

[448] *See* Roper, s*upra* note 33, at 9 ("The revolving door that existed between Andersen and Enron, and between Andersen and Waste Management, clearly helped to create the environment in which external auditors were viewed as just another part of the corporate family.").

[449] Ken Brown & Ianthe Jeanne Dugan, *Sad Account: Andersen's Fall From Grace Is a Tale of Greed and Miscues*, Wall St. J., June 7, 2002, at A1. The case of Waste Management also underscores the hazard of auditors consulting for their audit clients. The lead auditor for the company was known inside Arthur Andersen as "The Rainmaker" for his success in cross-selling non-audit services to audit clients. Between 1991 and 1997, Waste Management paid audit fees to Andersen of $7.5 million and non-audit fees of $17.8 million, while The Rainmaker was signing off on drastically inaccurate books. *Id.*

[450] Mark Allan Worden, Note, *Securities Regulation: Protecting Auditor Independence from Non-Audit Services – An Evolving Standard*, 55 OKLA. L. REV. 513, 520 (2002). The SEC fined Arthur Andersen $7 million in 2001 in connection with the firm's botched audits of Waste Management. This was touted by the SEC as the largest fine imposed against an accounting firm in U.S. history, but it represented less than 10% of the $79 million that Waste Management paid Andersen in 2000 for audit and other services. Steve Liesman, Jonathan Weil & Michael Schroeder, *Dirty Books? Accounting Debacles Spark Calls for Change: Here's the Rundown*, Wall St. J., Feb. 6, 2002, at A1. In 2005, Waste Management agreed to pay $26.8 million to settle an action filed by the SEC against four former top executives of the company. Craig Schneider, *Waste Management Ex-CFO to Fight Charges*, CFO Magazine, Aug. 30, 2005. Avaialble at http://www.cfo.com.

materially false and misleading audit reports.[451] But Andersen and its former clients Enron and Waste Management are not unique. Audit firms have been generally described as farm systems for major corporations.[452] A review of 200 accounting fraud cases arising between 1987 and 1997 found that in 11 percent of the cases, the Chief Financial Officer had previously been employed by the corporation's current auditor.[453]

Sarbanes-Oxley does not solve either of the foregoing problems. It makes only a token effort to shut the revolving door. Under the statute, a company may not retain an accounting firm as its auditor if any of the company's top officers had been an employee of the auditor in the previous year.[454] This provision permits most audit firm employees to take jobs with their former clients.[455] Sarbanes-Oxley also provides for a five-year rotation, but only of the lead and concurring review partners within a particular auditing firm.[456] Such minimal rotation is likely to have little or no effect, because it will not reduce the financial incentive for auditors to compromise their judgment on accounting

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[451] Landsman, *supra* note 365, at 1206.

[452] Schneider, *supra* note 443.

[453] Stephen Barr, *Breaking Up the Big 5*, CFO Magazine, May 1, 2000. Available at http://www.cfo.com. *See also* Stephen Taub, *PwC Settles Raytheon Case for $50 Million*, CFO Magazine, June 1, 2004 (PricewaterhouseCoopers settles accounting fraud case involving its client Raytheon for $50 million, where Raytheon's CFO had previously been auditor's lead partner on its work for the company). Available at http://www.cfo.com.

[454] 15 U.S.C. § 78j-1(l).

[455] Don A. Moore, *An Honest Account*, Wall St. J., Nov. 13, 2002, at A24. *See also The Lessons from Enron: After the Energy Firm's Collapse, the Entire Auditing Regime Needs Radical Change*, Economist, Feb. 7, 2002 (SEC should ban the practice of companies hiring managers and internal auditors from their external audit firms). Available at http://www.economist.com.

[456] Sarbanes-Oxley provides for the lead audit partner to rotate after five years, effective for the fiscal year beginning after May 6, 2003. The concurring review partner also must rotate after five years, and certain other audit partners on the engagement must rotate after seven years. 15 U.S.C. § 78(j)-1(j).

issues.[457] Indeed, it has been suggested that the rotation provision in Sarbanes-Oxley will exacerbate the current problem, to the extent that partners in major accounting firms compete against one another for promotion and bonuses.[458]

A number of commentators have concluded that mandatory rotation of auditing firms could help cure the problem,[459] and the limited experience of foreign countries tends to support this conclusion. Italy, which has had mandatory rotation for listed companies since 1975, has had generally positive results.[460] Other countries with

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[457] *See* Thomas J. Healey & Yu-Jin Kim, *The Benefits of Mandatory Auditor Rotation*, REGULATION 10, 11 (Fall 2003) ("[N]othing in the current Sarbanes-Oxley Act could have prevented debacles like Enron; mandatory audit firm rotation is the only practical, preventive mechanism."). Available at http://www.cato.org/pubs/regulation/regv26n3-noted.pdf.

[458] Macey & Sale, *supra* note 441, at 1168.

