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THE FOX AND THE OSTRICH: IS GAAP A GAME OF WINKS AND NODS?

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Abstract:

The fox is frequently described as sly, cunning and calculating in world literature. It is often associated with behavior that seeks advantage through trickery and pretext. The ostrich on the other hand, has been portrayed as cowardly and irrational. Its character defect is epitomized when it sticks its head in the sand at the first sign of trouble. The Financial Accounting Standards Board (FASB) can be described as the fox; the Securities Exchange Commission (SEC), the ostrich. This article examines the creation of accounting principles by the fox and the failure to govern by the ostrich. History demonstrates that the SEC adopted a policy of relying heavily on FASB in establishing accounting standards commonly known as generally accepted accounting principles (GAAP). However, neither FASB nor any of its predecessor organizations bear a responsibility of a public trust, nor any liability in the event of a breach of that trust. The SEC's failure to establish accounting principles and constant reliance on private standard setters has contributed to the manipulation and exploitation of GAAP by corporations and their auditors. This article challenges the SEC's policy of relying on third party standard setters such as FASB and calls upon the SEC to stop relying on private standard setters and start taking an active role in creating accounting standards. Only then, can it be said that the SEC is no longer sticking its head in the sand.

THE FOX AND THE OSTRICH: IS GAAP A GAME OF WINKS AND NODS?

Arthur Acevedo[1]

It has been observed that accountants "are quite prone to define 'generally accepted' as ... 'somebody *tried it.'* "[2]

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[2] Harold L. Cannon, *Tax Pressures on Accounting Principles and Accounts' Independence*, 27 Acct. Rev. 419, 421 (1952).

VI) Conclusion

"In a national survey of chief financial officers … 62 percent believe it would be possible to intentionally misstate their [company's] financial statement to their auditor."[3] Is this the voice of ego, experience, or both which speaks here? Whatever the answer, this is an alarming statistic given the fact that the Securities and Exchange Commission (SEC) turns to the accounting profession for help in creating the very accounting standards used by accountants and auditors when preparing and auditing financial statements. If chief financial officers believe they can mislead auditors, what prevents them from misleading investors?

This article examines the SEC's failure to create and to actively regulate accounting standards. The SEC's failure to act has contributed to the confusion experienced by the public and to the manipulation of financial results reported by companies. Congress expressly granted to the SEC, the authority to enact rules regulating accounting standards.[4] However, the SEC has pursued a policy of deferring to a private standard setter[5] to create and regulate the accounting standards commonly known as Generally Accepted

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[3] The following question was asked in a national survey conducted by Grant Thornton in 2007; "Do you believe it would be possible to intentionally misstate your financial statement to your auditor? 62.44% responded "yes" and 37.10% responded "no." See http://www.grantthornton.com/portal/site/gtcom/menuitem.550794734a67d883a5f2ba40633841ca/?vgnextoid=e43a105b46016110VgnVCM1000003a8314acRCRD&vgnextchannel=a44ecbbdad9c4010VgnVCM100000368314acRCRD (Last visited September 25, 2009).

[4] 15 U.S.C.A. §77s(b) states in relevant part that "(i)n carrying out its authority under subsection (a) and under section 13(b) of the Securities Exchange Act of 1934, the (SEC) may recognize, as 'generally accepted' for purposes of the securities laws, any accounting principles established by a standard setting body …that (i) is organized as a private entity, (ii) has… a board of trustees serving in the public interest (and,) (iv) has adopted procedures to ensure prompt consideration … of changes to accounting principles…" Pub.L. 107-204 §108(a) added subsection (b) and redesignated former (b) as (c) (2002).

[5] For purposes of this article, the term "private standard setters" includes the Financial Accounting Standards Board ("FASB") and its predecessor organizations, the Committee on Accounting Procedure ("CAP"), the Accounting Principles Board ("APB"), and any successor organization including the International Accounting Standards Board ("IASB"). The SEC is studying the possibility of requiring U.S. issuers to adopt International Financial Reporting Standards (``IFRS'') in lieu of GAAP in 2011. If adopted, IFRS would be created by yet another private standard setter, the International Accounting Standards Board (``IASB''). *See,* ROADMAP FOR THE POTENTIAL USE OF FINANCIAL STATEMENTS, FEDERAL REGISTER, Vol, 73, No. 226 (November 21, 2008) page 70820. The IASB has even less incentive than the FASB to protect the interests of U.S. investors.

Accounting Principles (GAAP).[6] The practice of deferring to private standard setters is negligent and irresponsible. Despite an unenforceable statement of public duty,[7] private standard setters bear no responsibility to the public and therefore, are free to advocate for the commercial interests of their members and their clients, all at great public expense.

Part I of this article briefly chronicles the consequence of unregulated financial activity. Part II examines the convergence of three distinct doctrines; flexible accounting standards, management discretion and judicial deference, and its collective impact on our jurisprudence. Part III analyzes the creation of accounting principles. Part IV examines the history and organizational structures of the accounting profession as well as the SEC, and evaluates whether government is a better standard setter. Part V explores GAAP's influence and impact on our courts. Specifically, this section examines instances where GAAP has been accepted and rejected by the courts in resolving a dispute among the litigants. Part VI concludes with a proposal that the federal government take on an active and primary role in establishing accounting standards which are clear, consistent, conservative, narrow the range of differences, and that are reasonably expected and understood by the average investor.

PART I - INTRODUCTION

The absence of financial regulation and its hazards on society is apparent when one examines economic history. Early examples include the Tulipomania[8] craze in Holland and the South-Sea Company[9] incident

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[6] "The phrase 'generally accepted accounting principles' is a technical accounting term that encompasses the convention, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules, and procedures provide a standard by which to measure financial presentations." Auditing Standards Board, AU Section 411.

[7] "The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information" See, http://www.fasb.org/facts/index.shtml#mission, (Last visited Nov. 1, 2009.)

[8] The Tulipomania craze describes an incident of speculative trading in tulip bulbs during the seventeenth century. The tulip was imported into the Netherlands from Turkey. The flower was revered as a symbol of wealth and status. A market in tulip trading developed. Investors and speculators entered into contracts to buy and sell tulip bulbs. Many individuals initially profited as the demand and price for tulips increased. However, the price and demand for tulips collapsed in 1637, when buyers would not buy the tulips at the higher prices. Sensing that a

in England. Both events reveal the psychology and perils of uninformed mass speculation by investors. The South-Sea Company incident highlights the consequences of groundless mass speculation that can easily occur in an unregulated market. The British Parliament enacted the South Sea Bubble Act in response to the abuses the marketplace exacted on investors. This law prohibited the incorporation of companies unless authorized by the British government.[10]

The consequence of an unregulated financial market is evident when one examines the stock market crash of 1929.[11] Responding to abusive practices in the capital markets, Congress enacted the Securities Act of 1933 (Securities Act)[12] and the Securities Exchange Act of 1934, (Exchange Act).[13] Nearly seventy years later beginning in 2001, the United States economy once again experienced the collapse of the financial

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price ceiling was reached, the market price collapsed thereby leaving many individuals in financial distress as their contract price far exceeded the value of the underlying tulip bulb. See generally, CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS, 73, (BARNES & NOBLE, 2004).

[9] England granted the South Sea Company an exclusive right to exploit trading opportunities in South America. In exchange for the trading rights, the South Sea Company had agreed to assume a portion of England's national debt. Public speculation in the activities of the South Sea Company fueled in part by the participation of government officials, causing the price of the stock to grow from £100 to almost £1000 in the course of one year, only to settle back to a price level near £100. The dramatic rise and fall of the stock price resulted in numerous losses and bankruptcies for investors. See generally, CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS, BARNES & NOBLE, 38, (2004)

[10] Bubble Act of 1720 (6 Geo I, c. 18).

[11] "During the speculative orgy of 1928 and 1929, stock-exchange authorities made no adequate effort to curb activities on their exchanges. On the contrary, they conceived it as no part of their function to discourage excessive speculation or to warn the public that security values were unduly inflated." Federal Securities Laws, Legislative History 1933 – 1982, Volume II, The Bureau of National Affairs, Inc., Washington D.C., pg. 1344 (1983). See also, James Harlan Koenig, THE BASICS OF DISCLOSURE: THE MARKET FOR INFORMATION IN THE MARKET FOR CORPORATE CONTROL, 43 U. Miami L. Rev. 1021, 1037-38, (May 1989), "Prior to the 1933 Act and during the stock market crash of 1929, investors generally purchased securities under the philosophy of caveat emptor." *Id.*

[12] Securities Act of 1933, 15 U.S.C.A. §§77a et seq. (2006)

[13] Securities Exchange Act of 1934, 15 U.S.C.A. §§78a et seq. (2006).

markets as company after company began to issue accounting restatements.[14] Investors were left wondering how it was possible that so many accounting restatements could occur. In response to the shaken investor confidence in the capital markets in general, and in the accounting industry in particular, Congress enacted the Sarbanes Oxley Act (SOA) in 2002[15] in an attempt to stem the decline in investor confidence. The common denominator in all of these incidents is that they operated in an unregulated environment.

Amazingly, episodes of financial ruin keep repeating themselves. A pattern of "boom, bubble, and burst"[16] is now imprinted on the pages of financial history. One reason for repeated incidents of financial adversity is that the enactment of financial reforms provides a false sense of security. Individual investors may reenter the market following a market reform under the mistaken impression that the enacted legislation is prophylactic in scope and therefore addresses all abusive practices.[17] Another reason may be due to the fact that knowledge of the financial adversity is private and localized and therefore, complete information of the event is not fully disclosed. Still another reason is quite simply government inaction.

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[14] "A financial statement restatement occurs when a company, either voluntarily or prompted by auditors or regulators, revises public financial information that was previously reported . . . From January 1997 through June 2002, about 10 percent of all listed companies announced at least one restatement. Among the restating companies . . . identified, the number of large company restatements had grown rapidly since 1997 . . . The average (median) size by market capitalization of a restating company increased from $500 million . . . in 1997 to $2 billion . . . in 2002. (It is estimated) that the restating companies lost about $100 billion in market capitalization . . ." See, U. S. GEN. ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, 4, 5, U.S. SENATE, (OCT. 2002).

[15] The Sarbanes-Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002).

[16] LAWRANCE LEE EVANS, *WHY THE BUBBLE BURST: US STOCK MARKET PERFORMANCE SINCE 1982, 204.* (2003), Edward Elgar Publishing, Northampton, MA.

[17] The federal securities laws are a perfect example of a piecemeal approach to securities regulation. "There is an important difference in style between the Securities Act and the Exchange Act. In the Securities Act, Congress empowered the Federal Trade Commission (FTC) to discharge a specific and well-defined task: the registration of (initial) public offerings of securities not otherwise exempt from the Act. In Contrast, the Exchange Act is …" designed to address problems investors encounter with public securities after the initial registration process has been completed. James D. Cox, Robert W. Hillman and Donald C. Langevoort, Securities Regulation, Cases and Materials, at 6, (Sixth Edition, 2009).

The SEC has recognized the importance and significance of sound financial reporting. The SEC has stated that a "complete and accurate financial reporting by public companies is of paramount importance to the disclosure system underlying the stability and efficient operation of our capital markets."[18] Joining the SEC, the Accounting Principles Board ("APB") noted that "[a]ccounting is essential to the effective functioning of any business organization, particularly the corporate form.[19] The test of the corporate system … ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not merely from that of any one group of interested persons."[20] Sound financial reporting presumes sound accounting standards.

Yet, for all of its social and economic importance, establishing accounting standards has been the subject of limited federal and virtually no meaningful state regulation. Several reasons explain this phenomenon. First, intense pressure from an accounting profession resistant to government regulation has until recently, been successful.[21] Second, scarce government resources have not been sufficiently allocated to handle the ever-increasing complexity of accounting issues.[22] Third, the deferential posture adopted by both legislators and courts has created within the accounting profession, a culture of entitled noninterference. Finally, a common misperception exists among many individuals, including lawyers and politicians, that accounting is a rudimentary number-crunching exercise.[23]

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[18] SEC Release No. 7788, Release No. 42326, Release No. 33-7788, p. 12

[19] Accounting principles apply equally to all forms of business entities from a sole proprietor to a multinational company. For purposes of this article, the corporate form is used throughout for ease of reference.

[20] Accounting Research Bulletin No. 43 introduction par. 1. (June 1953).

[21] The Sarbanes-Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002), ("SOX") regulates the accounting profession. Before SOX, the accounting industry was self-regulated.

[22] The budget request for FY 2009 and FY 2008 was $913 and $906 million respectively, a less than a 1% increase from FY2008 to FY 2009. "The budget request for FY 2010 totals $1.026 billion, a $66 million (7 percent) increase over the agency's FY 2009 funding level of $960 million." *See* 2010 U.S. Securities Exchange Commission, In Brief, FY 2010 Congressional Justification, at 7, (May 2009), available at http://www.sec.gov/about/secfy10congbudgjust.pdf (Last visited Sep. 6, 2009).

[23] Contrary to popular belief, accounting is not about number crunching, it also has very little to do with counting beans.

Rather than actively generating accounting standards, the SEC has consistently followed a policy, since its inception, of allowing private standard setters to establish accounting standards.[24] The failure by the SEC to actively create GAAP has contributed to the creation of accounting standards that are confusing, inconsistent, and at times, incomprehensible.[25] Conflicting levels of accounting authority among the accounting standards issued by private standard setters add to an atmosphere of complexity and confusion.[26] Moreover, private standard setters are not immune to the pressures of capitalism and therefore, may respond in ways that may not be in the best interests of transparent financial reporting.[27]

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[24] For an interesting discussion on the limits of government agencies in delegating their authority to private parties see, Jacob L. Barney, BEYOND ECONOMICS: THE U.S. RECOGNITION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS AS AN INTERNATIONAL SUBDELEGATION OF THE SEC'S RULEMAKING AUTHORITY, 42 Vand. J. Transnat'l L. 579, 592, March 2009. "Courts have long recognized that Congress cannot abdicate or delegate to another governmental branch or entity its "essential legislative functions," a prohibition known as the "nondelegation doctrine." That prohibition, however, does not prevent Congress from 'obtaining the assistance of its coordinate Branches.'"

[25] The Supreme Court notes that "(t)here are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question. When such conflicts arise, the accountant is directed to consult an elaborate hierarchy of GAAP sources to determine which treatment to follow." *Shalala v. Guernsey Memorial Hospital,* 514 U.S. 87, 101, (1995).

[26] "Financial statements of such and of other similar corporations, as usually put out, with a classification and transposition of denominated assets of self-serving values and of stated liabilities, and of items of discount and surplus of variant meanings operated like a shuttlecock between them, generally do not mean much to the ordinary person … and often are understood only by accountants or by those having knowledge of methods and terms of accounting, and when understood frequently are not what they seem." Guaranty Mortg. Co. v. Flint, 66 Utah 128, 240 P. 175, 185, Utah 1925.

[27] Throughout the 1980's and 1990's, when the use of stock options swelled, a furious debate developed concerning whether companies should reflect the current cost of stock options in their financial statements or defer the cost until a later point in time when the option was exercised. Clear and definitive guidance was slow in coming. Companies are now permitted to follow either APB Opinion 25 (intrinsic value method) or FAS 123 (fair value method) when accounting for stock option costs. The Department of Commerce noted in discussing the alternative treatments for stock option accounting that the "… accounting rules for financial statements result in an understatement of compensation costs and a corresponding overstatement of profits." Carol Moylan, Bureau of Economic Analysis, U. S. Department of Commerce, *Treatment of Employee Stock Options in the U.S. National Economic Accounts* At

Accounting standards are expressed through GAAP and comprise a network of concepts linking financial events to financial reporting. Accounting standards influence *how* and *what* financial results are reported to users of financial statements.[28] They are used to identify, record and report the financial events of an entity. Furthermore, accounting standards also have an immediate and direct influence on a company, its shareholders and ultimately, our society. Accounting standards influence our laws, our rights and our responsibilities. They are determinative in measuring rights, responsibilities, and are frequently at the center of debate among litigants.[29] Accounting standards function much like our laws and touch upon many aspects of our lives. The influence of accounting standards can be seen in federal and in state legislation, in the public and private sectors of the economy, and in many individual or corporate transactions. The importance of accounting standards has not escaped the courts. One court remarked that "[t]he 'single unified purpose' of GAAP is 'to increase investor confidence by ensuring transparency and accuracy in financial reporting.'"[30]

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page 2, available at http://www.bea.gov/papers/pdf/empstop.pdf (last visited August 28, 2009).

