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March 12, 2008

Chairman Robert C. Pozen
And Other Committee Members
SEC Advisory Committee on
Improvements to Financial Reporting
c/o Nancy M. Morris
Federal Advisory Committed Management Officer
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Open Meeting of the SEC Advisory Committee on Improvements to Financial Reporting ("CIFiR") at the University of California- San Francisco on March 13, 2008

Dear Chairman Pozen and other Committee Members:

It is an honor to be invited to participate in Panel One (Restatements and Discussion of Developed Proposals 3.1, 3.2 and 3.3), and Panel 2 (Professional Judgment and Discussion of Developed Proposal 3.4) of CIFiR's Open Meeting. Given the topics of my panels, I will limit my remarks to materiality and professional judgment.

As a young attorney in the Division of Corporation Finance of the Securities and Exchange Commission (the "SEC") in the mid-1970's, I was taught that a restatement of financial statements is required when an error has occurred and the error is material. Given the increased complexity of accounting principles, particularly with respect to matters such as Statement of Financial Accounting Standards No. 157, Fair Value Measurements, errors have become increasingly common.

When an error is identified, the focus turns to whether the error is material.[1] In the past two years, one out of five registrants under the Securities Exchange Act of 1934, as amended, has restated its financial statements. While the number declined in 2007 to approximately 1,000

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[1] See, e.g., TSC Industries, Inc. v. Northway, In 426 US 438 (1976) ("Northway"), Basic Inc. v. Levinson, 485 US 224 (1988) ("Basic") and Staff Accounting Bulletin No. 99 ("SAB 99'). When the Staff of the SEC adopted SAB 99, a debate ensued as to whether SAB 99 constituted a new standard of materiality or nothing more than a codification of existing legal and accounting standards. My views are set forth in Attachment A, "SAB 99: Materiality as We Know It or Brave New World for Securities Law."

reporting companies, when one considers that there are only 12,000 public companies, 8% of reporting companies restating in one year is an indication of something systemic, rather than a short term phenomenon. I respectfully submit that investor protection is not being served by having such a large number of restatements occur each year. If the threshold for when a restatement is required is too low, investors and the public interest are not being served.

If "everyone has one" the marketplace will soon draw its own distinctions as to what is important and alternatively decide how to differentiate between restatements that can affect the market and enterprise value of a company and those that do not. Thus, not all restatements are created equal. The market views some restatements as a selling event, when investors stampede out of the stock; yet other restatements are viewed as a buying opportunity by market professionals resulting in the stock prices not going down or not going down for a sustained period. The time needed to resolve restatement situations can result in market professionals, such as hedge funds or shareholder activists, buying the debt of a company that is in default under its debt covenants for the failure to file timely periodic reports or buying the common stock of a company that has an "accounting problem" to put it into play. The result in both situations can be a determination by the company's board of directors to consider "strategic alternatives," which can result in selling the company at a fire-sale price. For long-term shareholders, the short-term gains of others results in selling their investment on the cheap. For employees, it can mean the loss of jobs when the company is sold.

The Developed Proposals present a way to resolve the dilemma that has existed about materiality and restatements. I support Developed Proposals 3.1, 3.2 and 3.3. They are consistent with the recommendation of the Materiality Task Force of which I was a member in 2007.[2] Specifically, I recommend revising SAB 99 to put SAB 99 into its proper context. It should not be viewed as governing materiality generally, but rather a specific issue: can a quantitatively immaterial item be material because of qualitative factors? My answer is yes.[3] As a young attorney in Corporation Finance, I was taught that the dollar that took a registrant from a profit to a loss was material. Under SAB 99, that point is a qualitative factor. But SAB 99 should be revised to put it into that perspective, rather than having the much broader reach it has had. New guidance published by the SEC should clarify materiality consistent with the Developed Proposals.

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[2] Attachment B is the submission of the Materiality Task Force to CIFiR dated February 13, 2008.

[3] Cf. Todd E. Hardiman, "Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments" (Dec. 12, 2006), available at <http://www.sec.gov/news/speech/2006/spch121206teh.htm> ("Staff Accounting Bulletin No. 99 provides guidance on how to make materiality judgments. It provides guidance that helps answer the question: can small errors be material? The example cited in the SAB is financial statement errors below 5%. And the guidance it provides includes an illustrative list of qualitative considerations that may cause a quantitatively small error to be material.")