[459] *See* Conference Board Commission -- Parts 2 and 3, *supra* note 22, at 34 ("Rotation of auditors would also reduce any financial incentives for external auditors to compromise their judgment on borderline accounting issues."). *Accord Unresolved Conflicts: Reforms of the Auditing Industry Do Not Go Far Enough*, Economist, Oct. 16, 2003 (to break cycle of accounting scandals, U.S. should make auditor firm rotation mandatory) and *Accounting for Change: The Need for Radical Audit Reform in America Grows Ever More Pressing*, Economist, June 27, 2002 ("There is also a strong case for compulsory rotation of auditors. . . . Experience shows that the best form of peer review is a frequent change of reviewer."). Available at http://www.economist.com). *But see* Nashwa George, *Auditor Rotation and the Quality of Audits*, CPA J., Dec. 2004 (study of audit failure at 90 companies finds no credible evidence that mandatory auditor rotation will improve audit quality or reduce audit fees). Available at http://www.nysscpa.org.

[460] Mandatory Audit Firm Rotation, *supra* note 181, at 83. One study from Italy, which reported negative results, is often cited by critics of rotation. *See, e.g., Rebuilding Public Confidence in Financial Reporting: An International Perspective*, International Federation of Accountants Task Force on Rebuilding Public Confidence in Financial Reporting 33 (July 2003) ("The evidence from the only country which has had compulsory rotation of auditors for long enough to be able to evaluate its effects provides no evidence that compulsory rotation of firms increases audit quality.") (available at http://www.ifac.org.); Adrian Zea, *Study Backs Fears Over Auditor Rotation*, AccountancyAge.com, June 8, 2002. Available at http://AccountancyAge.com/News/1130223. However, the methodology and accuracy of this study have been criticized by both the GAO and the Commissione Nazionale per le Societa e la Borsa, the Italian securities regulator. *Mandatory Audit Firm Rotation, supra* note 181, at 83. The huge accounting scandal uncovered in December 2003 at Parmalat SpA, Italy's largest food company, does not prove that auditor rotation does not work. The $15-20 billion fraud (modern Europe's most significant white-collar crime) took place over a decade or more, and continued for years after the company rotated auditors in 1999. However, there was no rotation with regard to Parmalat's Cayman Islands-based subsidiary (Bonlat Financing Corp.) at the center of the scandal. At Parmalat's request, the Italian affiliate of Grant Thornton International continued to audit Bonlat even after Deloitte Touche & Tohmatsu became Parmalat's primary auditor. *See* David Reilly, Alessandra Galloni & Carrick Mollenkamp, *Parmalat Sues Bank of America Corp.*, Wall St. J., Oct. 8, 2004, at A3; Eric Silvers, *New Report Widens Parmalat's Debt*, N.Y. Times, Jan. 27, 2004 (available at http://www.nytimes.com). The Parmalat example may merely demonstrate that Italy

mandatory rotation include Brazil (since May 1999), Singapore (since 2002, but only with regard to banks incorporated locally), and Austria (beginning in 2004).[461]

While mandatory audit firm rotation could be an effective solution to the problem of impaired auditor independence, the auditing industry has successfully lobbied to prevent such reform in the United States.[462] The industry has publicly opposed mandatory rotation for more than a decade. The AICPA's SECPS Executive Committee adopted a position paper rejecting rotation in 1992,[463] and the AICPA reaffirmed that

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should have closed the loophole in its law that permitted foreign subsidiaries to be exempt from mandatory rotation. *See* Floyd Norris, *The Auditors Never Noticed*, N.Y. Times, Dec. 24, 2003. Available at http://www.nytimes.com. *But cf.* Christopher Wiggan, *Parmalat: Where Were the Auditors?*, Jan. 23, 2004 (jury is out on whether Parmalat scandal proves auditor rotation works) (available at http://www.issproxy.com/articles/008.asp); Joseph Weber & Gail Edmondson, *Auditors Asleep at the Wheel. Sound Familiar?*, BusinessWeek, Jan. 12, 2004, at 47 (Parmalat scandal shows that auditor rotation in Italy does not work). The Parmalat scandal has sparked renewed calls for auditor rotation in Europe. *See* Stephen Taub, *Auditor Rotation Gets A Fresh Start in Europe*, CFO Magazine, Feb. 4, 2004 (available at http://www.cfo.com); Daniel Dombey & Andrew Parker, *EU May Force Audit Firm Rotation After Scandals*, FT.com, Feb. 2, 2004 (available at http://www.financialtimes.com).

[461] Mandatory Audit Firm Rotation, *supra* note 181, at 84-85. *See also* Juan Pajuelo, *Brazil Reaffirms Tougher Auditor Rule Than in U.S.*, Nov. 21, 2003 (Brazilian securities regulator -- CVM -- determined that audit firm rotation would provide better safeguard against improper accounting than mere rotation of engagement partners). Available at http://www.issproxy.com/articles/archived115.asp. Spain imposed mandatory audit firm rotation during the period 1989 to 1995, and Canada imposed mandatory rotation for banks during the period 1923 to 1991. Spain abandoned the practice not because it was ineffective, but primarily because the main objective of increasing competition among audit firms had been achieved. Canada abandoned the practice due to cost considerations. Mandatory Audit Firm Rotation, *supra* note 181, at 86-89. Audit rules proposed by the European Commission in 2004 require rotation of audit firms every seven years or rotation of audit partners every five years. *More Rules*, Economist, March 18, 2004 (available at http://www.economist.com); Stephen Taub, *Europe's Tough New Auditing Standards*, CFO Magazine, March 18, 2004 (available at http://www.cfo.com).