[28] Elements of Financial Statements, Statement of Fin. Accounting Concepts No. 1, par 24 (Fin. Accounting Standards Bd. 1985). "Among the potential users (of financial statements) are owners, lenders, suppliers, potential investors and creditors, employees, management, directors, customers , financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial press and reporting agencies, labor unions, trade associations, business researchers, teachers and students, and the public." See also Concepts No. 1, par 27 for a further distinction between internal and "external users".

[29] Automodular Assemblies (DE), Inc. v. PNC Bank, Delaware, 2004 WL 1859828, Del.Ch.,2004., ("measuring … compliance with certain financial covenants").

[30] *In re Worldcom Inc. Securities Litigation*, 352 F.Supp.2d 472, 478 (2005). The plaintiffs in Worldcom alleged that Worldcom engaged in manipulation of the accounting entries. Specifically, the plaintiffs alleged that Worldcom was illegally shifting expenses into the capital accounts. The plaintiffs also alleged that there were a series of "high-level" accounting adjustments that bypassed the accounting system. In an interesting exchange, a WorldCom employee "went to … the Director of General Accounting, and told …(the Director) that he needed to understand the one page of adjusting entries better. (The Director) said, 'if you show that … piece of paper to our auditors, I'll throw you out of that … window.'"

History has shown that financial disasters can be placed into three broad categories: financial fraud,[31] groundless mass speculation,[32] and incessant individual greed.[33] The impact of these three categories, while personally devastating to the affected individuals, are limited in scope when considered within the broader context of society. However, a new category of potential financial ruin now lurks in our midst - accounting standards manipulation. Unlike its counterparts, this new category has the potential to reach far and wide, and hence, may lead to widespread financial ruin. Accounting standards manipulation results from a combination of factors that includes a lack of meaningful regulatory guidance by the SEC in establishing accounting standards, the creation of malleable accounting standards by private standard setters, and unregulated management discretion when selecting the accounting standards to be used in preparing financial statements.

PART II - ECONOMIC TRIFECTA OR BERMUDA TRIANGLE?

The SEC's failure to create and to actively regulate accounting standards has produced a gratuitous benefit to the business sector. Three policies combine to create an environment which grants corporate managers near unbridled discretion in reporting financial results: flexible accounting standards, management discretion, and judicial deference. Flexible accounting standards have developed as a result

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[31] "(A) securities fraud claim has six elements: (1) a material misrepresentation or omission; (2) scienter; (3) connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation. Dura Pharma., Inc. v. Broudo, 544 U.S. 336, 341-42, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005). Our focus here is on the adequacy of plaintiffs' allegations of scienter. Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud," and a plaintiff must allege that "defendants consciously intended to defraud, or that they acted with a high degree of recklessness." Aldridge, 284 F.3d at 82." Ezra Charitable Trust v. Tyco Intern. Ltd. 466 f. 3d, 6 (2006). For an interesting discussion on the impact of financial fraud in the United States see, Paul M. Clikeman, Routlede Taylor and Francis Group, Called to account: Fourteen Financial Frauds that Shaped the American Accounting Profession, (2009).

[32] It is reported that during the incident of the Tulipomania hysteria, "…one person offered (a) fee-simple (estate) of twelve acres of building-ground for the Harlaem Tulip." CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS, BARNES & NOBLE, at 75, (2004).

[33] The case of the Hunt brothers comes to mind. In 1979, the Hunt brothers and their associates allegedly attempted to corner the silver market by purchasing futures contracts while at the same time acquiring millions of ounces in silver. The apparent scarcity in silver would eventually result in a huge windfall to the Hunt brothers. Silver prices rose from $11 per ounce in September 1979 to a peak of about $50 an ounce in January 1980. The price of silver eventually collapsed below $11 an ounce within two months of its $50 high. *See*, New York Times, http://www.nytimes.com/1989/12/21/business/2-hunts-fined-and-banned-from-trades.html

of the accounting profession's belief that elastic accounting standards will generate reliable financial information.[34] Moreover, company managers have the discretion to choose among alternate GAAP standards under the premise that they are in the best position to select the applicable standard for the company. Finally, courts generally defer to economic decisions made by company managers. As a result, these three doctrines, when combined create an environment ripe for abuse of discretion, distorted financial results and a pursuit of self interest - all at great shareholder and public expense.[35]

The philosophical approach and justification for American economic jurisprudence reaches back to sixteenth century Europe. Adam Smith's philosophy "… against government interference in economic matters massively influenced late eighteenth century and nineteenth century politicians. Smith provided politicians with an academic cloak of respectability with which to justify their policy aims and ideas, in particular, the desire for unbridled industrialization."[36] United States capitalism, premised on Adam Smith's philosophy, similarly advocates for economic freedom and minimal government intrusion. It too, favors a clear separation of the economy and the state. This philosophical approach was evident throughout the formative years of the United States as farmers resisted government regulation. Later, when the industrialists arrived, it was their turn to resist the call to regulation. As the American economy transitioned from agricultural and industrial based economies to a more service oriented economy, there was yet again, expected resistance to increased regulation. Much of the resistance by the business sector to economic regulation is defended on the basis that it results in increased costs without a corresponding benefit.[37]

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[34] FASB Concept Statement No. 2, par 36 "… each decision maker judges what accounting information is useful…"

[35] These three factors give rise to a moral hazard, defined in this case "… as carelessness and indifference which may not suggest moral deficiency but still refer to personality traits which react with the security of … protection." FN 256 Bob Works, EXCUSING NONOCCURRENCE OF INSURANCE POLICY CONDITIONS IN ORDER TO AVOID DISPROPORTIONATE FORFEITURE: CLAIMS-MADE FORMATS AS A TEST CASE, 5 Conn. Ins. L.J. 505, footnote 256 (1998-1999)

[36] JOHN RICHARD EDWARDS, A HISTORY OF FINANCIAL ACCOUNTING, at 188.

[37] One commentator notes that "(a) common allegation is that the "Plain English" initiative -- which requires issuer disclosure documents to be written in clear, simple language--is another costly initiative imposed on companies …" See, Alicia Davis Evans, *A REQUIEM FOR THE RETAIL INVESTOR*, 95 Va. L. Rev. 1105, 1112 (June 2009)

However, America's affinity with the *laissez-faire* philosophy is raising considerable questions concerning its effectiveness within our economic and regulatory framework. Oppressive regulation is not welcomed, but neither is lax regulation. The SEC's approach of deferring to private sector standard setters in formulating GAAP is to be questioned. While the traditional policy of economic non-intervention has served U.S. interests well in the past, more recent events in the capital markets raise legitimate questions about accounting standards development and its limitations when developed by private standard setters.[38]

(a) GAAP's Flexibility

GAAP is not an absolute measure of the current financial state of the company. Rather, it is a system of estimates that are used to determine the relative financial state of the company. The United States Supreme Court recognizes that "GAAP is not the lucid or encyclopedic set of pre-existing rules that [some] might perceive it to be. Far from a single source accounting rulebook, GAAP 'encompasses the conventions, rules, and procedures that define accepted accounting practice at a particular point in time. GAAP changes and, even at any one point, is often indeterminate.' [T]he determination that a particular accounting principle is generally accepted may be difficult because no single source exists for all principles."[39]

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[38] Enron Inc., "indicating major (accounting) problems with special purpose entities…"; WorldCom Inc., improperly recorded expenses of "almost 11 billion"; HealthSouth Inc., is accused "…of accounting fraud involving 1.4 billion in earnings and $800 million in overstated assets…"; Adelphia Inc., "overstated earnings". See,Gary Giroux, Earnings Magic and the Unbalance Sheet, The Search for Financial Reality, 31, John Wiley & Sons, Inc., 2006

[39] *Shalala v. Guernsey Memorial Hospital,* 514 U.S. 87, 101, 115 S.Ct. 1232, 131 L.Ed.2d 106 (1995). *But see,* Financial Accounting Standard 168 (June 2009) ("FAS 168") which now codifies GAAP in one source.

GAAP is complex,[40] confusing[41] and at times, contradictory.[42] Individuals and investors alike are astonished to learn that the only accurate number reported on most financial statements are the cash account and certain liabilities such as notes payable.[43] The remaining numbers, although perceived by most readers as absolute, are merely reported estimates using methods prescribed by GAAP.[44] As noted by one court, "[t]he term [GAAP encompasses]… a wide range of acceptable [principles], such that 'an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting [principles] when that accountant prepares a financial statement.'"[45]

Understanding GAAP therefore, requires understanding the nature and function of an accounting principle. GAAP is defined as "[accounting] principles [that] are issued by the Financial Accounting Standards Board for use by accountants in preparing financial statements. The principles include not only broad guidelines of general application but also detailed practices and procedures."[46] GAAP is "based on

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[40] "Investor Warren Buffett, a billionaire and one of the most sophisticated investors in the world, has said, 'For more than forty years, I've studied the documents that public companies file. Too often, I've been unable to decipher just what is being said . . . .'" *See,* Alicia Davis Evans, A REQUIEM FOR THE RETAIL INVESTOR, 95 Va. L. Rev. 1105, 1112 (June 2009)

[41] *See*, Egelhof v. Szulik, 2006 WL 663410, 5, (N.C. Super.) where the court observes that "(e)vidently … two different partners at PWC who advised (the company) on the (revenue recognition) issue interpreted 'ratably' differently under GAAP rules."

[42] *Bolt v. Merrimack Pharmaceuticals Inc.,* 503 F. 3d 913, 918 (2007). "Unfortunately, GAAP is not found in a single source…Instead, in the United States, GAAP consists of a hodgepodge of accounting sources, which find their respective places in the hierarchical structure established by the American Institute of Certified Public Accountants ("AICPA")."

[43] Not all liabilities reflect a fixed and determinable value. Some liabilities such as pension, warranty or coupon redemptions are determined using estimates.

[44] Examples of accounts which are estimates include, accounts receivables, inventories, pension liabilities, revenues and expenses.

[45] *Lovelace v. Software Spectrum Inc.*, 78 F.3d 1015, 1020-21 (5th Cir. 1996) (quoting *Godchaux v. Conveying Techniques, Inc.,* 846 F.2d 306, 315 (5th Cir. 1988))

[46] BRYAN A. GARNER, BLACK'S LAW DICTIONARY, (8th ed. 2004), ThomsonWest.

flexible accounting concepts, which, when applied, do not always (or perhaps ever) yield a single correct figure."[47]

GAAP rules are flexible and permissive.[48] The choice of accounting principles will be determined by management after due attention to historical, economic, and tax considerations. For example, GAAP rules permit management a fair degree of discretion when determining accounts receivable, establishing inventory values,[49] reporting contingencies[50] or determining asset impairments.[51] The exercise of determining these amounts involves considerable management discretion which ultimately affects the financial results reported.

In June, 2009, FASB issued FAS 168 which codified all of GAAP in one source. Prior to the issuance of FAS 168,[52] GAAP authorities were scattered throughout the accounting and academic literature. Finding an applicable rule however, may continue to be a challenging process for both compliance and

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[47] *In re GlenFed. Inc. Sec. Litig.*, 42 F.3d 1541, 1549 (9th Cir.1994) (en banc).

[48] *See, IKON Office Solutions Inc. Securities Litigation*, 194 F.R.D. 166, 171, 182 (2000), where plaintiffs alleging that the "defendants engaged in a fraudulent scheme to falsify Ikon's financial results and issue aggressive financial projects for which defendants lacked a reasonable basis" conceded that GAAP "standards are somewhat flexible and that their application required judgment calls."

[49] Acceptable GAAP methods include, specific identification, average cost, first-in, first-out (FIFO), last-in, first-out (LIFO) and lower-of-cost-or-market (LCM). See DONALD E. KIESO, JERRY J. WEYGANDT, TERRY D. WARFIELD, INTERMEDIATE ACCOUNTING, TWELFTH EDITION, at 397, John Wiley & Sons, (2007), (hereafter, "KIESO, WEYGANDT, ET AL."), for an excellent illustration of the comparative results of Average Cost, FIFO and LIFO methods.

[50] FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARD (FAS) NO. 5, ACCOUNTING FOR CONTINGENCIES (March 1975).

[51] FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS (FAS) NO. 144, ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS," (2001). *See also*, KIESO, WEYGANDT, ET AL., at 534. "The going concern concept assumes that the company can recover the investment in its assets. Under GAAP companies do not report the fair value of long-lived assets because a going concern does not plan to sell such assets. However, if the assumption of being able to recover the cost of the investment is not valid, then a company should report a reduction in value."

[52] The great innovation of FAS 168 is that it codified GAAP standards in one source. One is required to pay a user fee before complete access will be granted to FAS 168. A basic version however, is available for free.

enforcement efforts because GAAP itself continues to be susceptible to multiple interpretations and applications. Furthermore, for periods before the enactment of FAS 168, finding an applicable GAAP rule was and most likely will continue to be a difficult process for litigants.[53]

(b) Management discretion in selecting accounting principles

It is a basic tenet of corporate law that "[a]ll corporate powers shall be exercised by or under the authority of the board of directors of the corporation and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors…"[54] In the case of a public corporation, the board's oversight responsibilities include attention to …[the] preparation of the corporation financial statements."[55]

Management has the responsibility of determining which accounting rules it will be adopting. The SEC states that "[t]he fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not

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[53] Before FAS 168, "(t)here (were) five categories in the GAAP hierarchy. Officially established accounting principles, referred to as Category (a) authority, are the highest level and include the Financial Accounting Standards Board ("FASB") Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board ("APB") Opinions, and AICPA Accounting Research Bulletins. Moreover, Securities Exchange Commission ("SEC") rules and interpretative releases take an authoritative weight similar to Category (a) authority for companies registered with the SEC. Category (b) authority, the next highest level, consists of FASB Technical Bulletins and, if cleared by FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position. *Id.* The third level of authority, Category (c), consists of AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by FASB and consensus positions of the FASB Emerging Issue Task Force. Category (d), the fourth level of authority, consists of AICPA accounting interpretations and implementation guides published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry. *Id.* In the absence of established accounting principles, auditors may consider accounting literature in the fifth and final level of authority, which includes FASB Statements of Financial Accounting Concepts; APB Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee ("IASC"); Governmental Accounting Standards Board ("GASB") Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. _____**Add Citation**_____.

[54] MODEL BUSINESS CORPORATION ACT §8.01(b).

[55] MBCA §8.01(c)(v).

discharge its obligations in this respect by the employment of independent accountants, however reputable."[56] SEC release No. 33-8040 further demonstrates this point by stating "the selection and application of the company's accounting policies must be appropriately reasoned."[57] It further states that "[m]anagement should be able to defend the quality and reasonableness of the most critical policies…"[58] Additionally, APB 22 provides that "[t]he accounting policies of a reporting entity are the specific accounting principles … that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly [the] financial position, cash flows, and results of operations in accordance with generally accepted accounting principles…[59] This approach, by the APB, reinforces the notion that management has the flexibility in selecting among the accounting standards it needs to measure, record and report a financial event. As noted by one commentator, "accounting permits alternative presentations for a particular transaction or account."[60]

Although accountants and business managers favor discretion and flexibility in selecting accounting principles, such discretion and flexibility also creates unintended opportunities that enable management to fabricate the earnings of the company[61] and to distort the fundamental economic activity of the company by manipulating the accounting standards.[62] Concerned with the excess that such flexibility provides, Arthur Leavitt, former Chairman of the SEC remarked that "[f]lexibility in accounting allows it to keep pace with business innovations. Abuses such as earnings management occur when people exploit this

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[56] Accounting Series Release No. 62, (June 27, 1947), (1937-1982 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 72,092, at 62,197 (Oct. 30, 1952).

[57] Add Citation _____.

