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

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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


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), which was adopted in 1995 in response to perceived abuses of the class action process. 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.

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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(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), signed into federal law in 2002 in direct response to the

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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.\textsuperscript{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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\textsuperscript{8} Sarbanes-Oxley did not alter the PSLRA’s strict pleading requirements regarding scienter. Lorna G. Schofield, \textit{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, \textit{infra}.  

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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. \textit{See id.} As will be seen \textit{infra}, the accounting industry has often successfully lobbied against reform measures. \textit{See also} J. Robert Brown, Jr., \textit{The Irrelevance of State Corporate Law in the Governance of Public Companies}, 38 U. RICH. L. REV. 317 (2004); Stephen Taub, \textit{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 \url{http://www.cfo.com}.  

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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. On average, 190 suits were filed annually during the period 1996 - 2003. In general, the recent wave of filings is driven by allegations of accounting-related fraud. In 2004, GAAP violations were alleged in 48 percent of securities class filings. 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. This figure is consistent with the comparable numbers for SEC enforcement actions.

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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.


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 and approximately 15 percent of all
post-PSLRA cases settled by December 2002 included accountants as named
defendants. Auditors were named as defendants in an additional 18 class action suits
filed during 2003 and 2004. Moreover, the presence of an auditor as a defendant has

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
contributed to the revenue recognition problem. At least 180 different standards have been used to

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
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
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,
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).


16 Post-Reform Act Securities Case Settlements: Cases Reported Through December 2002, Stanford

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. 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. Other recent studies have reached similar conclusions.


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://pwcglobal.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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Since its creation in 1973, most authoritative accounting standards have been issued by the FASB. 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.

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). 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

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

The FASB retains authority to promulgate GAAP even under Sarbanes-Oxley, 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. The PCAOB replaced the ineffective Public Oversight Board (POB), which was established in 1977 and terminated in May 2002. The POB was a captive of the auditing industry. It was funded by membership dues of the AICPA’s SEC Practice Section (SECP), and its charter provided for the POB to submit its budget to the SECP 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. The POB had no subpoena power and

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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).


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

little ability to impose penalties.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{34}


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. The foregoing split is designed to reinforce the PCAOB’s independence from the accounting profession. 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.

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).

literature exist,\textsuperscript{38} some of which are still in effect but are no longer being issued.\textsuperscript{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.\textsuperscript{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.\textsuperscript{41} The foregoing constitutes the fifth level. In total, there are probably thousands of rules and interpretations that comprise GAAP.\textsuperscript{42}


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

\textsuperscript{40} Id.


\textsuperscript{42} George J. Benston, \textit{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. By 2005, 153 FASs -- the primary source of GAAP -- had been issued. Thirty-three of these standards had been rescinded or superseded. 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.


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


materials, insurance policies, and other special cases. Leases are covered by 16 FASB Statements and Interpretations, nine Technical Bulletins, and more than 30 EITF Issues. 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.

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, but there is a “dearth of empirical evidence to support the assertion.” 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

47 McNamee & Capell, supra note 43.

48 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. . . .”).

50 Id. at 44.

Sarbanes-Oxley does nothing to improve performance.\textsuperscript{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\textsuperscript{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.\textsuperscript{54} The

\textsuperscript{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).


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


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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61 McConnell & Pegg, supra note 57, at 8.

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

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\(^{65}\) “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).


options granted has sharply declined.\textsuperscript{68} Recent estimates are that expensing would reduce earnings of the S&P 500 by five percent in 2005\textsuperscript{69} and by three percent in 2006.\textsuperscript{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.\textsuperscript{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.\textsuperscript{72}


\textsuperscript{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).


\textsuperscript{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 Act76 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


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).