[462] Floyd Norris, *The Auditors Never Noticed*, N.Y. Times, Dec. 24, 2003 (accounting industry bitterly and successfully opposed inclusion of mandatory rotation provision in Sarbanes-Oxley) (available at http://www.nytimes.com); Michael Schroeder, *CPA Trade Group Urges Caution in Rush to Regulate Industry in Wake of Enron*, Wall St. J., March 14, 2002, at A20.

[463] *See Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies*, American Institute of Certified Public Accountants (March 24, 1992). Available at http://www.aicpa.org/members/div/secps/lit/sops/1900.htm.

position in a White Paper issued in 2003.[464] Earlier, the accounting industry opposed mandatory rotation of auditors for the 50 largest U.S. banks.[465]

One of the primary arguments raised by the industry is that auditing costs would multiply if corporations were forced to periodically change auditors.[466] This argument has some validity. The GAO estimated that, in the first year following a change in auditor under mandatory audit firm rotation, audit-related costs could be 43 percent to 128 percent higher than the likely recurring audit costs had there been no change in auditor.[467] However, audit costs for public companies currently comprise a very small percentage of total operating costs,[468] and increased costs could be minimized if the outgoing audit firms were required to retain and transfer their working papers to the incoming firms. In any event, the increased costs are likely to be marginal in comparison to the costs incurred from the loss of investor confidence in response to inaccurate financial statements.[469]

In sum, the *DiLeo* reasoning is defective because it fails to consider a major cause of audit failure from the late 1990s onward -- the incentive structure that impels auditors

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[464] *Audit Partner Rotation – Issue Brief*, American Institute of Certified Public Accountants, Oct. 2003. Available at http://www.aicpa.org./statelegis/index.asp.

[465] Lee Barton, *GAO Weighs Auditing Plan for Big Banks: Accounting Firms Express Concern About Proposal to Require Rotations*, Wall St. J., March 27, 1991, at A3.

[466] *See*, *e.g.*, *Mandatory Rotation of Audit Firms – Will It Improve Audit Quality?*, PricewaterhouseCoopers (2002). Available at http://www.pwcglobal.com.

[467] Mandatory Audit Firm Rotation, *supra* note 181, at 33.

[468] In 2002/03, audit fees for public companies with annual revenues in excess of $5 billion averaged .04 percent of total operating costs. They averaged 0.08 percent of total operating costs for public companies with annual revenues of less than $1 billion. Mandatory Audit Firm Rotation, *supra* note 181, at 32-33.

[469] Conference Board Commission -- Parts 2 and 3, *supra* note 22, at 34. *Accord* C. Richard Baker, *The Varying Concept of Auditor Independence*, CPA J. (Aug. 2005) (benefits of regular audit rotation to investing public would outweigh added initial start-up costs). (Available at www.nysscpa.org.)

to curry favor with company management.[470] Sarbanes-Oxley provides no effective cure.[471]

(4) Auditors Are Often Irrational

A fourth reason to reject the *DiLeo* analysis is that it fails to address the phenomenon of the irrational auditor and auditor firm. *DiLeo* and its progeny assume that individual auditors and their audit firms, confronted with choices in the face of uncertainty, will rationally select options that maximize their subjective expected utility. But this perception of auditors as fully rational actors, while commonplace,[472] is not particularly accurate. A comprehensive analysis of the topic by Prof. Robert Prentice concludes that "[a]uditors' rationality, like that of the rest of the population, is highly suspect. . . ."[473] Prof. Prentice, relying upon a substantial body of interdisciplinary behavioral research, persuasively argues that *DiLeo* and its progeny are misguided, insofar as such cases assume the rationality of auditors and audit firms, and further

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470 McCoy, *supra* note 161, at 1008. Prof. McCoy argues that even mandatory rotation would not solve the problem, because audit firms would continue to work for their audit clients and would retain an inside track and a cost advantage in competitive bidding. *Id.* at 1009.

471 The PCAOB has vowed to scrutinize situations where corporations fire their external auditors, but it is not clear that this will have an impact on the entrenched system of incentives. *See Accounting Regulator Vows to Scrutinize Firings of Auditors*, Wall St. J., Sept. 23, 2003. Available at 2003 WL-WSJ 3980397. In the aftermath of Sarbanes-Oxley, auditor firings have increased. More than 1,600 companies changed auditors in 2004, a 78% jump from 2003. The total of 2,514 for the two years represents more than one-fourth of publicly listed companies in the United States. But most of the switching companies are small. Of those companies switching auditors in 2004, 85% posted $100 million or less in revenues that year. Stephen Taub, *Auditors Rotating at Dizzying Pace*, CFO Magazine, Feb. 18, 2005 (available at http://www.cfo.com); Diya Gullapalli, *Moving the Market: Number of Firms That Switched Auditors Jumped 78% in 2004*, Wall St. J., Feb. 17, 2005, at C3.

472 *See*, *e.g.*, Stanley Baiman, *et al.*, *Optimal Contracts with a Utility-Maximizing Auditor*, 25 J. ACCT. RES. 217 (1987); Rick Antle, *The Auditor as an Economic Agent*, 20 J. ACCT. RES. 503 (1982).

473 Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. Rev. 133, 142 (2000). For a general rebuttal to Prof. Prentice, *see* Mark Klock, *Are Wastefulness and Flamboyance Really Virtues? Use and Abuse of Economic Analysis*, 71 U. CIN. L. REV. 181 (2002).

assume that it is always irrational for auditors and audit firms to act recklessly or fraudulently.

