

Securities Litigation REPORT

October 2006, Vol. 3 No. 9

© Thomson/West



IN THIS ISSUE:

Boardroom Confidentiality
By Martin Lipton 1

From the Editors...

The Sarbanes-Oxley Act of 2002—
The Cost of Compliance
By David Lisi and John Horan 3

Early Warning: Recent and Forthcoming
Financial Reporting Developments That
May Spur Business Litigation
By Barry Jay Epstein, Ph.D., CPA 9

The Changing Dynamics of Internal
FCPA Investigations
By Homer E. Moyer, Jr. 14

Recent Developments in Securities
Litigation in Spain
By Rafael Murillo and Natalia Gómez 17

Early Warning: Recent and Forthcoming Financial Reporting Developments That May Spur Business Litigation

By Barry Jay Epstein, Ph.D., CPA

Barry Jay Epstein, Ph.D., CPA, is a partner in the Chicago accounting and consulting firm Russell Novak & Company LLP. His practice is largely devoted to litigation consulting. Dr. Epstein also consults with financial statement preparers and lectures on accounting and auditing matters. His litigation work involves commercial litigation, white collar criminal defense, and accountants' liability. He has consulted and/or testified as an expert witness for plaintiff and defense attorneys in over 80 cases, and has done substantial work for the Securities and Exchange Commission (SEC), the Department of Justice, and other agencies. He is co-author of Wiley GAAP and Wiley IFRS, two widely-used reference works for practicing accountants, and the author of other books. You can reach Dr. Epstein at BEpstein@rnco.com.

Common categories of business litigation, such as those involving purchase price adjustments for business acquisitions, disputed distributions under earn-out agreements, and percentage lease arrangements, often involve allegations that financial information does not conform to contractual requirements. Typically, those requirements stipulate that financial computations be based on an entity's financial statements "prepared in accordance with generally accepted accounting principles," sometimes with the added caveat that the principles applied be consistent with either the reporting entity's own past practices or with general industry standards. Additionally, the financial statements—or the computations based on selected data from the financial statements—may be subject to audit or other independent review under the terms of the governing document.

Generally accepted accounting principles ("GAAP") are dynamic and therefore change over time, so that even faithful compliance with GAAP as it existed at a given date may not describe current practices. Some contracts call for so-called "frozen GAAP," whereby the financial reporting standards that existed at the date of the contractual arrangement (say, an earn-out agreement) will govern for the life of the agreement. This has obvious advantages, but is rather uncommon, since it requires the preparers (and their auditors, if the information is to be independently certified) to effectively "keep two sets of books" for the duration, and over time there may be fewer persons qualified to apply the by-then obsolete standards. The more likely reason this feature is

WEST
LEGALworks

omitted, however, is that the ever-changing character of GAAP is simply overlooked. Indeed, many disputes arise when computations are subsequently based on GAAP that is newly imposed and had never been anticipated by the parties, but is now invoked to one party's advantage.

In recent years there have been a number of important revisions to GAAP, and the pace of change is not likely to slacken in the near future. In fact, there is yet a new stimulus for revisions to standards: a historic agreement between the US standard setter, the Financial Accounting Standards Board (FASB), and its international equivalent, the International Accounting Standards Board (IASB), which calls for "convergence" between the two sets of standards (US GAAP and International Financial Reporting Standards, or IFRS) within the next few years.¹ A number of changes to US GAAP have already been made to fulfill this commitment, in situations where IFRS were superior to US GAAP, and select IFRS have also been revised to converge with US GAAP where the US standards appeared better. More such changes are likely to occur in the very near term.²

Additionally, FASB is, as usual, continuing its work on several major projects apart from its convergence efforts, in some cases jointly with other standard setters, in other cases on its own. Some of these agenda projects have the potential to change current financial reporting in significant ways.³ Coupled with the various important changes made in recent years, there are and will continue to be enhanced opportunities for misunderstandings and disputes, some of which inevitably will develop into litigation.

The following discussion will survey a selection of recent GAAP developments and anticipated new standards, with an emphasis on those changes that, in the author's opinion, are most likely to create confusion or opportunities for mischief, particularly when contractual provisions rely on GAAP financial reporting and the contracting parties may have limited appreciation for these standards.