SAB 108 was a response from the Staff to companies using the Iron Curtain approach exclusively and ignoring the roll-over approach when they found errors. This allowed errors to build up on the balance sheet that became material over time, but were not corrected. Although necessary at the time, perhaps the abuse the Staff saw in the past has been resolved. If so, SAB 108 should be revised to differentiate how the roll-over and Iron Curtain methods are applied by making their use depend on whether the financial statements have been issued. Once a company issues financial statements, it should be required to restate only if there is an error that is material under the roll-over approach. Thus, the Iron Curtain approach would be applied only prior to the issuance of financial statements, rather than after issuance.

We need to return the test of materiality to what the Supreme Court decided in Northway and Basic. Contrary to what some might think, doing this will result in investor protection and promote public interest. Rather than be confronted with a blizzard of restatements that are difficult to differentiate, investors would be able to distinguish between restatements that represent truly important changes to the financial statements that a reasonable investor would consider in making an investment decision on the one hand, and accounting errors that would not affect their investment decision making on the other hand. In addition to helping investors, these changes would help public companies. Restatements are expensive in terms of time, effort, diversion of management resources, expenses, litigation and capital formation. Accounting errors that are material would still require the time, effort and expense they do now, but they would not be as frequent, and accounting errors that are not material would be handled in a manner that would avoid a restatement.

Developed Proposal 3.2 is an enlightened approach that protects investors while ensuring that financial statements reflect the needs of current investors. I have been involved in a number of restatements concerning amortization of leasehold improvements as well as options dating. While not generalizing because every restatement has different aspects,[4] there are similarities in both situations: errors occurred over a number of years and were corrected by massive, expensive and time-consuming restatements. Rather than restate in most of these situations, changes could have been reflected in current financial statements because the errors occurred long ago and/or were considered material only when the aggregate adjustment was calculated. At a concept level, it is clear that no restatement should be required for such errors in the absence of fraud. The specific method to implement this remains to be decided. Adjusting the current year's opening retained earnings is a balance sheet approach which I favor because it does not affect the income statement. Others favor reflecting the change in the income statement. While the debate should occur on the precise method, Developed Proposal 3.2 should be implemented.

Similarly, Developed Proposal 3.3 should be implemented to put errors in interim reports in the proper perspective. The approach of paragraph 29 of APB Opinion No. 28, Interim Financial Reporting, provides the right starting point. An error in an interim period that does not affect trends and is not material to the annual financial statements should not result in a restatement of the interim period. For example, a calendar-year retailer may earn the majority of

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[4] Attachment C is my Rules of the Road for Restatements which describes the differences and common features of restatements.

its income in the fourth quarter. Should a material accounting error that occurred in the second quarter that is not detected until the preparation of the annual financial statements result in a restatement? I doubt whether investor protection is served by: the delay in issuance of annual financial statements; the market uncertainty; or the potential liability if the retailer sold securities in the third quarter off a shelf registration statement in the third quarter when the trends and annual results are not materially affected by the correction of the second quarter error.

Critical to the approach I am recommending is that the correction of an error, short of a restatement must be accompanied by robust disclosure in the financial statements as well as in the narrative of the filing and that an Exchange Act filing should be made as soon as practicable. Lack of full disclosure will not adequately inform investors even if the numbers are corrected. Thus, lawyers who assist in drafting the disclosure are needed as part of the process. Lawyers need to know more about accounting in order to fulfill this role. With current, complete and correct disclosure this recommendation can enhance the flow of information to the marketplace, on a timely basis. Periods in which trading occurs without current information are now commonplace. The marketplace will be far more efficient if delays in getting accounting issues resolved can be shortened. Eliminating unnecessary restatements can do this.

I have advocated revisiting materiality under SAB 99 in the past with respect to the use of the term material in internal control over financial reporting.[5] The revision of AS 2, which resulted in AS 5 being adopted by the PCAOB, has gone a long way to address the issues under Section 404 of the Sarbanes Oxley Act of 2002 ("SOX"). I respectfully submit that implementation of Developed Proposals 3.1, 3.2 and 3.3 can go a long way to address restatements.