[58] *See*, SEC Release No. 33-8040 (Dec. 12, 2001), 66FR 65013.

[59] Accounting Principles Board ("APB") Opinion No. 22, par 6.

[60] Jeffrey N. Gordon, *THE RISE OF INDEPENDENT DIRECTORS IN THE UNITED STATES, 1950-2005: OF SHAREHOLDER VALUE*, 59 STNLR 1465, 1558 (April, 2007)

[61] Earnings management can be traced as far back as 1848 when corporate managers "…employ(ed) valuation procedures designed principally to produce a pattern of reported profit sufficient to cover the planned level of dividend." *See,* JOHN RICHARD EDWARDS, A HISTORY OF FINANCIAL ACCOUNTING, at 117, (1989), Routledge.

[62] APB No. 20, par. 15 (1971) contemplates that " in the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type.

pliancy. Trickery is employed to obscure actual financial volatility. This, in turn, masks the true consequences of management's decisions. These practices aren't limited to smaller companies struggling to gain investor interest. It's also happening in companies whose products we know and admire."[63] The SEC has observed that "[t]oo often, accounting and disclosure rules are disregarded in order that revenues and earnings … be inflated improperly to meet earnings projections of analysts or others in the financial community or to achieve some other objective."[64]

In re Netflix Inc. Securities Litigation ("In re Netflix")[65] is a stunning example demonstrating the wide discretion that management enjoys when selecting accounting principles. *In re Netflix* involved a novel application of a company created measurement in place of a recognized industry standard or a method recommended by the auditors.

The defendant, Netflix Inc., sells "monthly subscriptions allowing people to order DVD's on the Internet and to receive them by mail."[66] Since April 16, 2002, Netflix publicly reported a steadily decreasing churn rate[67] from a high of 8%, to a "record low…" of 4.7% by April 15, 2004. The "churn rate",[68] reflects the number of subscribers who "cancelled their [video product] subscriptions each month."[69] Subscriber cancellations are a critical element to a business model, such as Netflix, that relies heavily on monthly subscriptions.

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[63] http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt last visited July 31, 2009. Arthur Levitt further remarked that "Five of the more popular (accounting illusions) I want to discuss today are 'big bath' restructuring charges, creative acquisition accounting, 'cookie jar reserves,' immaterial misapplications of accounting principles, and the premature recognition of revenue."

[64] SEC Release 7788, Release No. 42326, Release No. 33-7788 pg. 12 (January, 11, 2000)

[65] *In re Netflix, Inc. Securities Litigation*, 2005 WL 3096209 (2005).

[66] *In re Netflix, Inc. Securities Litigation*, 2005 WL 3096209 (2005). Pg. 1

[67] Churn rates measure the percentage of customer cancellations. A high churn rate suggests a high customer cancellation rate for the period measured. In contrast, a low churn rate suggests a low customer cancellation rate.

[68] *In re Netflix, Inc. Securities Litigation*, 2005 WL 3096209 (2005) at 2.

[69] Id at 2.

Netflix management made a series of announcements which negatively affected the company's stock price. Management announced plans for a price increase, reported "delay[ed] plans to expand into the United Kingdom, and downgraded its earnings forecast from $80 million to zero."[70] The company stock price "cratered" from its high of $32 in mid-July, 2004, to a low of $10.30 by mid-October, 2004.

The plaintiffs claimed that the defendant, Netflix Inc., made a series of "false and misleading statements, and failed to disclose materials facts… "[71] The plaintiffs alleged that the defendants misled them because they improperly calculated their churn rate. Specifically, the plaintiffs claimed that the defendants were "…using a misleading calculation of …average subscriber cancellation rate[s]…"[72]The Plaintiffs asserted that the defendants' "novel churn rate" method was misleading and that instead, the defendants should have calculated the churn rate by using the preferred industry standard, or in the alternative, the standard proposed by its auditors.[73] Plaintiffs conceded however, that there was no applicable GAAP for churn rates.

The court dismissed the plaintiffs complaint reasoning that "this is not a case in which defendants used one calculation method when another is mandated by industry practice, generally accepted accounting principles or federal securities regulation….Plaintiffs cite no statute or SEC regulation barring Netflix from reporting its type of churn rates." The court further reasoned that " … the critical key to understanding defendants' methodology was adequately and repeatedly disclosed…"[74] The court concluded that "the use of a unique measure in and of itself does not render their reports false and

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[70] *Id.* at 2.

[71] *Id.* at 2

[72] *Id.* at 2

[73] *Id.* at 7. The two methods are:

"The number of cancellations in a month divided by the number of subscribers at the month's start." This is the method described by KPMG.

The number of cancellations in the month divided by the average number of subscribers at any one point during the month. Plaintiffs call this (method) 'true churn.'"

[74] *In re Netflix, Inc. Securities Litigation*, 2005 WL 3096209 (2005), at 9

misleading…. There are no plain-English definitions of these financial measures. They are, like all statistics, artificial constructs…"[75]

The court's resolution in *In re Netflix* is interesting because it suggests that in the absence of a stated GAAP principle, companies have considerable discretion in crafting their own financial standard so long as the methodology is disclosed. This interpretation is favorable to companies where novel accounting issues present themselves and private party standards are slow in following. Under these circumstances manipulation becomes - irresistible.

Admittedly, management is in the best position to know the salient features affecting a company's operations. There is often the individual temptation and external pressure to select accounting principles which will place the company in a favorable light. This is especially evident where management has stock options that are based on the performance of the company.[76] As noted further by Arthur Levitt, "[i]ncreasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices. *Too many corporate managers, auditors, and analysts are participants in a game of nods and winks.* In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation."[77] (emphasis added).

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[75] *Id.* at 10.

[76] The mere fact that an individual defendant's executive compensation is dependent on stock value or entails some other performance-based component cannot, by itself, support an inference of scienter. *See, e.g.,* *Acito,* 47 F.3d at 54; *Greene v. Hanover Direct, Inc.*, No. 06 Civ. 13308(NRB), 2007 WL 4224372, at *4 (S.D.N.Y. Nov. 19, 2007). "Nor can plaintiffs establish (a wrongful) motive by simply pointing to the lucrative change-of-control provisions in … employment agreements." In re IMAX SECURITIES LITIGATION, 587 F.Supp 471, 480 (2008). *But see*, Robert W. Holthausen, *Annual Bonus Schemes and the Manipulation of Earnings*, 19 J. ACCT. & ECON. 29 (1995), where the writer maintains that corporate managers manipulate year end accruals to maximize compensation plans based on the earnings of the company.

[77] http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt (last visited July 31, 2009). *See also,* Statement of Financial Accounting Concepts (SFAC) No. 2, *Qualitative Characteristics of Accounting Information,* par. 63, "Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations."

(c) Judicial Deference

Courts routinely defer to the judgment of corporate management with respect to matters of corporate policy and business objectives.[78] Reasons of efficiency, economy and competence account for this approach. The philosophy of judicial deference is articulated in *Kamin v. American Exp. Co*.,[79] where Judge Greenfield stated that "[q]uestions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to [the director's] unselfish decisions, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient."[80] The approach by the courts of deferring to the business judgment of company management is evident in matters concerning dividend policy,[81] pursuing a new line of business[82] or taking neighborhood interests into consideration.[83]

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[78] For an early case illustrating judicial notice of a method of accounting (depreciation) see Boston & A.R. Co. v. New York Cent. R. Co., 256 Mass. 600, 613, 153 N.E. 19, (Mass. 1926), "The method of determining depreciation by taking as a basic cost book value, or reproduction of property which will deteriorate with use, and deducting therefrom a percentage for the time it has been in use based upon the probable length of its life, has been in principle either approved by the court or held to be not wrong as matter of law. Stein v. Strathmore Worsted Mills, 221 Mass. 86, 108 N. E. 1029; Boston v. Treasurer & Receiver General, supra; Lapham v. Tax Commissioner, 244 Mass. 40, 138 N. E. 708; Knoxville v. Knoxville Water Co., 212 U. S. 1, 29 S. Ct. 148, 53 L. Ed. 371.

[79] *Kamin v. American Express Co.*, 83 N.Y.S.2d 807 (Sup. Ct. 1976), aff'd, 387 N.Y.S.2d 993 (App. Div. 1976).

[80] *Kamin v. American Exp. Co.*, 383 N.Y.S.2d 807, 811 (1976).

[81] *Kamin v. American Exp. Co.* 383 N.Y.S.2d 807, 812(1976) ("(T)he question of whether or not a dividend is to be declared or a distribution of some kind should be made is exclusively a matter of business judgment for the Board of Directors.

[82] *See generally*, Stephen M. Bainbridge, The *Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004)

[83] *Shlensky v. Wrigley,* 95 Ill.App.2d 173, 237 N.E.2d 776 (1968).

Courts are not predisposed to second guess the legitimate business decision of a corporate manager.[84] This line of reasoning is commonly referred to as the Business Judgment Rule. The court in *Aronson v. Lewis*[85] formulated the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption."[86]

In similar fashion, courts can be expected to refrain from interfering with the selection of an accounting policy by management. This is especially true, when GAAP offers management several alternatives when selecting accounting principles. It stands to reason that if courts are reluctant to second guess management on a prospective business decision, they are less likely to engage management on the selection of accounting principles to be used for financial reporting.

The only meaningful limitation on management when these three doctrines[87] converge is to refrain from engaging in a fraud or from making a material misrepresentation. The flexibility in GAAP, the discretion that management enjoys in selecting among alternative GAAP rules, and the deference courts give business decisions, all have combined to generate substantial benefits for business in particular and for society in general. However, the convergence of these three policies has also exacted costly financial consequences on American society as the U.S. Government if forced to step in to assist failed companies who abused GAAP in the name of increasing shareholder value.

PART III - THE REGULATORY FRAMEWORK OF ACCOUNTING RULES

(a) British Influence

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[84] See *Stahl*, "The (Business Judgment Rule) is a policy of judicial restraint born of the recognition that directors are, in most cases, more qualified to make business decisions than are judges. FDIC v. Stahl, 89 F.3d. 1510, 1517 (1996) 11th Circuit Court of Appeals.

[85] *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984).

[86] *Id.* at 812.

[87] The three doctrines are GAAP flexibility, management discretion and judicial deference.

Accounting standards in the U.S. were first introduced by British accountants during the end of the nineteenth century when the US economy was heavily steeped in the agricultural and manufacturing industries. The relatively few accounting standards that were then developed and applied, evolved from a commercial framework where assets were tangible and easily verifiable. British accountants also imported a "…tradition of treating accounting as an extension of the law …"[88]As a result, the accounting profession adopted the position that "financial reporting should be governed by principles and professional judgment, not blind conformance with arbitrary rules."[89]

During the nineteenth century, accounting standards, or more appropriately, accounting practices, were heavily concentrated on the form and content of the financial presentation. Unlike present day practices where judgment is pervasive, accounting practice during the late nineteenth century was predominantly a mechanical process involving little or no judgment. Accounting standards were rigid, highly mechanized, and focused almost exclusively on process. The posting and carrying of financial amounts was done in a prescribed manner following a prescribed order.[90] The accounting principles developed during this era focused primarily on *the mechanics* of accounting as distinguished from *the methods* of accounting. By the late nineteenth century, Britain's accounting industry was well formed with well developed practices and procedures that eventually migrated into the U.S. business environment as domestic businessmen sought qualified accountants to satisfy the ever increasing demand for financial information.

Early accounting practices heavily emphasized the reporting of the balance sheet accounts to reflect the state of affairs and the assets available to a business. Eventually, the emphasis on balance sheet reporting was replaced with an emphasis on income statement reporting. This shift resulted because the management and ownership model transitioned from a proprietary model with sole or limited ownership

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[88] THOMAS A. KING, MORE THAN A NUMBERS GAME, A BRIEF HISTORY OF ACCOUNTING, at 74, John Wiley & Sons, Inc., (2006).

[89] THOMAS A. KING, MORE THAN A NUMBERS GAME, A BRIEF HISTORY OF ACCOUNTING, at 74, John Wiley & Sons, Inc.,(2006).

[90] "The celebrated economist John B. Canning, writing in 1929, was totally disparaging of early writers on accountancy" ` they made little showing of any systematic thought, though they were sticklers for unswerving adherence to the technical procedure shown,'" JOHN RICHARD EDWARDS, A HISTORY OF FINANCIAL ACCOUNTING, at 71.

and a focus on ownership of assets, to a corporate model with dispersed ownership and an increased interest in a dividend distribution policy.[91]

(b) Interstate Commerce Commission

The United States' first attempt to establish accounting standards can be traced to the Interstate Commerce Act of 1887 ("ICC"). Congress enacted the ICC and created the Interstate Commerce Commission ("Commission") to address concerns raised by Western state farmers who were complaining about the practice of rate discrimination resulting from the different rates being charged to individuals who were similarly situated. Additionally, the farmers were also complaining that the railroad companies were engaged in influence peddling by offering state and local politicians free transportation in exchange for favorable legislation.

To remedy the abuses, Congress authorized the Commission to "require annual reports… and prescribe the manner in which such reports shall be made…" by the railroad companies. Additionally, the Commission also had the statutory authority to "prescribe … as near as may be, a uniform system of accounts, and the manner in which such accounts shall be kept."[92] Accounting principles, to the extent

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[91] JOHN RICHARD EDWARDS, A HISTORY OF FINANCIAL ACCOUNTING, at 111, Routledge, London and New York, (1989), "One reason (for the new approach in profit calculation) was the transition from the proprietorship view of the firm which treats business assets as personal possessions of the owner, to the entity basis, which regards the assets as an integral part of a permanent business venture…. A second reason … was the use of profits as a basis for dividend declarations."

[92] Section 20 of the Interstate Commerce Act of 1887 requires companies to furnish the Commission a detailed report. No other federal legislation before required such detailed information. Section 20 provides, "(t)hat the Commission is hereby authorized to require annual reports from all common carriers subject to the provisions of this act, to fix the time and prescribe the manner in which such reports shall be made, and to require from such carriers specific answers to all questions upon which the Commission may need information. Such annual reports shall show in detail the amount of capital- stock issued, the amounts paid therefor, and the manner of payment for the same; the dividends paid, the surplus fund, if any, and the number of stockholders; the funded and floating debts and the interest paid thereon; the cost and value of the carrier's property, franchises, and equipment; the number of employees and the salaries paid each class; the amounts expended for improvements each year, how expended, and the character of such improvements; the earnings and receipts from each branch of business and from all sources; the operating and other expenses; the balances of profit and loss; and a complete exhibit of the financial operations of the carrier each year, including an annual balance-sheet. Such reports shall also contain such information in relation to rates or regulations

they existed during this period, "… had largely been defined by academic writings and general industry practices."[93] The accounting profession itself, was in its infancy and still developing as a professional organization.[94]

Accounting standards in the U.S. did not begin to take form until 1917 when attempts to standardize the auditor's report were commenced.[95] A report issued by the Federal Reserve Board in 1917 attempted to bring about uniformity in the preparation of financial statements used by banks, manufacturing and merchandising concerns. The report contained statements illustrating the preference for conservative accounting principles whenever financial statements were prepared.[96] This report can be regarded as an initial attempt to create accounting principles.

(c) Federal Securities Acts

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concerning fares or freights, or agreements, arrangements, or contracts with other common carriers, as the Commission may require; and the said Commission may, within its discretion, for the purpose of enabling it the better to carry out the purposes of this act, prescribe (if in the opinion of the Commission it is practicable to prescribe such uniformity and methods of keeping accounts) a period of time within which all common carriers subject to the provisions of this act shall have, as near as may be, a uniform system of accounts, and the manner in which such accounts shall be kept."

[93] BARRY J. EPSTEIN, RALPH NACH, STEVEN M. BRAGG, *WILEY GAAP 2008* INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, John Wiley & Sons, pg 2, (2007).

[94] However, it was not until the Hepburn Act (1906) that violations of accounting rules enacted under federal law could be enforced by fines or imprisonment. See Hepburn Act, 59th Congress, Sess. 1, Ch. 3591, 34 Stat. 584, (June 29, 1906).

[95] *See*, Federal Reserve Bulletin, April 1, 1917.