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

With respect to the first factor, GAAP provides little guidance for setting the assumed return, and the assumptions used vary widely.\textsuperscript{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.\textsuperscript{81} Yet, the actual rate of return has been much lower.\textsuperscript{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.\textsuperscript{83} More recent data is less dramatic, but still compelling. From 2000-2003, the

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\item \textsuperscript{78} Arden Dale, \textit{Audit Watchdog Targets Pensions}, Wall St. J., Dec. 11, 2002, at B5.
\item \textsuperscript{79} Zion & Carache, \textit{supra} note 74, at 4. \textit{See also} Mary Williams Walsh, \textit{Pension Reserve: What’s Enough?}, N.Y. Times, June 22, 2003, at 3:1 (“Accounting is a dismal science, pension accounting even more so.”).
\item \textsuperscript{81} Zion & Carache, \textit{supra} note 77, at 82.
\item \textsuperscript{82} For example, the actual rate of return on pension plan assets for the S&P 500 was \textdaggerdash{7.5} percent in 2001 and only 4.94 percent in 2000. The vast majority of plans lost value in 2001. Zion & Carache, \textit{supra} note 77, at 86-87. \textit{See also} Thomas T. Amlie, \textit{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, \textit{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).
\end{itemize}
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. If actual return rates had been used during this time period, aggregate earnings would have markedly declined.

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


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?](http://www.businessweek.com), BusinessWeek Online, Oct. 25, 2004. Available at [http://www.businessweek.com](http://www.businessweek.com). But see Alix Nyberg Stuart, *Death to Smoothing*, CFO Magazine, Feb. 22, 2005 (recent study 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](http://www.cfo.com).
36 companies. 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.

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. 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. 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. 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).


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).


making substantive changes to FAS No. 87. This tweaking, which has had little effect, followed assertions by the FASB in both 1966 and 1985 that accounting for pension costs was “in a transitional stage.” 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. Enron achieved this lofty position in large part by creating at least 4,000 off-balance

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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. Enron incurred approximately $14 billion of off-balance sheet debt through structured finance transactions involving the use of SPEs. 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. Subsequent Enron-related class action litigation resulted in settlements that exceeded $7 billion by 2005.

Enron’s extensive use and misuse of SPEs was an extreme example of a common practice. 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 to 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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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.


to the cash flow of a segregated pool of assets.\textsuperscript{100} By 2002, the total outstanding value of asset-backed debt in the U.S. involving SPEs was an estimated $1.3 trillion.\textsuperscript{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.\textsuperscript{102} Corporations seek to avoid balance sheet debt because financial ratios used by analysts to value them are negatively affected by such debt.\textsuperscript{103} Enron, one such corporation seeking to obscure its debt, made extensive use of synthetic leases.\textsuperscript{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

\begin{footnotes}
\footnote{100} Carpenter, supra note 97, at 1072. See also Angela Petrucci, Note, Accounting for Asset Securitization in A Full Disclosure 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.”).


\end{footnotes}
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. The study also suggested that approximately $414 billion in pension liabilities remain off balance sheet.

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. FAS No. 140 governed, and still continues to govern, the accounting for securitizations of financial assets through Qualifying Special Purpose Entities (QSPEs). 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

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).
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 rearranged 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.\textsuperscript{109} This rule, derived from various EITF Issues and Topics, enabled Enron to conceal its staggering debt.\textsuperscript{110}

The FASB had debated reform of accounting for SPEs for two decades before Enron’s accounting fraud was exposed.\textsuperscript{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\textsuperscript{112} and compliance with them was sporadic.\textsuperscript{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.\textsuperscript{114}

\textsuperscript{109} FIN 46, \textit{supra} note 108, at 8.


\textsuperscript{111} Conference Board Commission (Parts 2 and 3), \textit{supra} note 22, at 39 (“\textit{E}fficient capital markets cannot tolerate a . . . 20-year delay for the publication of a standard relating to off-balance sheet, special purpose entities.”).

\textsuperscript{112} Simpson, \textit{supra} note 101, at A1.


\textsuperscript{114} \textit{Badly in Need of Repair}, Economist, May 2, 2002. Available at \url{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.\textsuperscript{115} But it was primarily the spectacular Enron fraud that finally compelled the FASB to respond.\textsuperscript{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.”\textsuperscript{117}

FIN 46 was superseded by FIN 46(R) in December 2003.\textsuperscript{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.

\textsuperscript{115} Simpson, \textit{supra} note 101, at A1. \textit{See also} Osterland, \textit{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).