But, having said that, one more Developed Proposal needs to be implemented to complete the package of enhancing investor protection, lowering compliance costs and promoting capital formation: Developed Proposal 3.4 as it relates to professional judgment. In the past six years, some restatements have occurred because restatement was the short-term cautious answer, rather than the long-term right answer for investors. A restatement was safe because the decision to do so would not be second-guessed, or so some thought. There have been instances where the restatement itself has had to be restated.

We need to reconstitute professional judgment. Professionals have to know that exercising judgment in good faith after examining all the facts available with the appropriate level of objectivity is not going to be a career-ending experience. The factors in Developed Proposal 3.4 are the right factors to focus on. I prefer guidance, rather than a safe harbor. I do not think that guidance will become a litigation trap if the guidance is properly calibrated. Are there examples where guidance or even a safe harbor has resolved a securities law issue without litigation? Yes. Rule 144 under the Securities Act of 1933, as amended, has been followed for

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[5] See Attachments D and E, letter to Jonathan G. Katz for the Roundtable on Implementation of Internal Control Reporting Provisions dated April 11, 2005 and letter to Nancy M. Morris, for the Roundtable on Second Year Experiences with Implementation of Sarbanes-Oxley Internal Control and Auditing Provisions dated May 1, 2006.

over 30 years. It has not led to litigation with respect to resales of restricted securities or sales of securities by affiliates. Rule 415 under the Securities Act, which I helped write, was touted by some on Wall Street as only resulting in litigation if it was adopted. It has not and it has been in effect since 1983. I believe that properly calibrated guidance on professional judgment can produce the same kind of result. I recommend that, like Section 404 of SOX, the Public Company Accounting Oversight Board should craft guidance for auditors and the SEC should do so for in-house accounting staff at public companies.

There's a phrase that is often used that I commend to you: the future is now. The needs for implementing these Developed Proposals are pronounced and are not going away. For the good of investors, the public interest, capital formation and companies deciding whether to go public in the US or stay as public companies, I respectfully submit, the future is now!

Sincerely,

John J. Huber

John J. Huber
of Latham and Watkins LLP

Attachments:

A "SAB 99: Materiality as We Know It or Brave New World for Securities Law."
B Submission of the Materiality Task Force to CIFiR dated February 13, 2008.
C Rules of the Road for Restatements.
D Letter to Jonathan G. Katz for the Roundtable on Implementation of Internal Control Reporting Provisions dated April 11, 2005.
E Letter to Nancy M. Morris, for the Roundtable on Second Year Experiences with Implementation of Sarbanes-Oxley Internal Control and Auditing Provisions dated May 1, 2006

Attachment A

SAB 99: MATERIALITY AS WE KNOW IT OR BRAVE NEW WORLD FOR SECURITIES LAW

JOHN J. HUBER

Latham & Watkins

November 19, 2001

I. INTRODUCTION

Staff Accounting Bulletin No. 99 ("SAB 99") expresses the views of the staff of the Securities and Exchange Commission (the "Commission") concerning materiality in the preparation and audit of financial statements. Materiality is the keystone of the disclosure system under both generally accepted accounting principles ("GAAP") and the federal securities laws. The meaning and interpretation of materiality are the subject of caselaw, including two Supreme Court decisions,[1] and accounting literature, such as SAS No. 47, Audit Risk and Materiality in Conducting the Audit, as amended by SAS No. 82.[2]

The long awaited SAB 99 resulted from Chairman Arthur Levitt's speech on earnings management in September 1998.[3] In addition to highlighting five accounting issues[4]

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1 *TSC Industries, Inc. v. Northway*, Inc. 426 US 438 (1976) ("*Northway*") and *Basic Inc. v. Levinson* 485 US 224 (1988) ("*Basic*").

2 American Institute of Certified Public Accountants ("AICPA"), Codification of Statements on Auditing Standards ("AU") §312, "Audit Risk and Materiality in Conducting an Audit."