[96] See Federal Reserve Bulletin, April 1, 1917, under the caption *Securities*, "(w)here the market values of securities are less than the book values, save where the variation is so small as to be trifling, a reserve for loss in value on the balance sheet date must be set up." at page 274; See also under the caption *Inventories*, "The auditor should satisfy himself that inventories are stated at cost or market prices, whichever are the lower at the date of the balance sheet. No inventory must be passed which has been marked up to market prices and a profit assumed that is not and may never be realized." At page 275; See also under the caption *Cost of Fixed Property*, "The total of the balances at the beginning of the period must agree with the cost of property figures given in the balance sheet at that date…" at page 276.

The next attempt by the federal government to establish accounting standards followed the stock market crash of 1929 when Congress passed legislation aimed at eliminating abusive practices present in the capital markets. In 1933, Congress passed the Securities Act.[97] The Federal Trade Commission administered the Securities Act.[98]

Section 19(a) of the Securities Act provides that "the Commission shall have authority … to prescribe the form… in which required information shall be set forth, the items… to be shown in the balance sheet and earning statement, and *the methods* to be followed in the preparation of [the] accounts…"[99] The Securities Act requires that all companies registering securities for public distribution contain a balance sheet and an income statement that has been certified by an independent public or certified accountant.[100] Additionally, Schedule A requires that an issuer[101] of securities supply a prospective investor with a

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[97] 15 U.S.C.A. §§77a et seq.

[98] Section 4 of the Exchange Act created the SEC. See 15. U.S.C. §78d. Authority for the administration and enforcement of the securities laws was transferred from the FTC to the SEC upon the enactment of the Exchange Act.

[99] 15 U.S.C.A. §§77a , §19(a) of the Securities Act.

[100] There is no explanation offered in the committee reports distinguishing between an "independent" or a "certified" accountant. The question, "who is an independent accountant" within the meaning of the Securities Act was answered by George C. Mathews in an address to the Illinois Society of Certified Public Accountants by quoting "from a letter which was sent by the Chief of the Securities Division of the Federal Trade Commission, at the time that that Commission administered the Securities Act, … "With respect to the question of stock ownership (in the audited company), I do not believe that this can be answered categorically either with regard to the amount of stock which may be held or with regard to the persons by whom it may be held. A nominal stock holding which obviously would not influence the judgment of an accountant, would not, I believe, affect the accountant's independence. … In any case, I believe that the stock holdings of all persons, either partners or employees, who are concerned with work for a particular client of an accounting firm, should be taken into consideration and I do not believe that a firm can be deemed independent if such stock holdings in any case, either directly or indirectly, are more than nominal in amount." ADDRESS OF COMMISSIONER GEORGE C. MATHEWS of the SECURITIES AND EXCHANGE COMMISSION DELIVERED ON JANUARY 18, 1935, before the ILLINOIS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS.

[101] 15 U.S.C.A., §78c(a)(8) defines the term "issuer" in relevant part to mean "…any person who issues or proposes to issue any security…"

balance sheet[102] and an income statement[103] that has been "certified by an independent public or certified accountant…"[104]

President Roosevelt said in his message which accompanied the Securities Act that "[t]here is … an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."[105] President Roosevelt's message echos the sentiment that Louis Brandies described 20 years earlier, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[106] The national goal during this challenging period was to reverse the financial demise of the American economy. Congress envisioned attaining this goal through a system of reporting and disclosure.[107] In passing the Securities Act, Congress remarked that "[o]ne would have to turn the pages of history back to the days of the South Sea Bubble to find an equivalent fantasy of security selling."[108]

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[102] 15 U.S.C.A., Schedule A, item 25. Schedule A requires "a balance sheet as of a date not more than ninety days prior to the date of the filing of the registration statement showing all of the assets of the issuer … ((a)nd) all of the liabilities of the issuer…"

[103] 15 U.S.C.A., Schedule A, item 26. Schedule A requires "a profit and loss statement of the issuer showing earnings and income, the nature and source thereof, and the expenses and fixed charges in such detail and such form as the Commission shall prescribe…

[104] 15 U.S.C. 77aa, Schedule A, item 26. Schedule A requires "a profit and loss statement of the issuer showing earnings and income… Such statement shall be certified by an independent public or certified accountant."

[105] Message from the President of the United States transmitting a recommendation to Congress for Deferral Supervision of traffic in investment securities in interstate commerce. Franklin D. Roosevelt, March 29, 1933.

[106] Louis D. Brandeis, *What Publicity Can Do*, Harpers Weekly, December 20, 1913.

[107] "The background of the President's message is only too familiar to everyone. During the post-war decade [of the 1920's] some 50 billion[ ] [dollars] of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities…" Federal Securities Laws, Legislative History 1933 – 1982, Volume I, The Bureau of National Affairs, Inc., Washington D.C., pg. 139 (1983), citing H.R. 5480, report No. 85.

[108] Federal Securities Laws, Legislative History 1933 – 1982, Volume I, The Bureau of National Affairs, Inc., Washington D.C., pg. 140 (1983).

The following year, Congress passed the Exchange Act.[109] As part of the Exchange Act, Congress created the SEC for the purpose of monitoring and regulating the financial markets with the stated objective of instilling confidence in the capital markets.[110] In contrast to the Securities Act which addresses the primary market, the Exchange Act was designed to deal with the secondary markets.[111]

With one key distinction concerning accounting standards regulation, the Exchange Act contained language substantially similar to the Securities Act which provides that "[t]he Commission *may* prescribe, in regard to reports made pursuant to this title, the form …in which the required information shall be set forth, the items … to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports…"[112] The key difference in language between the two pieces of legislation is that the Securities Act mandates the creation of accounting standards through the use of the word, "shall", whereas the Exchange Act is more permissive with respect to standard setting with its use of the word, "may." This subtle difference in language may account in part for the SEC's deferential posture with respect to setting accounting standards. However, by failing to enact accounting principles, the SEC left open a regulatory void that was quickly filled by the accounting profession.

(d) Administrative Guidance

The SEC made two significant policy announcements in the years following the enactment of the securities laws with respect to accounting standards. First, in 1938 the SEC issued Accounting Series Release No. 4 (ASR 4) which provides that "[i]n cases where financial statements filed with this

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[109] Securities Exchange Act of 1934, 15 U.S.C.A. §§78a et seq.

[110] The SEC is charged with the responsibility of protecting investors. To that end, in addition to the Securities Act and the Exchange Act, Congress has passed several significant pieces of legislation which include, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, the Sarbanes-Oxley Act of 2002 and most recently, the Credit Rating Agency Reform Act of 2006. All of these acts have the common objective of protecting shareholders, instilling confidence in the capital markets and promoting transparency.

[111] Blacks Law Dictionary defines "primary market" as "(t)he market for goods or services that are newly available for buying and selling; esp. the securities market in which new securities are issued by corporations to raise capital. — Also termed "*original market*" and, "secondary market" as the market for goods or services that have previously been available for buying and selling; esp., the securities market in which previously issued securities are traded among investors. " Black's Law Dictionary, pg 984 (7th ed. 1999).

[112] Add citation _____.

commission pursuant to its rules and regulations under the Securities Act … or the … Exchange Act … are prepared in accordance with accounting principles for which there is *not substantial authoritative support*, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant."[113] (emphasis added).

The purpose of issuing ASR 4 was to provide public guidance concerning how financial statements should be prepared when submitted to the SEC. However, ASR 4 fails in several respects. First, nowhere does it indicate how or where one finds "substantial authoritative support". Second, nowhere does it define what is meant by the terms "substantial" or "authoritative", thereby leaving the application of this point unclear and subject to multiple interpretations. Finally, nowhere does ASR 4 indicate what criterion shall be used when crafting accounting principles.

The SEC's enactment of Regulation S-X in 1940 is the second significant action taken with respect to accounting standards. Regulation S-X "sets forth the form and content of and requirements for financial statements required to be filed…" with the SEC.[114] Regulations S-X also sets forth requirements concerning auditor independence, and general instructions for financial statements.[115] Although Regulations S-X has repeated references to GAAP, it does not define GAAP. Regulation S-X "…does not by itself define or impose any limitations or prerequisites concerning the accounting principles and practices used in preparing [financial] statements…"[116] Regulation S-X is singularly focused on the form

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[113] Accounting Series Release No. 4, Securities and Exchange Commission (1938). The second sentence of ASR 4 is significant because it signals a conciliatory tone by the SEC thereby reinforcing the perception that "difference(s) of opinion between the Commission and the registrant" will be tolerated.

[114] Regulation S-X, 17 CFR 210.1-01(a).

[115] Regulation S-X, 17 CFR 210.1-01(a).

[116] Arthur Andersen & Co. v. SEC, Fed.Sec. L.Rep. (CCH) Par. 95,720 (1976)

of financial statement presentation. The more compelling issues, namely the methods, processes, and standards of measurement, are nowhere mentioned.

It should be noted that there were few accounting standards and no official GAAP standards when the Exchange Act was passed.[117] Carman G. Blough, *Chief Accountant of the Securities and Exchange Commission* remarked that "[m]any accountants would probably question the soundness of certain principles that they follow from day to day if they stopped to consider them, but, in many cases, they follow the precedent of other accountants or the opinions of recognized authorities in whom they have confidence without reasoning the problem through to their own satisfaction."[118]

Established GAAP standards began appearing soon after the advent of national accounting organizations. Over time, GAAP evolved in importance as our national economy matured from a local, to a regional, to a national, and now an international economic community. GAAP has been relied upon by shareholders, managers, accountants, courts, legislators and the public, as the financial yardstick to be used in

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[117] "In September 1939, six years after the passage of the Exchange Act, the Committee on Accounting Procedure of the American Institute of Accountants issued the first three of a series of Accounting Research Bulletins. In Bulletin No. 1 the six "rules or principles" just referred to were reprinted under the caption "Rules Already Adopted" by the membership of the Institute. King, Earle C., *Selected Papers of Earle C. King,* Arno Press (1980); *See also,* JERRY J. WEYGANDT, TERRY D. WARFIELD, INTERMEDIATE ACCOUNTING, TWELFTH EDITION, at 6, John Wiley & Sons, (2007) "At the time the SEC was created, no group – public or private – issued accounting standards.".

[118] Carman G. Blough, *Chief Accountant of the Securities and Exchange Commission,* "Some Accounting Problems of the Securities and Exchange Commission", January 11, 1937 (Address before the NEW YORK STATE SOCIETY of CERTIFIED PUBLIC ACCOUNTANTS. He added further, "You all know how precedents of this kind may become established. An accountant has a peculiar situation that he thinks may best be treated by some digression from what he himself considers to be the best practice under normal circumstances. Again a very positive and valued client has taken a position contrary to the accountant's best judgment but, in the particular case, the accountant, because he thinks the principle at stake is not sufficiently important to cause him to withdraw, accedes to the wishes of his client. After a few cases of this kind by reputable firms, some accountant, hurried in a job, accepts such precedent without giving careful thought to the problem. Subsequently, some textbook writer relates the practice as an example of a procedure followed in some instances and this is, in turn, cited by others in support of the practice. Thus a large body of precedent is established for a procedure that was first reluctantly undertaken as an exception."

measuring financial performance. Noticeably absent however, was a standard which itself would be used to create and characterize the creation of new GAAP standards.[119]

(e) Diverging from Congressional Policy?

There were six recognized accounting standards during the 1930's.[120] A fair question to be considered therefore, is whether Congress envisioned the surge of accounting standards from those it may have initially contemplated when it passed both the Securities Act and the Exchange Act. The answer to this question is not entirely clear. However, what is clear is that when Congress enacted the Securities Act and the Exchange Act, it placed its confidence in the belief that audited financial statements would produce accurate financial reporting. It is also clear that during the time Congress was busy implementing the newly enacted securities laws, the accounting profession was growing increasingly concerned with the legal exposure auditors experienced when certifying financial statements. The Supreme Court of New York stated that "[a]ccountants . . . are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible. Accordingly, we see no reason to hold that the accountant is not liable to his employer in such cases."[121]

Regretfully, the development of accounting standards began to diverge from the Congressional mandate of fair disclosure. Congress, envisioned a disclosure system where "[a] balance sheet … gives an

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[119] The accounting profession eventually published a "conceptual framework" in May 1980. See Statement of Financial Accounting Concepts No. 2, (pg. Con2-4), describing the conceptual framework as "…a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards… " One writer describes the conceptual framework "…like a constitution…" KIESO, WEYGANDT, ET AL., pg. 28.

[120] See Address of Earle C. King, before the New Jersey Society of Certified Public Accountants, October 15, 1948, whereby he reports that "(i)n September 1939, the Committee on Accounting Procedure of the American Institute of Accountants (adopted) … the six "rules or principles" … under the caption "Rules Already Adopted" by the membership of the Insititute. See also, Maurice Moonitz, *Some Difficulties in the Pursuit of Accounting Principles*, where he reports that "in the late 1930's, T.H. Sanders (Harvard), H.R. Hatfield (California), and U Moore (Yale) prepared *A Statement of Accounting Principles* … which would be useful in the clarification and improvement of corporate accounting and of financial reports issued to the public…. For all practical purposes, the report was ignored both by practitioners and by academicians despite the fact that the report mirrored quire faithfully the best practice of the day."

[121] National Surety Corporation v. Lybrand 256 A.D. 226, 236 (1939).

intelligent idea of the assets and liabilities of the issuer and a profit and loss statement … gives a fair picture of its operations …"[122] However, the accounting profession quietly began migrating away from principles based standards which emphasized "fair disclosure" in favor of rules based standards which emphasized mechanical compliance.[123] The reason for this change in financial reporting philosophy was to address the accountant's increasing concern with personal liability. Certifying financial statements as being in accordance with GAAP no longer meant that the financial statements were *fairly presented* in accordance with GAAP, rather, it meant that the financial statements were *technically compliant* with GAAP.[124] This subtle but important change in creating accounting standards by private standard setters would eventually spawn the financial disasters that befell the United States at the beginning of the twenty first century.[125]

The question remains, why has the SEC consistently failed to create sound accounting standards?[126] It is indisputable that the SEC has the authority to legislate accounting rules. Both the Securities Act[127] and the Exchange Act[128] authorize the SEC to prescribe "the methods to be followed in the preparation of…" accounts for filings that companies are required to submit to the SEC. The concept of a free and ordered market carries with it the necessary implication that both the buyer and seller are acting in the exercise of an informed judgment in arriving at a fair price. Insofar as the judgment of either party is distorted by the

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[122] Federal Securities Laws, Legislative History 1933 – 1982, Volume I, The Bureau of National Affairs, Inc., Washington D.C., pg. 144 (1983).

[123] Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System.

[124] Auditing Standards Board, AU Section 411.

[125] *See*, James J. Park, *ASSESSING THE MATERIALITY OF FINANCIAL MISSTATEMENTS*, 34 J. Corp. L. 513, 554, (Winter, 2009), Enron's abuse of Special Purpose Entities led to inflation of Enron's income "by $28 million in 1997 (of $105 million total), by $133 million in 1998 (of $703 million total), by $248 million in 1999 (of $893 million total), and by $99 million in 2000 (of $979 million total)."

[126] *See*, Securities and Exchange Commission v. Nacchio, Slip opinion, 2009 WL 211511, 6, where the (d)efendants cite to deposition testimony in which SEC witnesses conceded that the agency relied on *private sector* standard setting bodies (*e.g.,* the Financial Accounting Standards Board ('FASB') to establish GAAP" relating to the transaction at issue (indefeasible rights of use, and swap transactions).

[127] 15 U.S.C.A. §19(a)

[128] 15 U.S.C.A. 13(b)(1)

presence of false, inaccurate, or incomplete financial information, the price will be distorted and the markets will fail to reflect the normal operation of the law of supply and demand.