Prof. Prentice first demonstrates that individual auditors are subject to many of the same behavioral limitations that prevent the general population from functioning as fully rational actors. Specifically, auditors lack perfect information, suffer from a range of well-documented heuristics and biases[474] (*e.g.*, confirmation bias, hindsight bias, and cognitive dissonance), and tend to fall into various behavioral traps. These traps include the honoring of sunk costs. In the audit context, the manifestation stems from the not infrequent practice of low-balling, in which auditors bid at or below cost on an account in order to secure new business.[475] Low-balling has significant potential to impair auditor independence,[476] as auditors attempt to honor the sunk cost of low-balled audit business.[477]

Auditing firms also tend to function as less than fully rational actors, primarily because their employees suffer from the frailties described above. In a huge audit firm, these infirmities are multiplied and complicated by such organizational pitfalls as corporate culture, heuristics, groupthink, and authority leakage.[478] This last point

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[474] Prentice, *supra* note 473, at 144-81. *Accord Why Good Accountants Do Bad Audits, supra* note 341.

[475] *See* Steve Bergman, *Loss-Leader or Client-Feeder?*, CFO Magazine, Sept. 28, 2000 ("Accounting firms themselves often slash prices to win contracts, as if their services were blue-light specials.") Available at http://www.cfo.com.

[476] Prentice, *supra* note 473, at 173 (citing study by AICPA). *Accord* Ronald A. Dye, *Informationally Motivated Auditor Replacement*, 14 J. ACCT. & ECON. 347, 363 (1991) (low-balling encourages auditors to attest to more favorable financial reports than they otherwise would). *But see* Ch-Wen Jevons Lee & Zhaoyang Gu, *Low Balling, Legal Liability, and Auditor Independence*, 73 ACCT. REV. 533 (1998) (concluding, contrary to weight of evidence, that low-balling increases auditor independence).

[477] Prentice, *supra* note 473, at 171-74.

[478] *Id.* at 182-85.

pertains to the difficulty of maintaining control of individual behavior in organizations that have tens of thousands of employees. The problem is endemic in the Big 4, where each member had a professional staff in 2002 that exceeded 10,000 individuals.[479]

Moreover, it is not always irrational for individual auditors or their audit firms to audit recklessly or fraudulently. With regard to individual auditors, the revolving door described above provides substantial incentives to approve a client's improper accounting. This was certainly true in the case of Arthur Andersen and its clients Enron and Waste Management. Many other factors also come into play. These factors include observability (auditors take shortcuts, assuming their improprieties will not be detected or blame will be diffused among the audit team members),[480] stress, and the reward system utilized by audit firms.[481] Similarly, it is not always irrational for accounting firms to audit recklessly or fraudulently. Audit firms, like other organizations, often risk their reputations in order to generate short-term profits. The lobbying that the audit industry has historically engaged in to defeat the adoption of strong accounting standards is evidence of this proposition. Examples described above include industry lobbying to defeat the expensing of stock options and reform of SPE accounting.

Any damage to auditor reputation that does occur is mitigated by positive cash flow. Mitigation often occurs in the form of revenue from non-audit services, such as consulting and tax. Finally, empirical studies show that damage to auditor reputation

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[479] In 2002, the professional staffs of the Big 4 were: Deloitte & Touche -- 19,835; PricewaterhouseCoopers -- 16,774; Ernst & Young -- 15,078; and KPMG -- 10,967. Public Accounting Firms*, supra* note 360, at 17.

[480] *See* Coffee, *supra* note 4, at 1415.

[481] Prentice, *supra* note 473, at 188-95. *Accord* Benston, *supra* note 42, at 1345 (individual partners in charge of specific audits have incentives to take auditing risks, because their compensation is based on the audit fees they generate).

caused by audit failure is generally inconsequential. Auditors who err do not lose market share or pricing power.[482] Indeed, the Big 4 accounting firms are largely immune from reputational damage because of their market power.[483] The 2003 GAO study of consolidation and competition in the audit industry[484] tends to support this argument.

Prof. Prentice concludes that "the simplifying assumptions of the law and economics approach embodied in the DiLeo line of cases are clearly unreliable."[485] This unreliability, while manifest, has not yet been recognized by the judiciary. The deeply flawed *DiLeo* reasoning continues to be widely accepted by federal district and appellate courts, much to the detriment of shareholders who have been victimized by external auditors who have engaged in fraudulent conduct.

B. Recklessness, GAAP/GAAS Violations, and Red Flags

Plaintiffs who are unable to meet the pleading burden established by the motive and opportunity standard[486], or who have filed in courts not embracing that standard at all, can seek to plead scienter of external auditors on the basis of recklessness. But courts have set the pleading bar in this area unjustifiably high. While the PSLRA does not

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[482] Prentice, *supra* note 473, at 215. *See also* Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Revisited*, 8 STAN. J.L. BUS. & FIN. 39, 47 (2002) ("[T]he expected cost of litigation and other penalties is recouped on the average from the auditees. . . .").

[483] Prentice, *supra* note 473, at 215.

[484] Public Accounting Firms, *supra* note 360.

[485] Prentice, *supra* note 473, at 219. Prof. Prentice has applied behavioral analysis to Enron. *See* Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417 (2003).