\textsuperscript{118} \textit{See generally} Jalal Soroosh & Jack T. Ciesielski, \textit{Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R)}, CPA J., July 2004. Available at \url{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


follow certain rules set forth in GAAP.\textsuperscript{122} But the fraud also was facilitated and encouraged by such rules.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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


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

(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. Yet, pursuant to GAAP, these assets rarely appear on corporate balance sheets.

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

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


charge against current earnings.\textsuperscript{129} Such an approach falsely implies that R&D expenditures do not create an asset that has future value.\textsuperscript{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.”\textsuperscript{131} Many other intangible investments are never identified in financial statements.\textsuperscript{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,\textsuperscript{133} increased insider trading by managers who are able to exploit the information asymmetry between them and outside investors,\textsuperscript{134} an increased cost of capital, and the misallocation of resources.\textsuperscript{135}

\textsuperscript{129} Robert F. Reilly, \textit{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., \textit{Business and Financial Reporting, Challenges from the New Economy} 66 (Apr. 2001) (hereafter \textit{New Economy}). Available at http://www.fasb.org.

\textsuperscript{130} Margaret Blair & Steven Wallman, \textit{The Growing Intangibles Reporting Discrepancy} 449, 455 \textit{in} Intangible Assets, \textit{supra} note 127.

\textsuperscript{131} Baruch Lev & Paul Zarowin, \textit{The Boundaries of Financial Reporting and How To Extend Them} 487, 508, \textit{in} Intangible Assets, \textit{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).


\textsuperscript{134} David Aboody & Baruch Lev, \textit{Information Asymmetry, R&D, and Insider Gains} 366, 382 \textit{in} Intangible Assets, \textit{supra} note 127.

\textsuperscript{135} Blair & Wallman, \textit{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. 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. The FASB’s failure to bridge the current gap in accounting for intangibles is a fourth significant problem.

(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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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](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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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,\textsuperscript{142} has already been adopted, or is likely to be adopted, by many


\textsuperscript{141} Section 108(b) Study, \textit{supra} note 25, at 25.

\textsuperscript{142} \textit{See}, e.g., Bernhard Grossman, \textit{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, \textit{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

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. 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).

144 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).


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

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. More recently, the IASB projected that 100 countries will be using IFRSs in 2006, and 150 countries by 2010. 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. But Japan has not expressed an intention to converge with IFRSs, and the SEC has rejected the notion that


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.


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

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. . . .”)


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. Nicolaïsen (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.\textsuperscript{156} Given the wide disparities between the two systems, however, that objective was unrealistic.\textsuperscript{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.\textsuperscript{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.”\textsuperscript{159} Enron provides a stark example of the proposition that United States GAAP has been a


\textsuperscript{159} Benston, \textit{supra} note 42, at 1339-40.
substantial contributing factor in recent accounting fraud, and it is certainly not the only example. GAAP facilitated many of the recent scandals.

(6) Pro Forma Reports

A sixth weakness of the current financial reporting system in the United States is the permitted use of unaudited 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. 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.”).


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/download.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.

Pro forma reporting increased dramatically in the last 20 years.\textsuperscript{164} It first became popular among Internet companies during the dot.com boom,\textsuperscript{165} later expanded to nearly all industries,\textsuperscript{166} and has been described as a “make-your-own-accounting-rules habit.”\textsuperscript{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.\textsuperscript{168} Another survey from 2002 found that more than 300 companies in the S&P 500 engaged in pro forma reporting.\textsuperscript{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.\textsuperscript{170} These distortions are not readily apparent to many investors who read quarterly reports and are unaware, or fail to


\textsuperscript{168} Data reported at \url{http://niri.org/publications/alerts/EA20020117.cfm}.


understand, that data has been presented in such a format. Small investors rely most heavily on pro forma reports. 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. For example, the substantial accounting scandal involving Global Crossing, Ltd. was based on fraudulent pro formas.

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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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.

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.\textsuperscript{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.\textsuperscript{176} This is permitted, because Regulations S-K and G do not forbid the use of pro forma measures.\textsuperscript{177} And because such measures have no defined standards, misleading and confusing earnings reports continue to be issued.\textsuperscript{178} The issuance of such reports is not


\textsuperscript{177} David B.H. Martin, Reporting Earnings – A New Model, 1395 PLI/Corp 69, 75-78 (Nov. 2003).