Our national economy has evolved from one where investors sell goods with an intrinsic and immediately verifiable value, to an economy where vast sums of wealth is created by the sale and exchange of securities which do not have intrinsic and immediate value, but instead derive its value from assets reported through financial statements. One would reasonably expect the SEC in the interest of national economic stability to actively regulate the creation of accounting standards with the objective of ensuring certainty and confidence in the capital markets. Instead, it has been observed that "… we have drifted into a gambler's civilization, in which men are no longer inclined to invest their money in proven and honest business; but, believing they can make more money in the negotiation and sale of securities, sometimes upon a margin and upon a basis of gambling, our whole financial system has taken on the psychology of gambling instead of honest methods of … industry."[129] Is the "gambler's civilization" unstated SEC economic policy?

PART IV – GOVERNMENT OR PRIVATE STANDARD SETTER?

(a) SEC Structure

A related question relevant to the creation of accounting standards is "*who* should be creating accounting standards?" This question has been a point of continuing controversy. Is private industry the preferred standard setter or is it government? Or, quite possibly, is it someone who is external to the U.S. markets?[130] The debate concerning the creation of accounting standards has been present since the

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[129] Federal Securities Laws, Legislative History 1933 – 1982, Volume I, The Bureau of National Affairs, Inc., Washington D.C., pg. 172 (1983).

[130] The U.S. is currently examining whether the International Accounting Standards Board, should determine accounting standards for use within the United States. *See,* ROADMAP FOR THE POTENTIAL USE OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS BY U.S. ISSUERS, Federal Register, Vol. 73, No. 226. At 708166, (November 21, 2008). A study of IFRS is beyond the scope of this article. *But see,* Lawrence A. Cunningham, A PRESCRIPTION TO RETIRE THE RHETORIC OF "PRINCIPLES-BASED SYSTEMS" IN CORPORATE LAW, SECURITIES REGULATION , AND ACCOUNTING. 60 Vand. L. Rev. 1411 (October 2007) and, Robert H. Herz, Kimberly R. Petrone, INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS – PERSPECTIVES FROM THE FASB ON CHALLENGES AND OPPORTUNITIES, 25 Nw. J. Int'l L& Bus., 631, Spring 2005. The U.S. is presently studying the feasibility of adopting IFRS as a financial reporting system. There is

nineteenth century. At first blush, it appears that Congress answered this question when it created the SEC in 1934 and empowered it to establish accounting standards.

The SEC consists of four divisions: The Division of Corporate Finance,[131] The Division of Enforcement,[132] The Division of Investment Management,[133] and the Division of Trading and Markets.[134] Each Division is charged with a unique set of responsibilities designed to supervise and enforce compliance with the securities laws.

The mission of "The Division of Corporation Finance … is to see that investors are provided with material information in order to make informed investment decisions — both when a company initially offers its stock to the public and on a regular basis as it continues to give information to the marketplace. The Division of Corporation Finance also provides interpretive assistance to companies on SEC rules and forms and proposes new and revised rules to the Commission."[135]

The SEC policy of working in collaboration with the business community was shaped during the SEC's initial years. In a speech delivered by the SEC's first Chairman, Joseph Kennedy, he stated that "[p]aralyzing regulations are thoroughly un-American. No important rule or regulation will be adopted

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presently a healthy debate in the U.S. concerning the benefits and detriments of adopting IFRS as a reporting standard.

[131] SEC Website http://www.sec.gov/divisions/corpfin.shtml

[132] The Division of Enforcement investigates possible violations of securities laws, recommends Commission action when appropriate, either in a federal court or before an administrative law judge, and negotiates settlements. http://www.sec.gov/divisions/enforce.shtml last visited July 16, 2009.

[133] The Division of Investment Management regulates investment companies (such as mutual funds, closed-end funds, UITs, ETFs, and interval funds), including variable insurance products, and federally registered investment advisers. http://www.sec.gov/divisions/investment.shtml

[134] The Division of Trading and Markets establishes and maintains standards for fair, orderly, and efficient markets. The Division regulates the major securities market participants, including broker-dealers, self-regulatory organizations (such as stock exchanges, FINRA, and clearing agencies), and transfer agents. http://www.sec.gov/divisions/marketreg/mrabout.shtml last visited July 16, 2009

[135] SEC Website http://www.sec.gov/divisions/corpfin.shtml (last visited July 16, 2009).

without consultation with representatives of any class which might be affected thereby. No regulation will be passed which is not reasonably adapted to the accomplishment of the statutory objective. No promulgation by the Commission, I pledge you, shall involve any undue risk of embarrassment, expense, or liability to business."[136] This statement, foreshadowed what was to become the SEC's operating norm in the coming years.

The SEC faced considerable resistance from the business community as it began its task of administering the newly enacted securities laws. In an attempt to make the new securities laws more palatable to the business community, the SEC indicated that "[e]ffort has been made as far as possible to make the accounting requirements for registration of securities of going concerns[137] under the Securities Act consistent with those for the registration of securities on the exchanges."[138] This expressed desire to achieve parity in accounting with the exchanges profoundly influenced future action by the SEC. Moreover, the SEC added that it "... has carefully avoided requiring uniformity of accounting either as to matters of classification or as to matters of principle. It has provided for a degree of uniformity in methods of reporting the results of business operations and the financial condition of the business, but even here its requirements are not rigid."[139]

Concern for guidance and uniformity in accounting standards has been voiced since the enactment of the Securities Act and the Exchange Act. [140] The SEC originated its philosophy of yielding to the accounting

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[136] Address of Hon. Joseph P. Kennedy, Chairman of Securities and Exchange Commission, at Union League Club of Chicago, Ill., February 8, 1935.

[137] *Black's Law Dictionary* defines "going concern" as "(a) commercial enterprise actively engaging in business with the expectation of indefinite continuance." *Black's Law Dictionary* (8th ed. 2004). "There is, today, general agreement that the appropriate method for valuing fixed assets depends upon whether the accounts are prepared for a going concern or for a company about to be wound up. For the going concern, assets are normally reported at their 'value in existing use'. . . For the company about to be liquidated, it is the "value in alternative use' which is relevant, i.e. the market selling price." *Black's Law Dictionary* 113 (8th ed. 2004).

[138] Address of Commissioner George C. Mathews of the Securities and Exchange Commission delivered on January 18, 1935, before the Illinois Society of Certified Public Accountants, page 3.

[139] Address of Commissioner George C. Mathews of the Securities and Exchange Commission delivered on January 18, 1935, before the Illinois Society of Certified Public Accountants, page 4.

[140] In 1938, William O. Douglas, Supreme Court Justice, wrote to William Werntz, Chief Accountant, SEC, inquiring about a previous discussion he had with the Department of the

profession in establishing accounting standards during its formative years. The SEC stated that "[s]ince sound and informative accounting statements are basic under each of these Acts, the part played by the accountant in their administration is extremely important and much dependence is placed upon the results of [the accountant's] work."[141] The SEC added that "[s]ince most of the required financial statements must be certified by independent public or independent certified public accountants, the practical effect…is to leave the responsibility for the way in which the presentation is to be made, with certain expressed limitation, to the certifying accountant."[142] This concession by the SEC all but assured the accounting profession that the SEC will not take an active role in creating accounting standards.

(b) History of Private Standard Setter

The formation of the Committee on Accounting Procedure ("CAP") in 1939, a private organization of accountants, marks the first attempt by a national group of accountants to undertake the task of creating and organizing uniform standards. The CAP is also credited as being the first organization to use the term, "Generally Accepted Accounting Principle."[143] The CAP was in existence from 1939 to 1959. During its tenure, it issued 51 Accounting Research Bulletins (ARB) [144] designed to give the accounting profession guidance when recording financial transactions.[145]The CAP was dissolved in 1959 and replaced by its successor, the Accounting Principles Board (APB).

Treasury "relative to the possibility of the Treasury and the SEC working out greater uniformity in accounting practices." August 2, 1938 Letter from William O. Douglas to William Werntz.

[141] Add citation _____.

[142] *Some Accounting Problems of the Securities and Exchange Commission: Address of Carman G. Blough, Chief Accountant of the Securities and Exchange Commission, Before the New York State Society of Certified Public Accountants,* 2 (1937), http://www.sechistorical.org/collection/papers/1930/1937_0111_BloughNewYorkCPAT.pdf.

[143] Examination of Financial Statements by Independent Public Accountants, American Institute of Accountants,, New York, 1936.

[144] The accounting statements were issued under the nomenclature Accounting Research Bulletin (ARB).

[145] Accounting Research Bulletin No. 43 is a consolidation of the prior ARB's. It is captioned, "Restatement and Revision of Accounting Research Bulletins" (September 1, 1959), and includes a table illustrating the action taken (e.g. amended, deleted, etc.) on previously issued

The APB, another private member national organization, existed from 1959 to 1973. The stated objectives of the APB were "(a) to advance the written expression of accounting principles, (b) to determine appropriate practices, and (c) to narrow the areas of difference and inconsistency in practice."[146] During its tenure, the APB issued 31 accounting pronouncements, known as APB Opinions, regarding the suggested treatment of financial transactions. However, The APB met with considerable resistance from the accounting profession because of certain positions which it proposed.[147] In 1973, the APB was dissolved and replaced with the Financial Accounting Standards Board (FASB).[148]

FASB is recognized by accountants and the SEC[149] as the principal standard setting body for GAAP such that any FASB pronouncements are recognized as GAAP. Congress would eventually codify the SEC's authority to rely on private standard setters in 2002.[150] Since inception, FASB has issued 168 Financial

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statements. See Financial Accounting Standards Board, Original Pronouncements, as amended, 2007/2008 Edition, Volume III, John Wiley & Sons, Inc., ARB-2 and 3.

[146] Add citation _____.

[147] The APB and the SEC were unable to operate completely independently of the U.S. government. According to the SEC, "the over-all (*sic*) record of the APB was a reasonably good one, but it seems likely that a smaller full-time body directly in control of its research holds promise of more success." Burton, John C. (Chief Accountant, Securities and Exchange Commission), *General Thoughts on the Accounting Environment and Specific Thoughts on Accounting for Lease Financing: An Edited Transcript of a Talk Presented at the AGA-EEI Accounting Conference at The San Francisco Hilton*, 2 (1973), http://www.sec.gov/news/speech/1973/050773burton.pdf.

[148] "The FASB came into existence thirty-five years ago as the result of an ad hoc process looking toward the establishment of a viable standard setter under private auspices. The accountants' professional organization, the American Institute of Certified Public Accountants ("AICPA"), took the lead, with input from organizations and individuals representing management and the financial sector. The organizers had a high-powered incentive. They wanted a responsive standard setter without ceding territory to a federal agency, which in those days was associated with domination by progressive, anti-corporate types." See, William W. Bratton, Lawrence A. Cunningham, *TREATMENT DIFFERENCES AND POLITICAL REALITIES IN THE GAAP-IFRS DEBATE*, 95 Va. L. Rev. 989, 999 (June, 2009)

[149] See ASR # 150

[150] See 15 U.S.C. §77s which provides in relevant part that ". . . the Commission may recognize as 'generally accepted' for purposes of the securities laws, any accounting principles established by a standard setting body that is organized as a private entity, . . . has a board of trustees

Accounting Statements establishing GAAP. FAS 168, issued in June 2009, is the last accounting standard to be issued by FASB. It is a codification and descriptive hierarchy of GAAP.[151] Future FASB statements will not be issued. Instead, FASB "will issue Accounting Standards Updates ("ASU"). FASB will not consider ASU's as authoritative in their own right. ASU's will serve only to update the Codification…"[152] FAS 168 "identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements…"[153] FAS 168 is an ambitious undertaking and seeks to source the entire hierarchy of GAAP in one place. FAS 168 also introduces a new innovation in accounting standards, namely, the concept of authoritative and nonauthoritative GAAP.[154] FAS 168 permits management and accountants to select among both authoritative and nonauthoritative GAAP when preparing financial statements.[155]

Despite the SEC's conciliatory stance in regulating accounting standards, the accounting profession has demonstrated that it will aggressively object to the creation of new standards or enforcement actions by

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serving in the public interest, . . . has adopted procedures to ensure prompt consideration, by majority vote of its members, of changes to accounting principles and that the Commission determines has the capacity to assist . . . "

[151] FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARD (FAS), NO.168, THE FASB ACCOUNTING STANDARDS CODIFICATION AND THE HIERARCHY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES,(June 2009), ("FAS No. 168" or "Codification").

[152] FAS No. 168, Summary paragraph No. 2

[153] FAS No. 168, Introduction par. 2

[154] FAS 168, par. 10, "Sources of nonauthoritative accounting guidance and literature include, for example, practices that are widely recognized and prevalent either generally or in the industry, FASB Concepts Statements, … AICPA Issues Papers, International Financial Reporting Standards of the … IASB, pronouncements of professional associations or regulatory agencies, Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids, and accounting textbooks, handbooks, and articles. "

[155] "The new standard essentially reduces the GAAP hierarchy to two levels, one that is authoritative (in the codification) and one that is not (not in the codification)." *See* http://www.aicpa.org/download/fasb/Q&A-FASB-ASC-FINAL.pdf (last visited, October 7, 2009).

the SEC. The case of *Arthur Andersen v. Securities Exchange Commission ("Andersen")*[156] illustrates the tension that can arise whenever the SEC enacts new rules.

At issue in *Andersen* was whether the SEC had the authority to issue two disputed Accounting Series Releases (ASR).[157] The SEC issued ASR 150 and ASR 177. ASR 150 provides that "…standards and practices promulgated by the FASB in its statements and interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to FASB promulgations will be considered to have no such support."[158] ASR 177 "adopted a rule amending Instruction H(f) of Form 10-Q"[159] to require "that when a business enterprise changes an accounting principle or rule previously followed, the first quarterly financial report filed thereafter with the SEC must include a letter from the firm's independent accountant indicating whether the change to the alternate principle is preferable."[160]

The plaintiff, Arthur Andersen, sought an injunction seeking to restrain the SEC from implementing the disputed ASR's. Arthur Andersen argued that the SEC violated "the rule making provision of the Administrative Procedure Act… the SEC's own rule-making regulations… and generally the laws of the Constitution of the United States."[161] The District Court denied Arthur Andersen's motion for preliminary injunction reasoning as to ASR 150, that "… the SEC has said no more than it will henceforth, in making its long-standing inquiry into whether a financial statement has been prepared in accord with accepted

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[156] *Arthur Andersen v. Securities Exchange Commission*, 176WL 826 (N.D.Ill.) (1976).

[157] The 1944 SEC Annual Report states that "Accounting Series releases constitute the Commission's principal instrument, other than its formal decisions and reports, for informing the public as to its basic policy in accounting matters."

[158] Add citation _____.

[159] Form 10-Q is a form which must be filed on a quarterly basis by public companies with the SEC.

[160] *Arthur Andersen& Co. v. S.E.C.*, 1978 WL 1073, 2, (N.D.Ill.) (1976).

[161] *Arthur Andersen & Co. v. S.E.C.*, 1978 WL 1073, 1, (N.D.Ill.) (1976).

accounting principles, apply and look to the substantial authoritative support provided by the FASB…"[162] The court added "…the SEC has done no more that state the obvious."[163]

Regarding ASR-177, the court rejected Arthur Andersen's argument that Instruction H(F) "is arbitrary and capricious because it may prove impossible for an accountant's registrant client to comply with it."[164] The District Court noted that all ASR-177 "asks is that … a registrant's accountant state why the registrant has changed from one accepted method of principle of accounting to another. There must be a reason for the change. What harm can flow from articulating it."[165]

The suit between *Free Enterprise Fund and Beckstead and Watts, LLP v. Public Company Accounting Oversight Board* ("Free Enterprise Fund"),[166] illustrates yet another example where the accounting profession will aggressively defend its interests. The plaintiffs in this case are challenging the constitutionality of Title I of the Sarbanes-Oxley Act (SOX). "Congress passed [SOX] to improve the regulation of accounting firms."[167] The practical effect of Title I of SOX was to convert the accounting profession from a self regulated industry into a regulated industry. Title I of SOX creates the Public Company Accounting Oversight Board ("PCAOB"). "Title I of the Act established the PCAOB 'to oversee the audit of public companies that are subject to the securities laws … in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[168] Among its designated responsibilities, the PCAOB is charged with overseeing and setting accounting standards for use by the accounting profession. The issue in this case

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[162] *Arthur Andersen & Co. v. S.E.C.*, 1978 WL 1073, 3, (N.D.Ill.) (1976).