Accounting for business combinations and asset impairments

While of several years' maturity now, the important new requirements for the reporting of business combinations—together with a companion standard on accounting for intangibles, including goodwill—continue to have important impacts that remain overlooked by many.⁴ Although for many decades business combinations could, depending on the circumstances, be accounted for as either *purchases* or *poolings of interest*, with very different consequences for the financial statements of the surviving entity, today essentially all business combinations are treated as

acquisitions and accounted for as purchases. That means the fair values of the acquired assets and liabilities, and not their historical carrying values, must be recorded by the acquirer, creating new bases of accountability.

Pooling accounting had been widely criticized for decades, so deleting that option was well accepted as necessary to improve financial reporting. The complication is that in most purchase transactions where entire operating businesses are acquired (as opposed to groups of assets not constituting a full-fledged business⁵) a premium is paid, which in the past was simply called goodwill. This was subject to periodic amortization over a number of years, not to exceed 40. Under the new standards, however, goodwill is no longer subject to amortization—it must instead be tested every year for possible impairment, and adjusted as necessary to reflect diminution in value. Other acquired intangibles are to be separately recognized and (with limited exceptions) amortized.⁶

There are now more likely to be disputes over whether the excess purchase price was properly allocated between non-amortizable goodwill and other accounts, such as customer lists or intellectual property, which remain subject to strict amortization rules. The process by which these assignments are to be made are both difficult and subject to honest differences in opinion. More importantly, inasmuch as amortization charges reduce reported earnings, which may serve as the basis for earn-out or other contractual obligations, the temptation to misclassify is clear.

There are at least two litigation risks arising from the accounting for business combinations. First, there is the possible mis-assignment of excess purchase price between non-amortizing goodwill and amortizing intangible or tangible assets, with the obvious opportunity to manipulate earnings. Second, there is the matter of the appropriateness of subsequent charges for impairments (which can also arise in connection with tangible, depreciating assets⁷).

Regarding the latter issue, testing for impairments is itself hardly a straightforward matter, and there is great latitude for judgment—but also much opportunity for manipulation, if that was to be the goal. Impairment testing generally requires projections of future cash flows deriving from the assets being evaluated for impairment, which of necessity opens the door to a further set of assumptions, such as about the assets' expected economic lives, amounts of future overhaul or other maintenance costs, the pricing of inputs such as labor and materials, and selling prices for output. A subtle but enormously important assumption in impairment testing is the appropriate discount rate to use to reduce projected cash flows to their "present value." Even a modest adjustment to the discount rate can have a huge impact, even creating the appearance of impairment

where none really exists, or alternatively concealing a very real one.

Reporting the effects of accounting changes

Financial statements primarily report the effects of current period activities, but there are circumstances when items pertaining to prior years may impact the entity's reported results, sometimes significantly so. For example, when new accounting standards are promulgated, they often require "catch up" adjustments to be computed and included in current period results of operations. Also, because US GAAP still offers the reporting entity many areas of choice—such as the use of FIFO or LIFO costing for inventory calculation purposes—there remains the possibility that companies will opportunistically elect alternative GAAP to create a desired effect, whether to influence the price of its publicly-held shares or to impact contractually-dictated computations such as bonuses or earn-outs. This is a prime reason to suggest the provision of "frozen GAAP" language in contracts—but, as noted, this is infrequently found.

Traditionally, voluntary changes in GAAP required inclusion of a "cumulative effect adjustment" in earnings in the period a change was elected, which often had a substantial impact on that period, making it less readily compared with periods before or after.⁸ A new standard issued in 2005 ends this practice, and it is now necessary to restate all earlier periods to report them as if the newly adopted principle had always been used.⁹ This has the virtue of making data (after restatement) more comparable from one year to the next—which can be important, for example, if an earn-out is predicated on year-over-year growth in earnings, but can also lead to disputes, particularly if the treatment of restatements has been left unaddressed or is ambiguously worded in a merger or other agreement.

The revised standard for reporting the effect of voluntary accounting changes (which was the product of the IASB-FASB convergence efforts) requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in nondiscretionary profit-sharing payments resulting from an accounting change, are to be recognized in the period of the accounting change. This, too, is a change from past practice. Consistent with the past, however, the change from one acceptable method under GAAP to another requires that there be an assertion that the new method is actually preferable under the circumstances. If the financial statements are audited, the outside accountants will have to agree with this claim.