\textsuperscript{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 lan 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

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,
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).


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

the auditor’s review of the company’s records and verification of their accuracy through sampling, confirmation, or observation.\textsuperscript{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.\textsuperscript{184} Approximately 100 SASs have been issued, and they were substantially codified in 2002.\textsuperscript{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.\textsuperscript{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.\textsuperscript{187} In the meantime, the PCAOB adopted as interim standards the ASB’s auditing, attestation, and

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\item \textsuperscript{183} For a judicial description of the audit process, see Bily v. Arthur Young & Co., 834 P.2d 745, 749-50 (1992).
\item \textsuperscript{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 \url{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 \textit{16 Research in Accounting Regulation} 29, 31 (Gary J. Previdi ed., 2003).
\item \textsuperscript{186} David E. Hardesty, Corporate Governance and Accounting Under the Sarbanes-Oxley Act of 2002, at 107 (2002).
\end{itemize}

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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. These interim standards would ultimately be modified, repealed, replaced, or adopted permanently. The PCAOB adopted its first new auditing standard in December 2003.

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. SAS No. 99, which has been adopted on an interim basis by the PCAOB, replaced SAS No. 82, which carried the same title.

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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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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{197}

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\item \textsuperscript{192} Public Oversight Board, supra note 162, at 76.
\item \textsuperscript{193} Calderon & Kowal, supra note 191, at 437.
\item \textsuperscript{194} See McEnroe & Pitman, supra note 184, at 39.
\item \textsuperscript{195} Public Oversight Board, supra note 162, at 86. See also John H. Eicke-emeyer, 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.
\item \textsuperscript{196} Frieswick, supra note 188.
\end{itemize}
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 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).


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. 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.

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).


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.\(^{208}\)

\(^{204}\) 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)).


\(^{207}\) See n.14, *supra*.

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, 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. Likewise, a 2002 study by Bloomberg News found that in 54 percent of the 673 largest bankruptcies of public

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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).

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. 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.

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. 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. This is a remarkably low number, given the

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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](http://www.nysscpa.org).


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 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. Material 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

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).


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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\begin{footnotesize}
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\item[218] Public Oversight Board, \textit{supra} note 162, at 88.
\item[220] Stephen Taub, \textit{Audit Fees Double Due to Sarbox}, CFO Magazine, Feb. 11, 2005 (available at \url{http://www.cfo.com}); Jill M. D’Aquila, \textit{Tallying the Cost of the Sarbanes-Oxley Act}, CPA J., Nov. 2004 (available at \url{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. \textit{404 Tonnes of Paper}, Economist, Dec. 16, 2004 (available at \url{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. \textit{See Sarbanes-Oxley: A Price Worth Paying?}, Economist, May 19, 2005 (available at \url{http://www.economist.com}). \textit{See also} Stephen Taub, \textit{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 \url{http://www.cfo.com}); Donna Fuscaldo, \textit{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, \textit{Auditor Changes Accompany Controls Woes}, CFO Magazine, May 24, 2005 (available at \url{http://www.cfo.com}).
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some accounting firms to sell their forensic accounting practices, in order to avoid potential conflicts of interest.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{224} Forensic auditing techniques currently employed by the Big Four firms are not generally geared toward uncovering such high-level fraud,\textsuperscript{225} and thus it usually escapes undetected.

\textsuperscript{221} Marie Beaudette, \textit{Some Firms Profit by Sarbanes-Oxley}, Wall St. J., Nov. 10, 2004, at B12C.

\textsuperscript{222} Frieswick, \textit{supra} note 188.

\textsuperscript{223} Ken Brown, \textit{Auditors’ Methods Make it Hard To Catch Fraud by Executives}, Wall St. J., July 8, 2002, at C1. See also David M. Brodsky, \textit{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).


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

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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).


228 Id. at 193 n.12.


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.” 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. The circuit split emerged in large measure because the legislative history of the PSLRA provides little concrete guidance concerning the appropriate interpretation.

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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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. Gregor237 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,

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. This is the most pro-plaintiff standard in the country, and the Third Circuit is in accord.