[486] *See*, *e.g.*, In re Stone & Webster, Inc. Sec. Litig., 414 F.3d 187, 215 (1st Cir. 2005) (auditor's motivation to continue a profitable business relationship insufficient by itself to support a strong inference of scienter); In re Royal Dutch/Shell Transport Sec. Litig., 380 F. Supp.2d 509, 568-69 (D.N.J. 2005) (auditor's motivation to increase fees from non-auditing services insufficient to constitute evidence of scienter).

distinguish between external auditors and other defendants,[487] numerous courts have determined, with little or no analysis, that the bar for pleading scienter should be set higher for auditors.[488] The final section of this Article considers this issue.

With the exception of the Seventh Circuit, the First through Eleventh Circuits all have held that GAAP violations, without more, do not establish scienter in securities fraud cases.[489] The Seventh Circuit did not appear to have addressed the issue in a published opinion by December 2005, but numerous district courts in that circuit --

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[487] *See* In re Microstrategy, Inc. Sec. Litig., 115 F. Supp.2d 620, 650 (E.D. Va. 2000).

[488] *See, e.g.*, Fidel v. Farley, 392 F.3d 220, 227 (6th Cir. 2004) ("[W[hen the claim is brought against an outside auditor, we have concluded that the 'meaning of recklessness in securities fraud cases is especially stringent.'"); In re Learnout & Hauspie Sec. Litig., 230 F. Supp.2d 152, 160 (D. Mass. 2002) ("Courts assessing claims against independent auditors and accountants under the PSLRA have set a high bar. . . ."); In re Raytheon Sec. Litig., 157 F. Supp.2d 131, 154 (D. Mass. 2001) (same); In re Smartalk Teleservices, Inc. Sec. Litig., 124 F. Supp.2d 505, 514 (S.D. Ohio 2000) ("The standard for recklessness in securities fraud cases is more onerous when the claim is brought against an outside auditor."); and Reiger v. Altris Software, Inc., 1999 WL 540893, *4 (S.D. Cal., Apr. 30, 1999) ("The recklessness standard imposes an even heavier burden on plaintiffs seeking to add outside auditors and accountants as defendants in a securities fraud action."). *See also* Savett, *supra* note 305, at 1369 ("Courts have set the bar for pleading accountants' recklessness exceptionally high. . . .").

[489] *See, e.g.,* Greebel v. FTP Software, Inc., 194 F.3d 185, 203-04 (1st Cir. 1999); Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000); Stevelman v. Alias Research, Inc., 174 F.3d 79, 84-85 (2d Cir. 1999); Chill v. General Elec. Co., 101 F.3d 263, 270 (2d Cir. 1996); In re Westinghouse Sec. Litig., 90 F.3d 696, 712 (3d Cir. 1996); Malone v. Microdyne Corp., 26 F.3d 471, 479 (4th Cir. 1994); Abrams v. Baker Hughes, Inc., 292 F.3d 424, 432 (5th Cir. 2002); Fine v. American Solar King Corp., 919 F.2d 290, 297 (5th Cir. 1990); Wyser-Pratte Mgt. Co. v. Telxon Corp., 413 F.3d 553, 563 (6th Cir. 2005); PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 694 (6th Cir. 2004); In re Comshare, Inc. Sec. Litig., 183 F.3d 542, 553 (6th Cir. 1999); Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, 395 F.3d 851, 855 (8th Cir. 2005); Kushner v. Beverly Enterprises, Inc., 317 F.3d 820, 831 (8th Cir. 2003); In re Navarre Corp. Sec. Litig., 299 F.3d 735, 745 (8th Cir. 2002); In re Saxton, Inc. Sec. Litig., 2005 WL 3271342, *1 (9th Cir. Dec. 2, 2005); DSAM Global Value Fund. v. Altris Software, Inc., 288 F.3d 385, 390 (9th Cir. 2002); In re Software Toolworks, Inc., 50 F.3d 615, 627 (9th Cir. 1994); In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426 (9th Cir. 1994); Pirraglia v. Novell, Inc., 2003 WL 21907612, *7 (10th Cir., Aug. 11, 2003); City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1261 (10th Cir. 2001); and Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1208 (11th Cir. 2001). The persistence of GAAP violations for an extended period of time has not generally altered the universal holding. *See, e.g.,* In re: Telxon Corp. Sec. Litig., 133 F. Supp. 2d 1010, 1029 (N.D. Ohio 2000). While GAAP violations do not establish scienter, significant or egregious violations described with particularity can provide evidence of scienter. *See*, *e.g.*, In re PEC Solutions, Inc. Sec. Litig., 418 F.3d 379, 389 (4th Cir. 2005); Greebel, 194 F.3d at 203; and Blatt v. Muse Tech., Inc., 2002 WL 311075537, *9 (D. Mass., Aug. 27, 2002).

primarily in the Northern District of Illinois -- have reached the same conclusion.[490] A number of courts have similarly held that GAAS violations, without more, do not establish scienter.[491] Such holdings are appropriate, especially given the infirmities of GAAP and GAAS discussed in Section III of this Article. GAAP is not a particularly accurate yardstick against which securities fraud violations can be measured.