Contractual agreements should now, in light of this new requirement, contain provisions to deal with the effect

of restatements of earlier periods' results, which might otherwise "fall through the cracks" relative to a range of required computations. For example, consider a change in accounting effected in the current year which adds \$3 million to the entity's net income, upon which some form of pay-out to others is to be determined, but \$2.6 million of that amount is reported in restatements of prior periods' results. Due to this newly imposed *retrospective application* provision, only \$400,000 of the effect may ever be captured for purposes of the calculation, unless a mechanism for doing so is explicitly addressed in the contract. For example, a requirement could be stated that all retrospective adjustments effected in the current period be included as a special item used to compute adjusted earnings for contractual payment purposes. Unless this is set forth explicitly, however, it will likely be the subject of later disputes.

Accounting for guarantees

Information about guarantees given had long been relegated to the financial statement footnotes, where there was little or no impact on the typical GAAP computations, such as earnings. (If a loss from performing under a guarantee was deemed *probable*, and could be *reasonably estimated* as to amount, it was given recognition, but these arose in only a small fraction of situations where guarantees were made.¹⁰) This changed recently, with an important pronouncement that requires that the *fair value* of all guarantees made be fully recognized as an obligation of the entity, with corresponding effect on the guarantor's reported expenses.¹¹ For example, a machinery dealer that guarantees the customer's bank borrowings taken to finance the sale, even if only remotely likely to give rise to a demand for payment, now must be quantified and recorded as a liability, with a selling expense item also being reported. The effects are to reduce currently reported profits and alter the entity's debt to equity ratio.

While this accounting conforms to economic reality, it does have the potential to cause financial statistics to vary vis-à-vis past practice. Furthermore, unless the guarantee is purchased in an arm's-length transaction (e.g., paying an insurance premium in order to cap or eliminate their further exposure), there will be room for debate regarding the amounts to be accrued. As with other accounting accruals where estimation plays a key role—such as those made for warranty reserves, bad debt allowances, depreciation, and inventory obsolescence—even slight changes in key parameters can heavily impact the "bottom line" or other measures of interest to the contracting parties. Interestingly, although this new standard mandates up-front recognition of the fair value of all guarantee obligations, it offers no guidance to subsequent accounting (e.g., whether or

not the obligation is to be amortized over its term), and variations will likely develop which may also serve as a tool to influence reported earnings (although FASB staff issued an interpretation recently that should at least serve to narrow the range of alternatives¹²). Where such items are likely to be material, an ounce of contractual prevention may prove worth more than a pound of litigation cure.

Off-balance sheet transactions

Thanks to the Enron scandal, many more people have become aware of the fact that significant transactions and balances were often concealed via so-called *special purpose entities* and other means. (However, in fairness it must be noted that the tools used by Enron, Adelphia and others were violations of even then-existing GAAP, and the rules have also been substantially tightened since then.) Even after the issuance of major (and exceptionally complex) new standards on this subject, there remain arcane areas of practice—and some commonplace ones, also—where it is still possible to structure transactions to avoid revealing all the entity's obligations, or which alter the pattern of periodic results of operations. Operating leases, of course, have long been used for this very purpose, and remain valid if prescribed criteria are met.¹³

Current accounting standards have replaced the concept of special purpose entities with *variable interest entities* (VIEs), which often must be consolidated into the reporting entity's financial statements. The mechanical testing procedures that must be performed to make determinations of whether or not consolidation is required are exceedingly difficult; the original standard was, indeed, so confusingly written that it had to be entirely replaced less than a year after issuance.¹⁴ Its replacement is also challenging to understand and apply, and has since been supplemented by a flurry of official interpretations needed to make sense out of it, with more surely coming. The upshot is that there undoubtedly will continue to be, probably for many years to come, disputes revolving around how a given entity reports (or doesn't report) the balance sheet and income statement effects of VIEs with which it is involved.

Note that one common use for off-balance sheet structures is to securitize an entity's receivables, or to otherwise provide financing vehicles. If properly structured, as so-called *qualified special purpose entities* (QSPEs), these remain legitimately non-consolidated with the parent entity.¹⁵ Determining whether QSPEs achieve this goal, however, usually requires the assistance of lawyers, accountants and, sometimes, investment bankers.