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, which held that plaintiffs must plead, at a minimum, “particular facts giving rise to a strong inference of deliberate or conscious recklessness.” While adopting what has been described as a “super-recklessness” standard, the Ninth Circuit rejected the Second Circuit focus on pleading motive and opportunity. Despite criticism that its standard

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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).


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, the Ninth Circuit has not retreated. Cases decided in 2005 continued to adhere to *Silicon Graphics*.

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, Fourth, Fifth, Sixth, Eighth, Tenth, and Eleventh Circuits all have adopted the centrist view.


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.”).


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 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).

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.”).

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).


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.\textsuperscript{257} The D.C. Circuit also has been silent. One district court case from 2000 cited \textit{Bryant, Comshare, Advanta,} and \textit{Silicon Graphics,} but did not choose between them.\textsuperscript{258} The opinion rejected the idea that general allegations of motive suffice.\textsuperscript{259} Subsequent opinions, in 2004 and 2005, also failed to select a standard.\textsuperscript{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. . . .”\textsuperscript{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.”\textsuperscript{262} Second,


\textsuperscript{259} \textit{Id.} at 20.


\textsuperscript{261} Grundfest & Pritchard, \textit{supra} note 229, at 678.

\textsuperscript{262} \textit{Id.}
while the situation would appear ripe for Supreme Court review, 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. A petition was filed in Novak, but it was denied in November 2000.

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. 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. 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”).


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).


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.

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 al., 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\textsuperscript{270} and Ninth\textsuperscript{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 \textit{Schwartz v. Celestial Seasonings, Inc.},\textsuperscript{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 \textit{Celestial Seasonings} on the assumption that the doctrine does survive in the Tenth Circuit.\textsuperscript{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.\textsuperscript{274}

\textsuperscript{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).

\textsuperscript{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).

\textsuperscript{272} 124 F.3d 1246, 1254 (10th Cir. 1997).


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


of Arizona; the Central, Northern and Southern Districts of California; the District of Colorado; the District of Columbia; the Middle and Southern Districts of Florida; the Northern District of Georgia; the Northern District of Illinois; the Southern District of Iowa; the District of Kansas; the District of Massachusetts; the Western District of Michigan; the District of Minnesota; the Eastern District of Missouri; the District of Nevada; the Eastern and Southern

Districts of New York; the Northern\textsuperscript{308} and Southern\textsuperscript{309} Districts of Ohio; the Eastern District of Pennsylvania;\textsuperscript{310} and the Western District of Wisconsin.\textsuperscript{311} Other district courts have ducked the issue.\textsuperscript{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.\textsuperscript{313} A second argument is that the doctrine is inconsistent with the discovery stay imposed by the PSLRA at the outset of a case.\textsuperscript{314} The stay is designed to deny

\textsuperscript{309} In re Smartalk Teleservices, Inc. Sec. Litig., 124 F. Supp.2d 527, 545 (S.D. Ohio, Nov. 1, 2000).
\textsuperscript{311} Friedman v. Rayovac Corp., 295 F. Supp.2d 957, 991-93 (W.D. Wis. 2003).
\textsuperscript{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.”).
\textsuperscript{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. A third argument is that group pleading is inconsistent with the Supreme Court’s abolition in *Central Bank* of aiding and abetting liability under Section 10(b) of the Exchange Act and companion Rule 10b-5.

The counter-arguments, which seem more persuasive, are at least four-fold. First, no language in the PSLRA expressly abolishes group pleading. 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. 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. Absent the availability of group pleading,

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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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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.” Given the application of this test, the group-published doctrine is not inherently inconsistent with *Central Bank.*

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.” Conversely, in *Holmes v. Baker,* the federal district court asserted that the group pleading

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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).


doctrine “does not apply to the [PSLRA’s] scienter requirement.” The latter view is the clear majority view.

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. 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. 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. Since the same set of facts serves to establish both


\[329\] 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.”)


\[331\] 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


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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in many instances auditors are not truly independent of their corporate clients.\textsuperscript{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.\textsuperscript{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.\textsuperscript{342}


\textsuperscript{341} See Cassell Bryan-Low, \textit{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, \textit{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.”)