The tests for auditor recklessness that have been formulated by federal courts in lieu of accepting GAAP or GAAS violations are less appropriate. One common test equates recklessness with intent. Courts in this camp hold that plaintiffs must allege that the audit was conducted so recklessly that the auditor must have intended to engage in fraud (or, according to some versions, must have been aware of its client's fraud). The Second[492] and Sixth[493] Circuits have accepted this test, and district courts in California,[494] Massachusetts,[495] Michigan,[496] New Jersey,[497] and Virginia[498] have done so as well.

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[490] *See, e.g.,* Davis v. SPSS, Inc., 2005 WL 1126550, *18 (N.D. Ill. May 10, 2005); In re Spiegel, Inc. Sec. Litig., 2004 Wl 1535844, *39 (N.D. Ill. July 8, 2004); and Stavros v. Exelon Corp., 2003 WL 21372468, *15 (N.D. Ill., June 13, 2003).

[491] *See, e.g.,* PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 694 (6th Cir. 2004); In re Spear & Jackson Sec. Litig., 2005 WL 3032509, **10-11 (S.D. Fla. Oct. 19, 2005); D.E. & J Ltd. Partnership v. Conway, 284 F. Supp.2d 719, 745 (E.D. Mich. 2003); Riggs Partners, LLC v. Hub Group, Inc., 2002 WL 31415721, *9 (N.D. Ill., Oct. 25, 2002); and Cronau v. Asche, 2002 WL 832569, *2 (N.D. Ill., May 1, 2002).

[492] *See* Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000); Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 121 (2d Cir. 1982). *Accord* In re Priceline.com Inc. Sec. Litig., 342 F. Supp.2d 33, 57 (D. Conn. 2004); In re Complete Mgt. Inc. Sec. Litig., 153 F. Supp.2d 314, 333 (S.D.N.Y. 2001); and In re Wellcare Mgt. Group, Inc. Sec. Litig., 964 F. Supp. 632, 640 (N.D.N.Y. 1997).

[493] *See* Wyser-Pratte Mgt. Co. v. Telxon Corp., 413 F.3d 553, 563 (6th Cir. 2005); PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693 (6th Cir. 2004).

[494] Reiger v. Altris Software, Inc., 1999 WL 540893, *5 (S.D. Cal., Apr. 30, 1999).

[495] In re Learnout & Hauspie Sec. Litig., 230 F. Supp.2d 152, 160 (D. Mass. 2002).

[496] D.E. & J Ltd. Partnership v. Conway, 284 F. Supp.2d 719, 745 (E.D. Mich. 2003).

[497] See, e.g., Key Equity Investors, Inc. v. Sel-Leb Mktg., Inc., 2005 WL 3263865, *6 (D.N.J. Nov. 30, 2005) (with respect to auditor defendant, conduct must approximate actual intent to aid in fraud being perpetrated by audited company); In re Royal Dutch/Shell Transport Sec. Litig.,, 380 F. Supp.2d 509, 566

Many other courts have framed the scienter standard in negative terms -- plaintiffs must plead (and prove) that the auditor's conduct was so deficient that the audit amounted to no audit at all. The Sixth[499] and Ninth[500] Circuits and district courts in those circuits[501] and elsewhere[502] have utilized this latter test on numerous occasions.[503]

The adoption of an elevated standard for pleading scienter of auditors is unjustified. The express language of the PSLRA does not provide for such a standard,[504] and no compelling policy justification has been advanced by those courts that have, in effect, rewritten the statute. The widespread use of a standard that equates recklessness with intent is particularly suspect. Many courts adopting this standard cite Second Circuit precedent, but the relevant line of cases is weak. A careful parsing of the original

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(D.N.J. 2005) (same); In re Suprema Specialties, Inc. Sec. Litig., 334 F. Supp.2d 637, 657 (D.N.J. 2004) (same); and Nappier v. PricewaterhouseCoopers LLP, 227 F. Supp.2d 263, 275 (D.N.J. 2002).

[498] In re Microstrategy, Inc. Sec. Litig., 115 F. Supp.2d 620, 651 (E.D. Va. 2000).

[499] Fidel v. Farley, 392 F.3d 220, 227 (6th Cir. 2004); PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693 (6th Cir. 2004).

[500] *See* In re Saxton, Inc. Sec. Litig., 2005 WL 3271342, *1 (9th Cir. Dec. 2, 2005); DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 390 (9th Cir. 2002); and In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1426 (9th Cir. 1994).

[501] *See*, e.g., In re ICN Pharm., Inc. Sec. Litig., 2004 WL 42583, *11 (C.D. Cal., Jan. 5, 2004); In re Homestore.com, Inc. Sec. Litig., 252 F. Supp.2d 1018, 1042 (C.D. Cal. 2003); Mittman v. Rally's Hamburger's, Inc., 2003 WL 22017505, *5 (W.D. Ky., Aug. 25, 2003).

[502] *See, e.g.,* In re Freidman's Inc. Sec. Litig., 385 F. Supp.2d 1345, 1365 (N.D. Ga. 2005); McKowan Lowe & Co. v. Jasmine, Ltd., 2005 WL 1541062, *13 (D.N.J. June 30, 2005); Davis v. SPSS, Inc., 2005 WL 1126550, *17 (N.D. Ill., May 10, 2005); In re Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp.2d 334, 385 (D. Md. 2004); and RZ Investments v. Phillips, 2003 WL 22862738, *5 (N.D. Tex., March 26, 2003).