Related party transactions

While there have been no new accounting or reporting requirements concerning related party transactions, this

remains an area that should be attended to in contractual arrangements calling for future determinations involving financial reporting.¹⁶ In most circumstances, (VIEs) are related entities, and in fact the standard addressing VIEs established an expanded definition of related parties for that very purpose. Where contractual or other disputes arise regarding financial reporting-derived calculations, particularly involving privately held or smaller public companies, it is not uncommon to find allegations of related party transactions having been used to affect reported results. There is virtually no means by which to certify that related party transactions were truly conducted on arm's-length terms (in fact, auditors will insist that no such assertions are included in financial reports unless fully supported), and thus the mere existence of related party transactions is an invitation to a contractual dispute.

One way to prevent such difficulties is to include a contractual provision that no new related party transactions will be engaged in for the duration of the earn-out period or until all post-transaction contingencies have been resolved, coupled with representations that existing related party transactions and balances have been fully disclosed. This would have to include not merely on-balance sheet events, but off-balance sheet ones as well, such as guarantees under recently superseded GAAP.

Distinguishing liabilities from equity

While in the abstract there would appear to be no trouble in making this distinction, in practice there are many so-called hybrid financial instruments that have attributes of both debt and equity. If classified as equity, the reporting entity's debt-to-equity ratio is favorably affected, and distributions are likely to be called dividends and thus excluded from earnings, whereas interest on debt will be deducted in computing net income. Thus, correct classification is often a highly relevant issue, particularly where the entity has a complex capital structure.

In recent years a number of modifications to GAAP have attempted to close what had been a loophole whereby the balance sheet could easily be "dressed up." For example, a major and controversial standard was promulgated several years ago, which requires that equity subject to mandatory retirement provisions or containing options giving holders rights to demand redemption can no longer be deemed equity in the balance sheet.¹⁷ However, there are many variations, such as warrants for the purchase of the company's stock which include "puts" to become effective after exercise, and so-called "contingently convertible" securities, for which making accounting determinations has not always been straight forward. Some of these have been addressed in recent pronouncements, while others remain to be dealt with.¹⁸ Indeed, an indefinite postponement of

certain provisions of the new standard on the accounting for redeemable stock was granted by FASB shortly after the rule was first issued.¹⁹ This was due to anguished pleadings by many companies, particularly closely-held ones having so-called “buy-sell” agreements with all or most of their shareholders, thus (at the extreme) rendering all their equity as “debt,” and causing many loan covenants to suddenly, if nominally, be violated.

A related area of complexity involves the issuance of convertible debt or debt issued with stock purchase warrants. GAAP requires allocation of the proceeds between the fair value of the debt and the value of a detachable warrant, which obviously demands the application of judgement and is thus another invitation for dispute; current GAAP does not require allocations to conversion features, although this has been proposed.²⁰ Indeed, derivative financial instruments (of which conversion rights and warrants are merely two rather prosaic examples) are an entire, complex topic unto itself.²¹ A large fraction of the current professional accounting standards are devoted to this subject, but as new products are invented by financial engineers, accounting standard setters struggle to develop yet more guidance, in a game that is apparently endless. Entities employing derivatives for hedging purposes (e.g., interest rate swaps, currency forwards) have a further set of complex accounting decisions to make, with potentially large effects on reported results.

This area will continue to evolve under GAAP. One recent proposal would offer a so-called “fair value option,” permitting reporting entities to account for financial instruments at fair value, with changes reflected in current income.²² This is yet another attempt to converge with IFRS, and it will offer companies a way to simplify the accounting for certain assets that otherwise would require unrealized gains and losses to be carried in the oft-misunderstood “other comprehensive income” section of the equity caption of the balance sheet (while excluded from current income). However, it also will create the risk that entities opportunistically may elect this option, when doing so has some likelihood of contributing to desired financial reporting results, perhaps affecting contractual obligations.