[163] *Arthur Anderson & Co. v. S.E.C.*, 1978 WL 1073, 3, (N.D.Ill.) (1976)

[164] *Arthur Andersen & Co. v. S.E.C.*, 1978 WL 1073, 4, (N.D.Ill.) (1976).

[165] *Arthur Andersen & Co. v. S.E.C.*, 1978 WL 1073, 5, (N.D.Ill.) (1976).

[166] Free Enterprise Fund and Beckstead and Watts, LLP v. Public Company Accounting Oversight Board, et al., 537 F.3d. 667 (2008). Certiorari granted, May 18, 2009, 129 S.Ct. 2378, 173 L.Ed.2d 1291.

[167] Harvard Law Review, pg 2267 , Vol 122:2267

[168] *See,* KIESO, WEYGANDT, ET AL. at 669. Audit reports must state whether the financial statements are prepared in accordance with generally accepted accounting principles.

is whether the creation of the PCAOB violates the Appointments Clause of the United States Constitution and separation of power principles.

The plaintiffs are "a non-profit public interest organization that 'promotes economic growth, lower taxes, and limited government… [and] … a Nevada accounting firm[169] that is registered with the Board and is [the] subject of an ongoing formal investigation…"[170] Writing for the Court of Appeals, Judge Rogers held that "the Fund's facial challenge to Title I of the Act fails to reveal violation of the Appointments Clause or separations of powers…"[171] The practical effect of a victory for the plaintiff in this case would be a return to an era of self regulation by the accounting profession – releasing from regulation, the very problem that led to the enactment of SOX.

(c) What is the Public Interest?

"There are different views about the nature and purpose of professions and their professional associations. The 'altruistic' approach regards professions as providing services which make a distinctive contribution to the smooth operation of society… The 'cynical' assessment is that the professions comprise groups of individuals pursing self-interest, striving to convince others of their entitlement to professional recognition and reward, and doing a job which is just enough to satisfy clients and maintain their professional status."[172] It is unrealistic and unreasonable to expect a private standard setter, whose members depend on satisfying the needs of their clients, to advocate for accounting standards which are in the public interest. Several factors support this assertion.

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[169] The accounting firm is Beckstead and Watts, LLP.

[170] Free Enterprise Fund and Beckstead and Watts, LLP v. Public Company Accounting Oversight Board, et al., 537 F.3d. 667, 670, (2008). Certiorari granted, May 18, 2009, 129 S.Ct. 2378, 173 L.Ed.2d 1291.

[171] Free Enterprise Fund and Beckstead and Watts, LLP v. Public Company Accounting Oversight Board, et al., 537 F.3d. 667, 685, (2008). Certiorari granted, May 18, 2009, 129 S.Ct. 2378, 173 L.Ed.2d 1291.

[172] JOHN RICHARD EDWARDS , A HISTORY OF FINANCIAL ACCOUNTING, at 276.

First, neither private standard setters generally nor accountants specifically, bear a legal duty or responsibility to establish rules that are meant to benefit society.[173] This statement is true despite the Supreme Court's pronouncement in *U.S. vs. Arthur Andersen* that "[b]y certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[174]

Second, the proper role for private organizations advocating for commercial change is to improve and facilitate the markets to permit continued growth and innovation.[175] It is not to assume the role of a public caretaker, however altruistic. Managing and overseeing the public welfare is a governmental function, not a private organizational function. History bears out that the membership of the private standard setter will voice opposition and exert considerable pressure if a particular pronouncement will have an adverse impact upon clients.[176] It is reasonable, even expected, to believe that the ultimate motivation of the

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[173] *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179 (1931), is the touchstone case examining accountants' liability.[173] The plaintiff alleged that the defendants acted negligently and fraudulently when certifying the company's financial statements and sued the accountants. The defendants, a firm of public accountants, were employed "to prepare and certify a balance sheet exhibiting the condition of its business as of December 31, 1923." The plaintiff suffered financial losses as the result of lending money on the strength of the "balance sheet certified by the public accountants." Justice Cardozo, writing for the majority reversed the trial court's judgment against the defendants reasoning "(i)f liability for negligence exits, (then) a thoughtless slip or blunder, the failure to detect a theft of forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."

[174] United States v. Arthur Young & Co. 465 U.S. 805, 817-818 (1984).

[175] Frank H. Easterbrook, Daniel R. Fischel *MANDATORY DISCLOSURE AND THE PROTECTION OF INVESTORS,* 70 Va. L. Rev. 669, 688 (May, 1984). "Accountants … serve as intermediaries. … (T)o the extent accountants agree on a common language, they serve the function of standardizing (reducing the costs of) any amount of disclosure. Accountants spread over all firms the costs of creating and maintaining the standard language. Of course accountants may face pressures from individual firms to misuse their language, or they may be unable to agree on a common language at all …"

[176] Consider for example, the opposition raised by companies and the accounting profession during the debates for stock option expensing.

membership of any private standard setter is self interest, and not public duty. To believe otherwise, is foolhardy.

Third, there is a disturbing trend in accounting standards. Originally, accounting standards were restrictive in the sense that they were conservative and sought to minimize the overstatement of values.[177] Accounting standards at the time the Securities Act and the Exchange Act came into effect are entirely different from GAAP standards being adopted today. Accounting standards used during the early period of the Securities Act and the Exchange Act were conservative in posture.

Recently however, there has been a marked shift away from standards which follow the principle of conservatism,[178] to standards which follow the fair value principle.[179] Fair value accounting results in artificial increases to the value of the company and its portfolio value to shareholders. Although no reasonable investor will object to increased portfolio values, two immediate problems arise with this approach. One problem is that value creation activities should be done through legitimate company operations involving legitimate growth and market opportunities. Value creation should not be occurring through the niceties of accounting techniques which are now deployed by companies as if they were intangible assets. Another problem is that the further we stray into the concept of fair value accounting and away from the notion of conservatism, the greater the likelihood that company management will manipulate measurements and values, thereby ultimately steepening the decline in the event of another

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[177] For example, the lower-of-cost-or market inventory method is "a conservative approach to inventory valuation." See KIESO, WEYGANDT, ET AL. pg. 423. See also, ARB No. 43, Chapter 4, Par 9 (June 1953). "The rule of cost or market, whichever is lower is intended to provide a means of measuring the residual usefulness of an inventory expenditure."

[178] Statement of Financial Accounting Concepts (SFAC) No. 2, Qualitative Characteristics of Accounting Information, par. 91 provides "(f)requently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism … (Quoting APB Statement 4, paragraph 171).

[179] See SFAS 107, par 10, (Dec. 1991), "An entity shall disclose, either in the body of the financial statements or in the accompanying notes, the fair value of the financial instruments for which it is practicable to estimate that value." See also, SFAS 133, par 3 b., Accounting for Derivative Instruments and Hedging Activities , (June 1998), "Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value…"

financial meltdown.[180] Fair value accounting has merit. However, the decision whether to pursue it should be undertaken by a federal entity with a public interest, and not by a private standard setter lacking a positive public duty.

PART V - GAAP'S INFLUENCE BEYOND SECURITIES LAW

(a) Federal Level Influence

Government intervention in establishing accounting standards is warranted when one considers that GAAP has expanded beyond the domain of securities regulation. Congress has adopted GAAP as the preferred measurement standard, not only within a securities laws context, but in other areas of federal regulation.[181] For instance at the federal level, the Department of Agriculture requires that an entity's accounting records comply with GAAP before the entity is eligible to receive federal funds;[182] federal banking legislation requires that a bank's "core capital" be calculated in accordance with GAAP;[183]

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[180] Critics of fair value accounting point to the fact that the fair value determination is a subjective standard and that companies will be involved "gains trading" as they cherry pick their asset reporting to maximize the company value. See KIESO, WEYGANDT, ET AL. pp 860 – 861.

[181] GAAP's reputational influence, be it real or perceived, is akin to the Good Housekeeping seal of approval and has garnered the favor of our legislators.

[182] (F) Accounting

> To be eligible to receive amounts from the Fund, an entity must agree to account for the amounts using generally accepted accounting principles.

[183] 12 U.S.C.A. §4502 (7) Core capital

> The term "core capital" means, with respect to an enterprise, the sum of the following (as determined in accordance with generally accepted accounting principles):
>
> **(A)** The par or stated value of outstanding common stock.
>
> **(B)** The par or stated value of outstanding perpetual, noncumulative preferred stock.
>
> **(C)** Paid-in capital.
>
> **(D)** Retained earnings.

federal legislation also requires that all reporting of Troubled Asset Relief Program (TARP)[184] fund activities be made in accordance with GAAP;[185] and, federal legislation dealing with American Indian tribe reporting requires GAAP compliant statements to retain federal benefits.[186] GAAP bears directly upon the substantive legal rights of persons in areas beyond securities regulations albeit with no legislative or administrative guidance.[187]

(b) State Level Influence

The argument for governmental intervention intensifies when one considers that GAAP has also been influential at the state level. Many state governments have incorporated GAAP in state legislation as the standard of measurement for financial transactions. The implication is that GAAP will provide the legislation with a fair degree of certainty in its enforcement. For example, state legislatures in Delaware,[188] New York,[189] Illinois[190] and California,[191] have all adopted GAAP in their respective

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[184] Public Law 110-343, 122 Stat. 3765, enacted October 3, 2008.

[185] 12 U.S.C.A. §5226 (b)(1)(b) Comptroller general audits

(1) Annual audit

The TARP shall annually prepare and issue to the appropriate committees of Congress and the public audited financial statements prepared in accordance with generally accepted accounting principles.

[186] See, 25 U.S.C.A. § 3304, which provides in relevant part that . . . "(t)he Secretary may revoke the eligibility of an Indian tribe for a grant under this subchapter if such tribe . . . fails to submit to the Bureau an annual financial statement that reports revenues and expenditures determined by use of an accounting system, established by the tribe, that complies with generally accepted accounting principles."

[187] Private parties can agree on how to measure rights and responsibilities through the device of contract. However, when a system of measurement has a broader public impact, it then becomes necessary for governmental intervention to help determine the underlying rights and responsibilities of parties who are both relying upon a system of measurement which was created without either party's expressed mutual assent.

[188] 8 Del. C. §503, "Interests in entities which are consolidated with the reporting company shall be included within "total assets" and "total gross assets" at a value determined in accordance with generally accepted accounting principles."

[189] New York Banking Law §651 (McKinney 2003), provides in relevant part that "(e)very licensee … shall at all times maintain permissible investments having (i) a market value, computed in

legislation. GAAP is now influencing state corporation statutes, trust and estates law, banking law, commercial law, and non-profit law.[192]

GAAP also influences state level litigation. *Peco Energy Company v. Commonwealth of Pennsylvania*, (Peco),[193] is an example of this influence. In Peco, the dispute between the parties centered on the interpretation of "cost" for purposes of a tax computation under the Public Utility Realty Tax Act (PURTA).[194] The taxpayer, Peco Energy Company, "allege[d] that the plain language of [the statute] indicate[d] that the cost to be used is the cost 'as shown on the books of account of a public utility.'"[195] Peco contends that the meaning of the term "cost" includes a deduction for asset impairment which is in accordance with GAAP. However, the Commonwealth of Pennsylvania argued that the term "cost" means only, "original cost" and does not include a deduction for asset impairment. The difference in interpretation would directly affect the Commonwealth of Pensylvania's tax revenues. The Supreme Court of Pennsylvania held for the taxpayer noting that "the Legislature is presumed to understand that

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accordance with generally accepted accounting principles, … or (ii) a net carrying value, computed in accordance with generally accepted accounting principles… "

[190] § 760 ILCS 15/9. Business and farming operations. Section 9 provides in relevant part "… (a) If a trustee uses any part of the principal in the operation of a business or, except as provided in subsection (b), an agricultural or farming operation, including the raising of animals or the operation of a nursery, the net profits and losses shall be computed in accordance with generally accepted accounting principles…",

[191] Ca. Ch.12.5, Art. 4, §8880.41. , "The director shall make and keep books and records that accurately and fairly reflect each day's transactions . . . so as to permit preparation of financial statements in conformity with generally accepted accounting principles . . ."

[192] For example, the California Attorney General maintains that "(t)he charitable solicitation statutes, such as *B & P C §§ 17510.3* and *17510.4*, requiring certain affirmative disclosures by solicitors of donations, *B & P C § 17510.5*, requiring business records and disclosures be based on GAAP as defined by AICPA and the Financial Accounting Standards Board…" citing *California. People v. Orange County Charitable Services (1999, Cal App 4th Dist) 73 Cal App 4th 1054, 87 Cal Rptr 2d 253,* review denied.

[193] See Peco Energy Company v. Commonwealth of Pennsylvania, 591 Pa. 405, 919 A.2d 188 (2007).

[194] 72 Pa.C.S. §§8101-A-8109-A.

[195] Peco Energy Company v. Commonwealth of Pennsylvania, 591 Pa. 405, 407 (2007).

different terms mean different things"[196] and therefore, it knowingly chose the intended standard. The Supreme Court of Pennsylvania further reasoned that the taxpayer's position "is born out by the uncontroverted testimony in the expert [accountant's] reports … as well as by the actual language of SFAS 71 and 121"[197], the applicable GAAP standards.

While Congress and state legislatures seem willing to adopt GAAP as a standard, courts have grappled with the application of GAAP as a standard and have reached surprisingly conflicting results. Some courts have upheld the application of GAAP, while other courts have rejected it. The inconsistent position taken by courts when interpreting GAAP contributes to the confusion surrounding GAAP. The lack of definitive guidance by the government only exacerbates the state of confusion.

(c) Instance of Cases Accepting GAAP

These following cases illustrate the willingness by some courts to embrace GAAP as a financial standard. In some instances, courts will look to GAAP for guidance in resolving the conflict and in determining the rights of the litigants.

(i) *Salant Corporation v. United States*

In *Salant Corporation v. United States*,[198] the Court of International Trade (CIT) issued an opinion sustaining a decision by the U.S. Customs to include "fabric waste generated during the manufacturing process of imported shirts" as an element of taxable value.[199] The Customs office took the position that product waste is a taxable component of the finished good. Specifically, the Customs office argued that product waste[200] is considered an "assist" under the relevant statute [201] and therefore, is to be *included* in

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[196] Peco Energy Company v. Commonwealth of Pennsylvania, 591 Pa. 405, 411 (2007).

[197] Peco Energy Company v. Commonwealth of Pennsylvania, 591 Pa. 405, 409 (2007).

[198] *Salant Corporation, v. UNITED STATES,* 24 C.I.T. 24, 86 F.Supp.2d 1301, (2000).

[199] *Salant Corporation, v. UNITED STATES,* 24 C.I.T. 24, 86 F.Supp.2d 1301, (2000). "Prior to 1995, Customs excluded the value of waste and scrap from the value of an assist. In 1995, Customs published, for comment, a notice changing this policy." See, 35 INTLLAW 321, International Lawyer, CUSTOMS LAW, Summer, 2001, page 326, Matthew T. McGrath, Robert A. Shapiro.

[200] The term "product waste" is also known as shrinkage or slippage.

[201] See 19 U.S.C.A. §1401a(h)(1)(A)

determining the value of the article for custom valuation purposes. Salant Corporation ("Salant") objected to this approach arguing instead that product waste is not an element to be included when valuing an article. Salant challenged the determination by the U.S. Customs Department and brought suit.

The CIT noted that its task was "to determine based upon the legislative intent and statutory language, whether or not Customs' interpretation of the assist statute was correct…"[202] The court began its analysis by invoking the standard articulated in *Chevron U.S.A. Inc. v. Natual Resources Defense Council, Inc.,*[203] which instructs that "[w]hen a court reviews an agency's construction of the statute which [the agency] administers, [the court] is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[204] Finding that Congress had not directly spoken to the precise question at issue, the CIT determined that this case was a matter of statutory construction and therefore, decided the case, in part, on that basis.