[503] A variation of this test is that the accounting judgments that were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts. *See, e.g.*, In re Ikon Office Solutions, Inc. Sec. Litig., 277 F.3d 658, 669 (3d Cir. 2002); Julie A. Boncarosky, *Accounting Firm or Guarantor? The Third Circuit's Answer to Rule 10b-5's Scienter Requirement in Accountant Liability Cases*, 48 VILL. L. REV. 1329 (2003).

[504] Sherrie R. Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff's Perspective*, 1505/Corp 17, 62 (Sept. 2005) ("The PSLRA's pleading requirements do not distinguish between corporate defendants and accountants.").

source of the line discloses only weak support for the holding that is so often cited.[505] Even the parallel standard -- that the audit amounted to no audit at all -- is unjustified. In the absence of sound policy reasons to the contrary, external auditors should be held to the same recklessness standard that other defendants are held to. That standard, as applied to auditors, should not require that plaintiffs allege and prove that, in effect, no audit was conducted. Such a requirement subverts the meaning of recklessness.

Plaintiffs asserting auditor liability often allege that the auditors ignored "red flags" that signal accounting misconduct. Red flags have been judicially defined as facts that would place a reasonable auditor, to whose attention they have come, on notice that the audited company was engaged in wrongdoing to the detriment of its investors.[506] As a general rule, GAAP and/or GAAS violations, coupled with sufficient disregarded red flags, can suffice to support an inference of scienter.[507] But some courts have held that the auditor must have intentionally or deliberately disregarded the flags, in order for the allegation to suffice.[508] Such a requirement once again subverts the meaning of

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[505] A fairly recent Second Circuit statement of the standard appears in Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000). *Rothman* cites Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 121 (2d Cir. 1982), which in turn cites IIT, an Int'l Inv. Trust v. Cornfeld, 619 F.2d 909, 927 (2d Cir. 1980). But *Cornfeld,* decided long before the PSLRA was enacted, only weakly supports the proposition that plaintiffs must plead actual intent when alleging scienter of external auditors.

[506] In re Recoton Corp. Sec. Litig., 358 F. Supp.2d 1130, 1147 (M.D. Fla. 2005).

[507] *See, e.g.*, In re Royal Dutch/Shell Transport Sec. Litig., 380 F. Supp.2d 509, 570 (D.N.J. 2005); In re AOL Time Warner, Inc. Sec. & ERISA Litig., 2004 WL 992991, *34 (S.D.N.Y. May 5, 2004); Teachers' Retirement System v. A.C.L.N., Ltd., 2003 WL 21058090, *11 (S.D.N.Y., May 15, 2003); and In re Hamilton Bankcorp, Inc. Sec. Litig., 194 F. Supp.2d 1353, 1359 (S.D. Fla. 2002). The red flag must be something more than the GAAP violation itself, in order for the allegation to suffice. In re: Stone & Webster, Inc. Sec. Litig., 253 F. Supp.2d 102, 133 (D. Mass. 2003).

[508] *See, e.g.*, Great Neck Capital Apprec. Inv. Partnership v. PricewaterhouseCoopers, L.L.P., 137 F. Supp.2d 1114, 1124 (E.D. Wis. 2001) (deliberately ignoring red flags can constitute the recklessness necessary to support a § 10(b) violation).

recklessness. Numerous other courts have rejected arguments that the specific red flags alleged by plaintiffs support an inference of scienter against the auditor defendants.[509]

One red flag that is commonly alleged is the sheer magnitude of the accounting fraud at issue. Some courts have held that this flag can suffice to allege,[510] or is probative of,[511] scienter. But other courts have determined that magnitude is a mere manifestation of the accounting violation itself, and thus cannot create an inference of scienter.[512] Another approach taken by courts seeking to limit the exposure of auditors is to hold that the magnitude of the accounting fraud, even if substantial, is insufficient to constitute evidence of scienter.[513] Auditing cases that do find magnitude of the fraud to be a sufficient red flag to be probative of scienter have not infrequently involved

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[509] *See, e.g.*, Fidel v. Farley, 392 F.3d 220, 229-30 (6th Cir. 2004); PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 695 (6th Cir. 2004); Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1120 (11th Cir. 2001); Umsted v. Andersen LLP, 2003 WL 222621, *4 (N.D. Tex., Jan. 28, 2003); Yadlosky v. Grant Thornton, L.L.P., 120 F. Supp.2d 622, 631 (E.D. Mich. 2000); and Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp.2d 1003, 1009 n.5 (S.D. Cal. 2000).

[510] *See, e.g.*, In re Leslie Fay Cos. Sec. Litig., 835 F. Supp. 167, 175 (S.D.N.Y. 1993).

[511] *See, e.g.*, Lewin v. Lipper Convertibles, L.P., 2004 WL 1077930, *2 (S.D.N.Y., May 13, 2004) (accounting violations on repeated and pervasive scale could provide evidence of recklessness on part of Pricewaterhouse Coopers); In re Microstrategy, Inc. Sec. Litig., 115 F. Supp.2d 620, 651 (E.D. Va. 2000); In re Livent, Inc. Sec. Litig., 78 F. Supp.2d 194, 217 (S.D.N.Y. 1999); In re Baan Co. Sec. Litig., 103 F. Supp.2d 1, 21 (D.D.C. 2000); and Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp.2d 1324, 1339 (N.D. Ga. 1998).