Exchanges of nonmonetary assets

Under longstanding GAAP, exchanges of nonmonetary assets (e.g., one machine traded for a similar but different one), generally involved no gain or loss recognition, but merely accounted for as “book value” swaps.²³ As yet another product of FASB’s efforts to converge with IFRS, it has been concluded that all such transactions (with a few exceptions retained) are now to be recorded at fair values.²⁴ Thus, gain or loss from such transactions will

now be included in earnings. This is a relatively simple new rule, but it does differ from past practice and hence may, in some situations, make future financial statements non-comparable with those of earlier periods, possibly affecting contractual computations in the process. At the margin, these matters can make a difference, particularly when a contractual requirement contains a “cliff provision” (such as for a pay-out when earnings exceed a defined threshold, which the entity is already approaching).

Forthcoming convergence and other developments affecting US GAAP reporting

There are many more recent pronouncements that have the potential to cause confusion, at best, and to stoke mischief or fraudulent reporting, at worst. However, the final comments will be reserved for forthcoming standards that will also change income measurements and thus, under certain circumstances, affect contractually dictated payments.

Under US GAAP, research and development expenditures (“R&D”) must be charged to expense as incurred, notwithstanding that an often large part of those costs result in important, revenue-producing products or services. This extremely conservative stance was adopted in the 1970s in response to the increasingly commonly observed excessive deferral of so-called R&D costs, only to be followed in later years by “big bath” write-offs. Because the future value of R&D is very difficult to assess, it was decided to account for these as “sunk costs” having no later benefits. Obviously, entities would not commit to such expenditures if they believed all efforts were “sunk costs,” and the transformation of the economy over the past thirty years to one far more dependent on new product development and the creation of intellectual property has made this requirement ever more difficult to justify. By way of contrast, IFRS requires expensing of research costs, but capitalization (i.e., deferral and later amortization) of development costs—a method emulated to a degree for computer software development costs under US GAAP.

A related issue is that of so-called “in-process research and development” (“IPRD”), which is the allocated part of purchase cost in a business combination, which must also be expensed immediately. In some cases, most of the cost of a business acquisition is allocated to IPRD, although the SEC did step in several years ago when it began to appear that acquirers were exaggerating this in order to clear the way for future reportable earnings, since little or none of the costs were being attributed to assets, the depreciation of which would have depressed future results of operations. Reportedly FASB will soon adopt a standard that would require capitalization of IPRD, but inconsistently

would not alter the requirement for expensing all internally created R&D.

Whether US GAAP does embrace capitalization of IPRD, or whether IFRS-style bifurcated treatments for research and for development costs are adopted, there will be a sharp departure from longstanding practices that will serve to impact many contractual agreements.

Accounting for income taxes, already a complex and oft-misunderstood topic, may also be revised in the near term. FASB has already promulgated one change—which will have serious implications for many companies—in FASB Interpretation No. 48, which will limit the accounting recognition given to hoped-for tax benefits arising in connection with aggressive tax positions. Other changes are being considered, to attempt convergence with IFRS on several rather specialized issues on which the two standards, although quite similar overall, do differ.

Last, but certainly not least, both FASB and IASB are working on major projects that would fundamentally alter the notion of revenue, and make revenue recognition dependent upon receipt of assets and/or extinguishment of liabilities. Doing so would continue and perhaps culminate the marked shift to a balance sheet orientation in accounting theory over the past thirty years. Making such a change could potentially have enormous impact on income measurement and, if it does, would obviously have major implications for any contractual measures driven by the GAAP-basis financial statements.

Thus, standards for financial reporting, and *changes* to those standards, are of great significance for many contractual provisions, and thus need to be given timely attention by contracting parties and their counsel. With specific regard for the costs and time consumption which inevitably accompany litigation, consultation with qualified accounting advisors is always the wisest course.

Notes

- 1 The "Norwalk Agreement" between FASB and IASB was signed in September 2002. Perhaps in response to this, and also to the European Commission's endorsement of IFRS for use by some 7,000 publicly held companies in the EU beginning in 2005, the pace of worldwide adoption of IFRS has accelerated. Currently, some 100 nations either endorse IFRS for at least some financial reporting purposes or base their national GAAP standards, to greater or lesser degree, on IFRS.
- 2 FASB's technical agenda currently has three projects identified as being for short-term convergence purposes (dealing with earnings per share, income taxes, and research and development costs), and IASB similarly has five such projects in process (income taxes, segment reporting, borrowing costs, joint ventures, and impairment). Readers can monitor developments on these organizations' web sites, www.fasb.org and www.iasb.org, respectively.
- 3 Some of these projects, not discussed in this article, include further revisions to accounting for business combinations, and a thorough reworking of revenue recognition standards, potentially having very major impact on future financial reporting.
- 4 Statements of Financial Accounting Standards Nos. 141 and 142.
- 5 This distinction is explained by FASB Emerging Issues Task Force Issue 98-3.
- 6 FAS 142 provides detailed guidance about classes of intangibles that are to be given