The CIT reasoned that as the final authority on issues of statutory construction, it employs the traditional tools of statutory construction and therefore finds that the fabric waste comes within the plain meaning of the term "assist". The CIT further reasoned that "Congress intended the valuation statute to be interpreted in accordance with Generally Accepted Accounting Principles."[205] The CIT stated that Customs "appropriately draws the inference that because inclusion of fabric waste in the definition of an assist is in accordance with GAAP, inclusion of fabric waste in the definition of an assist is in accordance with

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[202] *Salant Corporation, v. UNITED STATES,* 24 C.I.T. 24, 86 F.Supp.2d 1301, 1303, (2000).

[203] *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*467 U.S. 837, 104 S.Ct. 2778, (1984)

[204] *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.* 467 U.S. 837, at 842-43 (1984).

[205] *Salant Corporation v. UNITED STATES,* 24 C.I.T. 24, 86 F.Supp.2d 1301, 1306, (2000).

Congressional intent"[206] and ultimately held in favor of the government. The Congressional preference for GAAP clearly influenced the outcome of this case. [207]

Three observations are required at this point. First, there is no GAAP standard identifying the accounting treatment for waste.[208] Waste (or its variants) are terms that are used by accountants and businessmen to identify product that is not fully utilized when taken from its raw and unprocessed stage to its final and manufactured stage, priming it for sale to a customer or consumer. Therefore, the courts reliance on a GAAP standard in this case is misplaced. Second, the court is confusing financial accounting concepts, which are intended for external users,[209] with managerial accounting concepts, which are intended for internal users.[210] Finally, Salant illustrates the challenges courts must face in resolving financial disputes when presumed terms are not clearly defined by statute or administrative guidance.

(ii) Continental Web Press, Inc., v. National Labor Relations Board

Continental Web Press, Inc., v. National Labor Relations Board is another example where a court embraces the use of GAAP. After prevailing in litigation, the plaintiff, Continental Web Press, Inc., (Continental) applied for an award of "roughly $18,000 in attorney's fees and related expenses under the Equal Access to Justice Act [EAJA] which allows …awards if the government's position is not

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[206] *Salant Corporation v. UNITED STATES,* 24 C.I.T. 24, 86 F.Supp.2d 1301, 1307 (2000). See also, *IPSCO, Inc. v. United States,* 12 CIT 384, 388, 687 F.Supp. 633, 636, n. 3 (1988) for the proposition that "for purpose of making other determinations under the antidumping laws, Congress has approved use of generally accepted accounting principles." H.R. Rep. No. 571, at 71 (1st Sess., 1973).

[207] The CIT further notes that Customs "cites IPSCO, Inc. v. United States for the proposition that "for purpose of making other determination under the antidumping laws, Congress has approved use of (GAAP)". See. footnote 4.

[208] Waste can also be called, shrinkage, slippage or spoilage. Jan Willimas, Sue Haka, et al., *Financial & Managerial Accounting, The Basis for Business Decisions.* Fifteenth Edition,(2010) Pg. 253. Inventory shrinkage refers to unrecorded decreases in inventory resulting from such factors as breakage spoilage, employee theft, and shoplifting.

[209] An external user of financial statements includes shareholders and creditors.

[210] An internal user of financial statements includes directors, officers and corporate management.

'substantially justified'".[211] The National Labor Relations Board (NLRB) argued against the award. The relevant statute provides that "[t]o be entitled to attorney's fees … a firm must have either a net worth no greater than $5 million or no more than 500 employees."[212] Unfortunately for the litigants, Congress did not define the meaning of the term "net worth". The Court of Appeals reviewed the question of whether Continental's "net worth" was less than $5 million. If so, then Continental would be eligible for a recovery of attorney's fees.

Continental argued that its net worth value was less than $5 million dollars. Continental maintained that a deduction for depreciation expense is permitted. The depreciation expense deduction brought Continental's net worth below $5 million dollars thereby making it eligible for attorney's fees. GAAP allows an expense deduction for depreciation charges.[213] The National Labor Relations Board (NLRB) however, argued that depreciation expense should not be allowed in determining Continental's net worth. The NLRB maintained that the legislative history of the EAJA provided that "[i]n determining the value of assets, the cost of acquisition rather than the fair market value should be used."[214]

The Court of Appeals rejected the NLRB's argument. It reasoned that nothing in the legislative record indicated that Congress meant "the cost of acquisition" to mean, the "*undepreciated* cost of acquisition." (emphasis added). Instead, the Court of Appeals noted that "Congress did not define the statutory term, 'net worth.'"[215] Therefore, the Court of Appeals surmised that "[i]t seems a fair guess that if it had thought about the question, it would have wanted the courts to refer to generally accepted accounting

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[211] Continental Web Press, Inc., v. National Labor Relations Board, v. Chicago Local 245, Graphics Arts International Union, AFL-CIO, 767 F.2d 321, 322, (1985).

[212] 28 U.S.C. §2412(d)(2)(B) as in effect on December 24, 1984. "(T)he Act in Question expired shortly after (the court's) decision (the expiration does not affect this (decision), however)…"

[213] "Companies may use a number of depreciation methods, as follows: Activity method, Straight-line method, Decreasing charge methods (such as the Sum-of-the-years'-digits (and) Declining-balance method." See, Donald E. KIESO, WEYGANDT, ET AL., Jerry J. Weygandt, Terry D. Warfield, Intermediate Accounting, Twelfth Edition, pg.525, John Wiley & Sons, (2007).

[214] Continental Web Press, Inc., v. National Labor Relations Board, v. Chicago Local 245, Graphics Arts International Union, AFL-CIO, 767 F.2d 321, 323, (1985), citing to H.R. Rep. No. 1418, 96th Cong., 2d Sess. 15 (1980).

[215] Add citation _____.

principles. What other guideline could there be? Congress would not have wanted us to create a whole new set of accounting principles just for use in cases under the EAJA."[216]

As in *Salant*, the court in *Continental Web Press, Inc., v. National Labor Relations Board* incorporates into its reasoning, a presumption that Congress would have favored a GAAP treatment in this instance. It is noteworthy to point out that there is no defined GAAP standard identifying the term "net worth."[217] However, at least one court has defined the term net worth to mean "assets minus liabilities."[218]

(d) Instance of Cases Rejecting GAAP

One consequence of the lack of guidance by the federal government in defining GAAP, is that unrestrained and contrasting interpretations can be given to a transaction. Inconsistent application of GAAP has created uncertainty in compliance and enforcement efforts by the public and regulators. At times, GAAP is accepted by the courts and at other times, it is rejected. As stated by one court, "GAAP does not constitute legal authority for the propriety of a given accounting method; rather, GAAP is merely a nondispositive statement of customary accounting practices."[219] The following cases reflect the tension created by such a "nondispositive" approach.

(i) Thor Power Tool Co., v. C.I.R.

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[216] See also, *Broaddus v. U.S. Army Corps of Engineers*, 380 F.3d 162, 166 C.A.4 (Va.),2004. "We agree with our sister circuits that GAAP applies to EAJA, and net worth is calculated by subtracting total liabilities from total assets."

[217] "What should be included in net income has been a controversy for many years." Kieso, pg. 134. See also, John Richard Edwards, A History of Financial Accounting, Chapter 8, pg 77-79, for an interesting discussion of early profit calculations ("The Roman agricultural writer Columella (circa 60 AD) made an estimate of the profits to be derived from vine growing and compared it with the return which could be obtained by instead investing the money at 6%.")

[218] See also, *Ramco Oil & Gas, Ltd. v. Anglo Dutch (Tenge) L.L.C.*, 171 S.W.3d 905, 915, (2005) ("While determining "net worth" under GAAP may be quite complicated and may involve different considerations . . ., the unambiguous meaning of this term is the difference between total assets and total liabilities determined in accordance with GAAP.").

[219] Doyon, LTD. V. U.S. 42 Fed. Cl. 175, 185-186, (1998).

Thor Power Tool Co., v. C.I.R.,[220] ("Thor") is the seminal case illustrating a rejection of GAAP. Thor manufactured "hand-held power tools, parts and accessories and rubber products."[221] Thor's tools required between 50 to 200 parts each. Manufacturers like Thor, require a sizeable product inventory to continue production. Thor's management adopted a policy of maintaining "liberal quantities" of inventory items in order to reduce inventory stock-outs and avoid "delays in filling orders." Thor used the lower of cost or market inventory method (LCM) to calculate inventory costs, an inventory method approved by GAAP.

In 1960, Thor's management initiated the practice of writing down inventory costs at 10% per year so that the entire cost of the product was written off over a 10 year period. Four years later, a new management team was installed. The new management determined that the recorded inventory values were overstated. As a result, Thor adopted a new inventory policy and recalculated its inventory values. The new inventory policy, another GAAP approved method, resulted in a loss in inventory value to Thor.

Thor's approach in calculating the new inventory values was consistent with GAAP.[222] Thor reported this new value and the resulting inventory write-off on its tax return. On audit however, the Internal Revenue Service rejected Thor's inventory write-off deduction.

Thor arranged the inventory write downs into three categories. Deductions for the first two categories of inventory were allowed because these items were scrapped by Thor.[223] However, deductions for the third category [224] were disallowed because despite reducing the inventory value, Thor failed to "scrap" these items. Instead, Thor retained the scrapped inventory on hand and held it out for sale. Thor's justification for determining the inventory write down for this third category was based on two methods. First, the

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[220] *Thor Power Tool Co., v. C.I.R.*, 439 U.S. 522, (1979)

[221] *Thor Power Tool Co., v. C.I.R.*, 439 U.S. 522, 525 (1979)

[222] 64 T.C. 154, 155 (1975). Thor calculated its inventory value using the current replacement costs of units method. It changed to the current net realizable value method.

[223] Group 1 inventory items consisted of obsolete, damaged or defective inventory items with a value of $2.75 million dollars. Group 2 inventory items consisted of inventory parts for unsuccessful products. Both groups were scrapped and disposed. *Thor Power Tool Co., v. C.I.R.*, 439 U.S. 522, 99 S.Ct. 773 (1979)

[224] Group 3 consisted of "excess" inventory which Thor "did not immediately scrap or sell at reduced prices." *Thor Power Tool Co., v. C.I.R.*, 439 U.S. 522, 529, (1979).

inventory write down was justified based on Thor's president's 20 year industry experience. He rationalized that a 20 year write down period was proper in this instance. Second, Thor defended its decision to the inventory write down based on its naked assertion of a "best estimate."

Thor argued that its deduction for an inventory write-off expense was based on GAAP and therefore, the deduction should be allowed. The IRS countered and stated that compliance with GAAP was not the sole measure of financial performance. The IRS argued that consistent with IRC 446(b), the method used in calculating income or expense, must "clearly reflect income."[225]

The Tax Court concurred with the IRS's position. The Tax Court held that consistent with the Income Tax Code and the Income Tax Regulations, a determination of income must clearly reflect income. The Tax Court found that the excess inventory write down did conform with GAAP. However, the Tax Court rejected Thor's reliance on GAAP stating that "conformance with GAAP is not enough." The Court recognized that "… the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes on the other, need not necessarily be the same."[226]

The second issue addressed by the court dealt with whether Thor should be entitled to an additional deduction for bad debts. "During 1965, Thor's new management took a stringent review of the accounts receivable"[227] and had determined that an additional deduction for bad debts in the amount of $136,150 was warranted. The increased deduction was based on the professional judgment of three levels of Thor's management. The IRS rejected this deduction claiming the amount was excessive. According to the IRS the correct amount of the additional deduction was $61,359.20. This amount was determined by the IRS after examining Thor's average annual chargeoffs[228] over a six-year period and applying that amount to the outstanding balance of the accounts receivable.

Thor clearly illustrates the IRS's authority to reject GAAP principles whenever the Commissioner believes that the basis of calculating income or expense does not clearly reflect income. Thor further demonstrates that adopting a GAAP method for financial reporting purposes, does not ensure its acceptance by regulators or courts outside of a financial reporting context. The result in Thor can be

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[225] 26 U.S.C.A. §446(b)

[226] *Thor Power Tool Co., v. C.I.R.*, 439 U.S. 522, 541, (1979).

[227] *Thor Power Tool Co., v. C.I.R.*, 439 U.S. 522, 546, (1979).

[228] The term "chargeoff" means recording an expense or charge against income.

explained from several different perspectives. First, this case stands for the proposition that taxable income and financial income do not need to be determined on the same basis or use the same methodologies. Given the differing objectives between the two structures (GAAP and tax), it is reasonable to expect that differences will exist. Second, the IRS is charged with the responsibility of protecting the public treasury. As such, in its role as the guardian of the public coffers, it will not permit charges against the treasury unless such charges are clear, definite and determinable. Finally, the taxpayer's failure to dispose of the inventory and its justification for bad debt expenses were fraught with inconsistent actions and unsubstantiated assertions which invited the only reasonable response from the IRS under these circumstances.

(ii) Shalala v. Guernsey Memorial Hospital.

Shalala v. Guernsey Memorial Hospital[229] is another case in which the federal government rejected GAAP as the relevant financial standard. The plaintiff, Guernsey Memorial Hospital ("Guernsey"), issued bonds to fund a capital improvements project. The bonds were refinanced several years later to take advantage of a change in interest rates. The refinancing transaction generated "an estimated $12 million" dollars in interest expense savings. However, the refinancing transaction resulted in an "advance refunding or defeasance loss, of $672,581."[230] Guernsey sought a reimbursement from Medicare for the loss of approximately $314,000. The amount of the loss was not at issue. However, the timing and the resulting recognition of the loss was at issue. Guernsey wanted payment of the loss in the year the loss was incurred. The defendant, the Secretary of Health and Human Services ("HHS") however, wanted to amortize the loss over the life of the loan.

Guernsey based its reimbursement claim on two regulations[231] and argued that GAAP controlled the determination. First, Guernsey argued that the applicable regulation allows for reimbursement of reasonable costs provided to program beneficiaries. Guernsey calculated its reimbursement in accordance

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[229] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, (1995)

[230] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 90 (1995). "The particular costs at issue in this case are known technically as "advance refunding" or "defeasance" costs: costs incurred in connection with the refunding of bonded mortgage indebtedness ahead of schedule in order to obtain new financing." See, *Shalala v. Guernsey Memorial Hospital*, 996 F.2d 830, 831 (1993).

[231] 42 CFR 413.20 (a) and 42 CFR 413.24. Guernsey ". . . contends that two of these regulations . . . mandate reimbursement according to GAAP. . ." See *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 92 (1995).

with this regulation.[232] Second, Guernsey argued that the regulations require that reimbursements be "based on the accrual basis of accounting."[233] Guernsey argued that the Medicare regulations "mandate reimbursement according to GAAP."[234] The HHS disagreed with Guernsey's argument and rejected its claim for reimbursement. The HHS argued that it is not bound to follow GAAP when determining expense reimbursements. The HHS forcefully argued that the regulation relied upon by Guernsey, "does not bind [it] to reimburse according to GAAP."[235] Instead, the HHS relied upon the Medicare Act which it maintained "authorizes the [HHS] to promulgate regulations "establishing the method or methods to be used" for determining reasonable costs [and,] directs it to "consider, among other things, the principles generally applied by national organizations or established prepayment organizations in computing reimbursement amounts."[236]

Even more startling, the HHS sought to rely upon "an informal Medicare reimbursement guideline" [237] in support of its position, instead of relying on published regulations. The HHS argued that it is entitled to issue and follow, its own informal Medicare reimbursement guideline.[238] Contrary to the position

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[232] 42 C.F.R. 413.20(a) provides "(t)he principles of cost reimbursement require that providers maintain sufficient financial records and statistical data for proper determination of costs payable under the program. Standardized definitions, accounting, statistics, and reporting practices that are widely accepted in the hospital and related fields are followed. Changes in these practices and systems will not be required in order to determine costs payable under the principles of reimbursement. Essentially the methods of determining costs payable under Medicare involve making use of data available from the institution's basis accounts, as usually maintained, to arrive at equitable and proper payment for services to beneficiaries."

[233] Shalala pg 95. The Supreme Court notes that "Section 413.24 requires that a provider's cost data be based on the accrual basis of accounting, in which `revenue is reported in the period when it is earned, regardless when it is collected and expenses are reported in the period in which they are incurred, regardless of when they are paid."