[512] *See, e.g.*, Fidel v. Farley, 392 F.3d 220, 231 (6th Cir. 2004) ("Allowing an inference of scienter based on the magnitude of fraud 'would eviscerate the principle that accounting errors alone cannot justify a finding of scienter.'"); In re Raytheon Sec. Litig., 157 F. Supp.2d 131, 155 (D. Mass. 2001) (issuance by PricewaterhouseCoopers of clean audit letter when write-downs of $300 million should have been made does not support inference of scienter). *See also* In re SCB Computer Tech., Inc. Sec. Litig., 149 F. Supp.2d 334, 357 (W.D. Tenn. 2001) (magnitude of fraud, without more, cannot sustain finding that auditor acted with scienter). *Cf.* In re Van Wagoner Funds, Inc., 2004 WL 2623972, *9 (N.D. Cal. July 27, 2004) ("A court should not infer an independent acocuntant's scienter based solely on the magnitude of his client's fraud.").

[513] *See, e.g.*, Geinko v. Padda, 2001 WL 1163728, *9 & n.12 (N.D. Ill., Sept. 28, 2001) (court acknowledges that $39 million fraud is huge, but still dismisses complaint against KPMG).

overstatements of revenue, income, or earnings per share in excess of 100 percent.[514] In general, the examination of red flags by federal district courts has resulted in the exercise of a significant amount of discretion, "often creating unpredictable and arguably inconsistent results."[515]

VII. CONCLUSION

Accounting fraud has been widespread in the United States in recent years. This fraud has been facilitated by GAAP and GAAS, and driven to a certain extent by the active participation of external auditors. Investors seeking redress against auditors under the federal securities laws have been unfairly thwarted in many cases by courts defectively analyzing scienter. The federal judiciary's current approach to analyzing the adequacy of scienter allegations against external auditors seems designed to artificially minimize the exposure of auditors to liability under the securities laws. With regard to pleading motive and opportunity to commit fraud, a number of courts apply *DiLeo* to effectively insulate auditors from liability, notwithstanding the untenable logic of that

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[514] *See, e.g.,* In re Rent-Way Sec. Litig., 209 F. Supp.2d 493, 507 (W.D. Pa. 2002) (restatement of earnings resulting in reduction of earnings per share from $0.66 to $.04 is probative of PricewaterhouseCooper's scienter); In re Learnout & Hauspie Sec. Litig., 2002 WL 31961469, *9-10 (D. Mass., Nov. 18, 2002) (overstatement of reported earnings by 103 percent is probative of KPMG's scienter); Kinney v. Metro Global Media, Inc., 170 F. Supp.2d 173, 180 (D.R.I. 2001) (overstatement of net income for two fiscal years by 240 percent and 306 percent is probative of auditor's scienter); and In re Cendant Corp. Litig., 60 F. Supp.2d 354, 372-73 (D.N.J. 1999) (court denies Ernst & Young's motion to dismiss where earnings per share were overstated by 130 percent over a period of three years). *See also* In re BISYS Sec. Litig., 2005 WL 2844792, *11-13 (S.D.N.Y., Oct. 28, 2005) (size of fraud may contribute to inference of scienter if, for example, fraud actually bankrupts company); In re Tyco Int'l, Ltd., 2004 WL 2348315, *13 (D.N.H. Oct. 14, 2004) (overstatement of earnings by $5.6 billion sufficient to plead scienter against Pricewaterhouse Coopers only in combination with other factors); In re Spiegel, Inc. Sec. Litig., 2004 WL 1535844, *40 (N.D. Ill. July 8, 2004) (understatement of debt by $3 billion, in combination with other factors, sufficient to plead scienter of KPMG); Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp.2d 1324, 1339 (N.D. Ga. 1998) (overstatement of financial results must be "drastic").

[515] Sanford P. Dumain, *Class Action Suits, Auditor Liability, and the Effect of the Private Securities Litigation Reform Act of 1995*, SK086 ALI-ABA 501, 585 (Feb. 2005). *Accord* In re Spear & Jackson Sec. Litig., 2005 WL 3032509, *10 (S.D. Fla. Oct. 19, 2005) (some courts have accepted a type of red flag as evidence of scienter, while other courts have rejected the same type of allegation).

case. *DiLeo*'s reasoning is open to challenge on numerous grounds. The case erroneously posits that auditors have no economic incentive to engage in fraudulent audits, it ignores the oligopolistic nature of the accounting industry, it fails to consider the revolving door phenomenon and the absence of auditor rotation, and it wrongly assumes that auditors and auditing firms conduct themselves as rational actors. Similarly, courts finding insufficient allegations of motive and opportunity often apply an elevated recklessness standard to auditors that cannot be justified. These courts require plaintiffs to plead and prove that external auditors intended to commit fraud, or conducted no audit at all.

The foregoing approaches cannot be reconciled with the judicial treatment of non-auditor defendants. The PSLRA does not distinguish between auditors and non-auditors with regard to scienter, and courts have no basis for doing so. The same tests should be applied uniformly to both categories of defendants. Uniform application of the tests for assessing scienter across different categories of defendants will more effectively accomplish the goals of the federal securities laws.