- 7 separate recognition.
- 8 The rules for impairment testing of assets other than goodwill are found in Statement of Financial Accounting Standards No. 144. These differ in important regards from the impairment testing regime for goodwill, set forth in SFAS No. 142. Both sets of rules rely heavily on easily-disputed assumptions, even slight changes in which can materially alter the resultant computations.
- 9 The former requirements were set forth in Accounting Principles Board Opinion No. 20.
- 10 Set forth by Statement of Financial Accounting Standards No. 154, issued May 2005, and generally effective for 2006 financial statements.
- 11 See Statement of Financial Accounting Standards No. 5, Contingencies.
- 12 FASB Interpretation No. 45.
- 13 FASB Staff Position FIN 45-2.
- 14 The basic accounting requirements for leases are found in Statement of Financial Accounting Standards No. 13, but scores of other standards, interpretations, technical bulletins and EITF Issues had been promulgated since SFAS No. 13 was issued, demonstrating the difficulty of establishing unambiguous rules even for this relatively simple matter. The mechanical criteria of SFAS No. 13 are often cited in the ongoing debate over "rules-based" versus "principles-based" accounting standards.
- 15 FASB Interpretation No. 46, issued in early 2003, was replaced by FASB Interpretation No. 46[R] later that same year. It has subsequently been clarified by at least six FASB Staff Positions.
- 16 See Statement of Financial Accounting Standards No. 140.
- 17 Statement of Financial Accounting Standards No. 57 addresses related party disclosures to be made in financial statements. The challenge for auditors has long been to uncover such transactions, which are not always acknowledged by management and can be difficult to identify.
- 18 Statement of Financial Accounting Standards No. 150.
- 19 For example, EITF Issues 05-1, 05-2, 05-7 and 05-8 address aspects of conversion features, and EITF Issue 04-8 deals with contingently convertible securities. A large fraction of all the guidance issued by the Emerging Issues Task Force has dealt with financial instruments, which remains one of the most complex areas in accounting.
- 20 FASB Staff Position FAS 150-3 indefinitely postponed application of Statement of Financial Accounting Standards No. 150 for redemption provisions associated with equity of privately held companies, unless mandatorily redeemable at fixed dates for fixed amounts or amounts determinable by reference to external indices. The main effect is to lift the requirement that equity subject to "buy-sell" agreements be classed as debt, a provision that was vehemently opposed. It is not clear when, or if, FASB will return to this topic.
- 21 Accounting Principles Board Opinion No. 14 addresses accounting for debt with conversion features or detachable warrants. A FASB proposal dating from 2000 would require, if adopted, that conversion features be separately recognized as an element of equity upon issuance of convertible debt. FASB has struggled with this project for years, and plans to issue another preliminary views document in 2007.
- 22 Basic guidance on accounting for derivatives and hedging transactions is found in Statement of Financial Accounting Standards No. 133. It has been supplemented by a large body of implementation guidance and other interpretive literature.
- 23 The proposed standard on the fair value option was issued in January 2006; a final standard is promised by year end.
- 24 As set forth by Accounting Principles Board Opinion No. 29.
- 25 Statement of Financial Accounting Standards No. 153.

Dr. Epstein is available to discuss how accounting changes may affect specific contractual matters relating to current or potential litigation. He also offers complementary in-house CLE seminars on this and related accounting, securities fraud or white collar crime topics. You can reach Dr. Epstein directly at:

Barry Jay Epstein, Ph.D., CPA
RNCO Financial Litigation Advisors
Russell Novak & Company LLP
 225 W. Illinois Street, Suite 300
 Chicago, IL 60610
 Direct Phone 312 464 3520
 Direct Fax 312 222 1377
 Email: bepstein@rnco.com