[234] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 92, (1995).

[235] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 94, (1995)

[236] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 91-92, (1995), Citing 42 U.S.C. §1395x(v)(1)(A).

[237] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 90, (1995) See U.S. Dept. of Health and Human Services, Medicare Provider Reimbursement Manual §233 (Mar. 1993 ("PRM").

[238] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 90, (1995).

proposed by Guernsey, the HHS reimbursement guideline established the principle that defeasance losses will be amortized over the life of the loan.[239]

The Court considered "whether the Medicare regulations require reimbursement according to generally accepted accounting principles (GAAP)."[240] In conducting its analysis, the Supreme Court scrutinized the content and the structure of the regulations.[241] The Supreme Court noted that GAAP is ". . .a beginning point from which the Secretary 'arrive[s] at equitable and proper payment for services.'" [242] However, GAAP is not the end point. The Supreme Court flatly rejected Guernsey's contention that the relevant GAAP standard, APB Opinion 26[243], controls the accounting treatment of this transaction. Instead, the Supreme Court supported the assertion by the HHS that reimbursement occur under its informal guidance. The majority noted that "GAAP 'does not necessarily parallel economic reality."[244] The majority added that "[f]inancial accounting is not a science. It addresses many questions as to which the answers are uncertain and is a 'process [that] involves continuous judgments and estimates.'"[245]

The Supreme Court's approach in *Shalala* raises a number of interesting questions about GAAP, among them, GAAP's scope, its efficacy, and its persuasive weight before administrative and judicial tribunals. If one reads *Shalala* narrowly, then one can reasonably conclude that GAAP can be disregarded within the context of a medical reimbursement when the agency has a reimbursement rule. This approach is consistent with the fiscal philosophy of protecting the public treasury and deferring payments. However,

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[239] It is interesting to note that the approach advocated by HHS is actually consistent with original issue discount principles which require the amortization of a premium/discount over the life of the original debt. See APB Opinion 21, Interest on Receivables and Payables, (Aug. 1971).

[240] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 90, (1995). There was a second issue which the Court examined, namely, whether the reimbursement guideline the Secretary relied upon is invalid because it did not follow the notice-and-comment provisions of the Administrative Procedure Act (APA).

[241] "Structure" in this sense means the title, captions and sequence of the regulations. See *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 92, (1995).

[242] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 93, (1995).

[243] APB Opinion 26, Early Extinguishment of Debt (1972).

[244] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 100 (1995).

[245] *Shalala v. Guernsey Memorial Hospital* , 514 U.S. 87, 100, (1995).

if one reads Shalala broadly, then one can likewise reasonably conclude that GAAP can be disregarded anytime a state or federal agency prescribes its own financial standards, be they cost reimbursement, or otherwise.

Unresolved questions abound. Are federal and state agencies required to follow GAAP?; Do federal and state agencies have the discretion to craft their own internal policies whenever they relate to budgetary and fiscal matters?; Are internal agency guidelines exempt from APA procedures? Shalala raises a gnawing question about the role of GAAP outside of the securities context. Not only did the HHS reject GAAP as the standard of measurement, it replaced it with a measurement standard that was neither "generally accepted" nor subjected to the procedures required by the Administrative Procedure Act. Shalala is best explained as demonstrating the vast deference the Supreme Court willingly gives to matters involving economic affairs.

(e) Instance of Private Party Reliance on GAAP

Reliance on GAAP is not limited to matters involving federal or state government. GAAP also influences private party transactions. For example, private parties will frequently use GAAP as a basis to determine their financial rights and obligations[246] be it in a corporate,[247] partnership, joint venture or, an individual context. As we saw in public party transactions however, reliance on GAAP in private party transactions will not necessarily ensure the intended result.

Bolt v. Merrimack Pharmaceuticals

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[246] See LSB Intern. Inc., v. Mohawk Valley Ranch, Inc., WL 1243955, pg 2, a partnership dissolution case. In the instant case, "Article IX, paragraph (B) (of the partnership agreement) provides generally that "net profits and net losses ... shall be determined in accordance with generally accepted accounting principles … in the same manner as the net income or net loss ... is determined for federal income tax purposes."

[247] See, Schulenberg v. River Hills Investments, Inc., 160 Wis. 2d 47, 1990 WL 262065 (1990), unpublished opinion, at 1, Schulenberg involved a common stock buy-out agreement that used GAAP as a reference for valuation purposes. "The formula in this buy-sell agreement set the common stock value at book value, as determined by generally accepted accounting principles (GAAP)." Schulenberg v. River Hills Investments, Inc., 160 Wis. 2d 47, 1990 WL 262065 (1990), unpublished opinion. The Supreme Court of Wisconsin amended the rule to provide that unpublished opinions issued on or after July 1, 2009 "may be cited for its persuasive value." See http://www.wicourts.gov/sc/rulhear/DisplayDocument.html?content=html&seqNo=35116 last visited January 7, 2009).

In *Bolt v. Merrimack Pharmaceuticals* [248]the court was asked to resolve the meaning of the term, "net worth" within the context of a disputed redemption transaction.[249] Neither the state statute, the articles of incorporation, nor GAAP define the meaning of the term "net worth."

The plaintiff, Albert Bolt, owned "52,488 shares of Series A Redeemable Preferred Stock"[250] in the defendant company, Merrimack Pharmaceuticals Inc. ("Merrimack"). Bolt, sought to redeem his stock in accordance with the terms of the company's articles of organization which provided that a shareholder can redeem his stock anytime the "net worth of the Corporation determined in accordance with . . . [GAAP] . . . equals or exceed five million dollars.[251] Merrimack, however, resisted the attempt to redeem the stock. Merrimack argued that the redemption provisions implicitly contemplated that the redeemable preferred stock would be characterized as debt and therefore treated as a liability. Merrimack thus maintained that the financial threshold requiring a redemption of the stock had not been reached. Bolt disagreed and argued that the redeemable preferred stock is properly characterized as equity, not debt.

Bolt initiated a lawsuit seeking a declaration that the company's "net worth" exceeded the five million dollar threshold after repeated requests to Merrimack by Bolt to redeem his Series A Redeemable Preferred Stock proved unsuccessful. Following a trial, the district court held that the company's net worth in fact, exceeded the five million dollar threshold. The court of appeals affirmed.

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[248] *Bolt v. Merrimack Pharmaceuticals Inc.,* 503 F. 3d 913, (2007).

[249] Jeffrey D. Bauman, Elliott J. Weiss, Alan R. Palmiter, Corporations Law and Policy, pg. 242, West Publishing (2003). "Preferred stock sometimes represents a permanent commitment of capital to a corporation and sometimes does not. The right to require redemption may be held by the stockholder, by the corporation, or by both.

[250] *Bolt v. Merrimack Pharmaceuticals Inc.,* 503 F. 3d 913, (2007).

[251] "The relevant redemption provision of Merrimack's Restated Articles of Organization provides: At any time from and after December 31, 1997, if the net worth of the Corporation, determined in accordance with generally accepted accounting principles and as shown on the balance sheet of the Corporation as of the end of the fiscal quarter then most recently ended, equals or exceeds five million dollars ($5,000,000.00), then upon the request of the holder of (the Series A) Preferred Stock, the Corporation shall redeem at the Redemption Price any and all shares of (the Series A) Preferred Stock which such holder, by such request, offers to the Corporation for redemption." *Bolt v. Merrimack Pharmaceuticals Inc.,* 503 F. 3d 913, (2007).

This case demonstrates the various approaches and the range of authorities that a court may encounter when resolving questions concerning GAAP. The court in Bolt examined the relevant regulations and, three varying levels of accounting pronouncements before making a decision. First, the court examined the applicability of Regulation S-X. Merrimack argued that Regulation S-X required treating the preferred stock as a liability and not as equity. Merrimack relied on language dictating *the physical placement* of the preferred stock on the balance sheet in support of his position (emphasis added). Specifically, Merrimack argued that since Regulation S-X required placing the preferred stock "outside" the equity section that "it should [therefore,] be considered akin to a liability for purposes of determining net worth." The court however, rejected Merrimack's interpretation of Regulation S-X.

The court then examined Accounting Standard 150 (AS 150). Although AS 150 was not in effect at the time of the disputed transaction, the court nonetheless considered it in its analysis because it "… believed that this statement offers helpful guidance that confirms [its] conclusion."[252] After reviewing AS 150, the court then went on to reject it as a source of authority. The court reasoned that AS 150 is not applicable to the transaction at hand because AS 150 deals with unconditional events while the present case deals with a conditional event.[253]

The next source the court examined was FASB Concept No. 6. The court stated that "we do not believe that the conceptual definitions found therein require a conclusion that the Series B Stock must be classified as part of total liabilities…" The court noted that "Concept No. 6 defines "liabilities" as

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[252] *Bolt v. Merrimack Pharmaceuticals Inc.,* 503 F. 3d 913, 919, (2007). "We recognize, as does Merrimack, that Statement No. 150 was not effective until after the balance sheet involved in this case was prepared. However, we believe that this statement offers helpful guidance that confirms our conclusion."

[253] The court notes that "Statement No. 150 requires that a mandatorily redeemable financial instrument, defined as a financial instrument that "embodies an *unconditional* obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur," be reclassified as a liability. *Id.* § 9, at 10 (emphasis added). Even if Statement No. 150 applied in this case, the parties agree that it would not require the Series B Stock to be classified as a liability because redemption of that stock is *conditional* and expressly beyond the statement's scope. *See id.* at 5. A redeemable preferred stock conditioned "upon an event not certain to occur becomes mandatorily redeemable-*and, therefore, becomes a liability*-if that event occurs, the condition is resolved, or the event becomes certain to occur."" *Bolt v. Merrimack Pharmaceuticals Inc.,* 503 F. 3d 913, 919, (2007).

"probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events," … and [defines] "equity" as "the residual interest in the assets of an entity that remains after deducting its liabilities…". What is striking here, is that the court and the litigants failed to take note of the declaration by FASB that "[u]nlike a Statement of Financial Accounting Standards, a Statement of Financial Accounting Concepts does not establish generally accepted accounting principles…"[254]

In the final analysis, the court used two lines of reasoning to resolve the meaning of "net worth." First, the court considered the common and ordinary meaning of the term, "net worth." In this part of the analysis, the court rejected the narrower reading advanced by Merrimack and opted for the common and ordinary meaning of the word. Second, the court simply deferred to the determination made by the independent auditors "that Merrimack's balance sheet 'presents fairly … the financial position of Merrimack … in conformity with accounting principles generally accepted…'" and held for Bolt.[255]

In addition to consulting the traditional case law, statutes, and administrative resources, courts dealing with accounting issues must also consult a vast array of GAAP standards that are pliable, complex and confusing. As these cases illustrate, courts must discern among the differing levels of GAAP and evaluate the conflicting interpretations of GAAP before deciding whether to accept or reject GAAP as a source of authority. The final result, is not always clear or consistent. The challenge is further exacerbated by the lack of certainty and guidance as courts apply GAAP standards which are perceived by professionals in varying degrees as aspirational, discretionary or prescriptive.

PART VI - CONCLUSION:

This article proposes that a federal agency (be it a reformed SEC or a newly created agency) take an active and primary role in establishing accounting standards.[256] Given the pervasive nature of accounting

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[254] See, Con1, under caption, Statements of Financial Accounting Concepts, third paragraph (unnumbered).

[255] *Bolt v. Merrimack Pharmaceuticals Inc.,* 503 F. 3d 913, 921, (2007).

[256] "One potential argument against a government . . . agency is the potential for inefficiency, a common criticism of government institutions. This argument loses its potency when one puts it in perspective. Financial statement restatements over the five-year period between 1997 and 2002 cost financial markets approximately $100 billion in market capitalization. It's unlikely that

standards, their influence on U.S. economic policy and their relevance to the substantive rights of individuals, requiring the SEC (or a newly created federal agency) to take an active and primary role in creating accounting standards is both reasonable and responsible.[257] Private sector observations, however, should be encouraged.

Transparency, disclosure and confidence building, the stated objectives of SEC policy, are substantially compromised when third party standard setters are involved. The government's act of delegating standard setting responsibility to an organization with no meaningful public duty is imprudent and irresponsible, and will predictably contribute to another collapse of the markets as accountants and management conceive of new ways to circumnavigate rules shrouded with the veil of ambiguity and discretion.

To be effective, rules should enable predictive behavior, provide certainty, assist with compliance and enforcement efforts, and be not unduly burdensome or repressive. These elements invariably make for effective jurisprudence. In contrast, rules which tolerate extreme ranges in behavior are counterproductive, self destructive, and are ultimately of limited social utility. History has demonstrated that a repressive and interventionist structure is inevitably doomed to failure.[258] Similarly, a

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even the most inefficient government agency would lose $100 billion over a five-year period." Denis A. Klimentchenko, *MYTH OF AUDITOR INDEPENDENCE*, 2009 U. Ill. L. Rev. 1275, 1299 (2009).

[257] James Harlan Koenig, THE BASICS OF DISCLOSURE: THE MARKET FOR INFORMATION IN THE MARKET FOR CORPORATE CONTROL, 43 U. Miami L. Rev. 1021, 1037-38, (May 1989). "Although mandatory disclosure seems to be a means of generating vital market information, many commentators argue that securities laws, like disclosure rules, produce few benefits and considerable costs. Specifically, under the free market for information theory, regulation is costly and unnecessary because corporate managers, seeking to maximize shareholder value, will release information voluntarily up to the point that the marginal benefits of disclosure equal the marginal costs. Because market participants desire information to make investment decisions and "assume the worst" in the absence of released information, a company that wishes to raise capital through public markets has an incentive to and can profit by providing voluntary disclosures."

[258] Vincent J. Samar, CAN A CONSTITUTIONAL AMENDMENT BE UNCONSTITUTIONAL?, 33 Okla. City U. L. Rev. 667, footnote 55, (Fall 2008), "The failure of Prohibition has been admitted by many of its own supporters. In a 1932 letter, the wealthy industrialist John D. Rockefeller, Jr., stated that '(w)hen Prohibition was introduced, I hoped that it would be widely supported by public opinion and the day would soon come when the evil effects of alcohol would be recognized. I have slowly and reluctantly come to believe that this has not been the result. Instead, drinking has generally increased; the speakeasy has replaced the saloon; a vast army

noninterventionist policy invites adversity as participants will predictably seek to maximize their gains and externalize all possible costs.

The process of creating accounting standards is in need of reform. Accounting standards, be they called GAAP or by any successive nomenclature,[259] must be clear, consistent, conservative,[260] narrow the range of differences, and be such that they are reasonably expected and understood by the average investor. Accounting standards must be oriented to benefit shareholder disclosure to allow for reasonably prudent and meaningful investor decisions. Accounting standards should not be oriented to facilitate management discretion or self interest. Any new, emerging, or extraordinary method of measurement that is inconsistent with how an average investor reasonably expects reported must be fully disclosed setting forth the rationale for the use of the method, the projected benefits of the proposal and the risks associated with the method.

Financial statement reporting, under any system, will have inherent limitations. The goal of a reporting system should be to create a system that reflects the reasonable expectations of the user.[261] Perhaps then, we can begin to reduce the dissonance between competing reporting interests among shareholders, management and accountants and arrive at a reporting system which is representationally faithful of the underlying company economics, and stop the game of nods and winks.[262]

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of lawbreakers has appeared; many of our best citizens have openly ignored Prohibition; respect for the law has been greatly lessened; and crime has increased to a level never seen before.'"

[259] A possible successive standard would be IFRS.

[260] Conservatism is the hallmark of financial reporting. "There is a place for a convention such as conservatism – meaning prudence – in financial accounting and reporting, because business and economic activities are surrounded by uncertainty…" Con 2 par. 92 "Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered." Con 2 par. 95.

[261] For example, accounting standards could be gauged from the point of view of the contracting counterparty. In this regard, revenues and expenses would only be recorded if the contracting counterparty hypothetically recognizes and agree that there exists an enforceable right and a resulting performance obligation.

[262] Con2 par. 63, "Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions

and events that change those resources and obligations." See, Arthur Leavitt, http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt (last visited July 31, 2009).