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

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 and Ninth Circuits, as well as by federal district courts in California, Colorado, Illinois, Indiana, Maryland, New York, Ohio, Pennsylvania, Virginia, and other states.

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


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. 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.”

While the influence of DiLeo has been pervasive, 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.


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. 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. 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.

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. The

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.”).


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).

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. Deloitte & Touche LLP, the remaining member of the Big Four, broke from the auditing pack and voted in March 2003 to retain its consulting arm, after initially deciding to divest. But while fees from

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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.

consulting began to slide for most large accounting firms, total fees from non-audit services remained substantial.\textsuperscript{367} In 2002, accounting firms still obtained more than 50 percent of their revenues from non-audit services,\textsuperscript{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.\textsuperscript{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.\textsuperscript{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


\textsuperscript{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).


\textsuperscript{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

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.

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.\textsuperscript{374} Indeed, the general abdication of responsibility by audit committees was a contributing factor in a number of the recent accounting scandals.\textsuperscript{375} SEC rules enacted pursuant to Sarbanes-Oxley\textsuperscript{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


\textsuperscript{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.\textsuperscript{377} The result is that tax work continues to be performed for audit clients by their external auditors.\textsuperscript{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.\textsuperscript{379} This expansive definition of audit services also was the result of

\textsuperscript{377} Tim Reason, \textit{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).


industry lobbying,\textsuperscript{380} and the effect has been to re-characterize many millions of dollars worth of services to make them permissible under Sarbanes-Oxley.\textsuperscript{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)\textsuperscript{382} accounted for 21%, 38%, 23%, and 37%, respectively, of the total revenues derived by Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers, and KPMG.\textsuperscript{383} More recently, a 2004 survey of 1,652 companies, including most of the S&P 500, found that


\textsuperscript{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.

\textsuperscript{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.”).

\textsuperscript{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


an estimated $10-20 billion in annual revenue\textsuperscript{389} and state governments an additional $8-12 billion.\textsuperscript{390}

Many accounting firms are deeply involved in creating these tax shelters and aggressively marketing them to audit clients.\textsuperscript{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.\textsuperscript{392}

These shelters were facilitated by Enron’s creation, with Andersen’s assistance, of 881 offshore subsidiaries.\textsuperscript{393} KPMG and Ernst & Young also heavily promoted tax shelters during the late 1990s.\textsuperscript{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


\textsuperscript{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 \url{http://www.economist.com}.

\textsuperscript{393} Alexander, \textit{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 \url{http://www.cfo.com}.

United States Treasury billions of dollars in lost tax revenues.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{399}

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\textsuperscript{396} U.S. Tax Shelter Industry, supra note 395, at 15-16.


\textsuperscript{398} U.S. Tax Shelter Industry, supra note 395, at 22.

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.\textsuperscript{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.”\textsuperscript{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.”\textsuperscript{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.\textsuperscript{403} In November 2000 the SEC imposed such a reporting requirement, applicable to proxy statements and annual reports of all public companies.\textsuperscript{404} Corporations were required to disclose fees


\textsuperscript{401} Accounting Profession, supra note 21, at 8.

\textsuperscript{402} Public Oversight Board, supra note 162, at 110.

\textsuperscript{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.

\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{407} The authors concluded: “Taken together, our results suggest that the provision of non-audit services impairs independence and reduces the quality of earnings.”\textsuperscript{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


\textsuperscript{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).


earnings deterioration for a sub-group of firms with weak corporate governance. 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.

While other studies are to the contrary, 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. 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. Much of the consulting work was performed in connection with structuring Enron’s thousands of off-


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).

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.” This conclusion is reinforced by Arthur Andersen’s participation in an extended sequence of accounting scandals prior to its demise.

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. 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.”).


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.\textsuperscript{417} The analysis is infirm for a number of additional reasons, which
are discussed below.

(2) The Auditing Industry Operates As An Oligopoly

\textit{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.\textsuperscript{418} The reduction was the result of mergers involving six of the top

\textsuperscript{417} See, e.g., Joseph Nocera, \textit{Auditors: Too Few to Fail}, N.Y. Times, June 25, 2005, at C1 (“Accounting
firms are no longt 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.”).

\textsuperscript{418} Public Accounting Firms, \textit{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 Tohmatu), Ernst & Young LLP, KPMG LLP,
and PricewaterhouseCoopers LLP. \textit{Id.} at 1 n.2. The Big Four are structured as loose alliances of
independent partnerships that belong to global membership organizations. Jonathan Weil, \textit{KPMG Opens
so loose that affiliates of one organization can never be held liable for misconduct of other affiliates. \textit{See In
re Parmalat Sec. Litig.}, 377 F. Supp.2d 390, 404 (S.D.N.Y. 2005); \textit{In re Parmalat Sec. Litig.}, 375 F.
Supp.2d 278, 294-96 (S.D.N.Y. 2005); and Stephen Taub, \textit{One Lawsuit, One Deloitte}, CFO Magazine,
June 30, 2005 (available at \texttt{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. \textit{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); \textit{In re Royal Dutch/Shell Transport Sec. Litig.}, 380 F. Supp.2d 509, 571-72 (D.N.J. 2005)
(dissinguing 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); \textit{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
(allegation that KPMG acted as worldwide organization insufficient to state claim against KPMG LLP for
acts of KPMG member firm in Morocco); \textit{Nuevo Mundo Holdings v. PricewaterhouseCoopers LLP}, 2004
eight firms since the late 1980s\footnote{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.} and the dissolution of Arthur Andersen in 2002. Some of these mega-mergers were specifically designed to boost the auditors’ consulting practices.\footnote{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.”).} 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.\footnote{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.} 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.\footnote{Public Oversight Board, supra note 162, at 184. Cf. Louis Grumet, State Legislative Power Supersedes 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).}

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.\footnote{Public Accounting Firms, supra note 360, at 20-21.} A tier of firms below the Big Four,
known in the industry as Group B, has hundreds of members. 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. Even a merger of the five largest members of Group B might not create a firm capable of competing with the Big Four. 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.

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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.


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, major corporations generally shun them. 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.”

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

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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.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{433}

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

\textsuperscript{431} Public Accounting Firms, \textsuperscript{supra} note 360, at 26-30. \textit{See also} \textit{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 \texttt{http://www.economist.com}); Cassell Bryan-Low & Jonathan Weil, \textit{GAO Warns on Future Problems from Audit-Industry Mergers}, Wall St. J., July 31, 2003, at C11; and \textit{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).

\textsuperscript{432} Public Accounting Firms, \textsuperscript{supra} note 360, at 30. \textit{See also} \textit{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 \texttt{http://www.hypermediative-dev1.net/programs.dir/prog_display_ind_pdf}; \textit{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 \texttt{http://www.economist.com}.

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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{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).


\textsuperscript{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 indicted 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.\(^{440}\)

\(^{437}\) 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.

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.\textsuperscript{441} Enron is a classic example. A revolving door connected Enron and Arthur Andersen, its external auditor since 1985.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{445}


\textsuperscript{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.

\textsuperscript{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 \url{http://www.cfo.com}.


\textsuperscript{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.\textsuperscript{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.\textsuperscript{447} Each time the door revolved, Waste Management’s fraud multiplied.\textsuperscript{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.\textsuperscript{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.\textsuperscript{450} Andersen also entered into a consent decree with the SEC regarding charges that the auditor failed to maintain its independence and issued

\textsuperscript{446} Roper, supra note 33, at 4.

\textsuperscript{447} Schneider, supra note 443.

\textsuperscript{448} See Roper, supra 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.”).

\textsuperscript{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. \textit{Id.}


102
materially false and misleading audit reports. 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. 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.

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. This provision permits most audit firm employees to take jobs with their former clients. Sarbanes-Oxley also provides for a five-year rotation, but only of the lead and concurring review partners within a particular auditing firm. 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

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.


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. 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.

A number of commentators have concluded that mandatory rotation of auditing firms could help cure the problem, 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. Other countries with

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


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).


One of the primary arguments raised by the industry is that auditing costs would multiply if corporations were forced to periodically change auditors.\footnote{See, e.g., Mandatory Rotation of Audit Firms – Will It Improve Audit Quality?, PricewaterhouseCoopers (2002). Available at http://www.pwcglobal.com.} 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.\footnote{Mandatory Audit Firm Rotation, supra note 181, at 33.} However, audit costs for public companies currently comprise a very small percentage of total operating costs,\footnote{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.} 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.\footnote{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.nyssepa.org.)}

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
to curry favor with company management. Sarbanes-Oxley provides no effective cure.

(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, 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. . . .” 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

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.


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\textsuperscript{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.\textsuperscript{475} Low-balling has significant potential to impair auditor independence,\textsuperscript{476} as auditors attempt to honor the sunk cost of low-balled audit business.\textsuperscript{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.\textsuperscript{478} This last point

\textsuperscript{474} Prentice, \textit{supra} note 473, at 144-81. \textit{Accord Why Good Accountants Do Bad Audits, supra} note 341.

\textsuperscript{475} \textit{See} Steve Bergman, \textit{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 \url{http://www.cfo.com}.


\textsuperscript{477} Prentice, \textit{supra} note 473, at 171-74.

\textsuperscript{478} \textit{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

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.\textsuperscript{482} Indeed, the Big 4 accounting firms are largely immune from reputational damage because of their market power.\textsuperscript{483} The 2003 GAO study of consolidation and competition in the audit industry\textsuperscript{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.”\textsuperscript{485} This unreliability, while manifest, has not yet been recognized by the judiciary. The deeply flawed \textit{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.

\textbf{B. Recklessness, GAAP/GAAS Violations, and Red Flags}

Plaintiffs who are unable to meet the pleading burden established by the motive and opportunity standard\textsuperscript{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


\textsuperscript{483} Prentice, supra note 473, at 215.

\textsuperscript{484} Public Accounting Firms, supra note 360.


\textsuperscript{486} \textit{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, numerous courts have determined, with little or no analysis, that the bar for pleading scienter should be set higher for auditors. 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. 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 --


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. . . .”).

primarily in the Northern District of Illinois -- have reached the same conclusion.\textsuperscript{490} A number of courts have similarly held that GAAS violations, without more, do not establish scienter.\textsuperscript{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\textsuperscript{492} and Sixth\textsuperscript{493} Circuits have accepted this test, and district courts in California,\textsuperscript{494} Massachusetts,\textsuperscript{495} Michigan,\textsuperscript{496} New Jersey,\textsuperscript{497} and Virginia\textsuperscript{498} have done so as well.


\textsuperscript{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).


\textsuperscript{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\textsuperscript{499} and Ninth\textsuperscript{500} Circuits and district courts in those circuits\textsuperscript{501} and elsewhere\textsuperscript{502} have utilized this latter test on numerous occasions.\textsuperscript{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,\textsuperscript{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


\textsuperscript{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).

\textsuperscript{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).


\textsuperscript{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).

\textsuperscript{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.\textsuperscript{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.\textsuperscript{506}
As a general rule, GAAP and/or GAAS violations, coupled with sufficient disregarded red
flags, can suffice to support an inference of scienter.\textsuperscript{507} But some courts have held that
the auditor must have intentionally or deliberately disregarded the flags, in order for the
allegation to suffice.\textsuperscript{508} Such a requirement once again subverts the meaning of

\textsuperscript{505} A fairly recent Second Circuit statement of the standard appears in Rothman v. Gregor, 220 F.3d 81, 98
(2d Cir. 2000). \textit{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 \textit{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.

\textsuperscript{506} \textit{In re Recoton Corp. Sec. Litig.}, 358 F. Supp.2d 1130, 1147 (M.D. Fla. 2005).

\textsuperscript{507} \textit{See, e.g.}, \textit{In re Royal Dutch/Shell Transport Sec. Litig.}, 380 F. Supp.2d 509, 570 (D.N.J. 2005); \textit{In re
AOL Time Warner, Inc. Sec. & ERISA Litig.}, 2004 WL 992991, *34 (S.D.N.Y. May 5, 2004); Teachers'
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. \textit{In re: Stone &

\textsuperscript{508} \textit{See, e.g.}, \textit{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.\textsuperscript{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,\textsuperscript{510} or is probative of,\textsuperscript{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.\textsuperscript{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.\textsuperscript{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


overstatements of revenue, income, or earnings per share in excess of 100 percent. 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.”

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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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.