3 Chairman Arthur Levitt, the "Numbers Game", NYU Center for Law and Business (September 28, 1998) (the "NYU Speech"). Chairman Levitt believes that earnings management "is a game among market participants. A game, that if not addressed soon, will have adverse consequences for America's financial reporting system. A game that runs counter to the very principles behind our market's strength and success." David Porter, *SEC Ready to Crack Down on Accounting Games*, Crain's Cleveland Business, Sept. 20, 1999, *available* in LEXIS, All Sources Library, News Group.

4 These include "Big Bath" Restructuring Changes; Creative Acquisition Accounting, such as in process research and development ("IPR&D"); Cookie Jar Reserves; Revenue Recognition; and the abuse of materiality. With respect to materiality, Chairman Levitt stated: "But some companies misuse the concept of materiality. They intentionally record errors within a defined percentage ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that's the case, why do they work so hard to create these errors? Maybe because the effect can matter, especially if it picks up that last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly . . . 'It doesn't matter. It's immaterial.' In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called non-events simply don't matter." NYU Speech at 4-5. Since the NYU Speech, the Staff has taken vigorous action, including targeted reviews of more than one hundred public companies that had one or more of the accounting issues highlighted in the speech as well as enforcement actions. In addition the Blue Ribbon Committee constituted to study the audit committee has rendered its report (Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees) and the Commission has published proposals to implement certain recommendations in the report. Release No. 34-41987 (October 7, 1999).

which have become the focus of much commentary, as well as Commission review in the comment process, the NYU speech sets forth the nine steps[5] which have become the game plan for the Commission's Year of the Accountant.

When it was released on August 12, 1999, SAB 99 generated much discussion as to its meaning and scope. Does SAB 99 create a new standard of materiality or merely recite existing law, accounting and auditing principles? Will SAB 99 be limited in scope to accounting matters or will it be applied in other areas, such as insider trading, press releases for material events and disclosure generally? Does SAB 99 constitute a helpful guideline to persons responsible for preparing and auditing financial statements or does it draw the line in the sand by putting registrants and their accountants on notice that enforcement cases will be brought for violating the staff accounting bulletin? Will the Commission adopt SAB 99 as its own? Will the Commission file briefs, *amicus curiae*, to convince courts to follow or adopt SAB 99 as their own?

In the 17 months since SAB 99's release, some of these questions have been answered. The Commission adopted SAB 99 as its own and filed a brief *amicus curiae* asking the Second Circuit to reverse a district court's ruling on materiality grounds and citing SAB 99 as the basis for reversal. The Second Circuit applied SAB 99 with approval in a non-financial statement context. Other questions still remain, and new questions have arisen. Will other circuits follow the Second Circuit? How will SAB affect compliance with Regulation FD?[6] Will SAB 99's materiality test result in a profusion of disclosure by public companies under Regulation FD or will it be business as usual?

In examining these issues, this outline will first summarize materiality under the federal securities laws and the Commission's experience with quantitative and qualitative standards. The outline will then discuss SAB 99 and answer some of the questions concerning the meaning and scope of SAB 99.

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5 The nine steps include: the Staff requiring issuers to disclose the impact of changes in accounting assumptions; asking the AICPA to change the accounting for IPR&D; a staff accounting bulletin on revenue recognition; prompt action by the Financial Accounting Standards Board (the "FASB") on the liability project; staff review and enforcement of the five issues (see footnote 4); a review of the audit process by the Public Oversight Board; the Blue Ribbon Committee on the Audit Committee; focusing corporate management and Wall Street on the issue; and Staff guidance on materiality. As the Chairman stated, and SAB 99 reflects: "[M]ateriality is not a bright line cut off of three or five percent. It requires consideration of all relevant factors that <u>could</u> impact an investor's decision (emphasis added) NYU Speech at 6.

6 For a discussion of Regulation FD, see John J. Huber, Thomas J. Kim, Brian G. Cartwright, Kirk A. Davenport and Erica H. Steinberger, The SEC's Regulation FD – Fair Disclosure.

II. BACKGROUND OF MATERIALITY

While both the Securities Act of 1933 (the "Securities Act") and the Securities and Exchange Act of 1934 (the "Exchange Act") use the term "materiality," its meaning has been left to caselaw development.

A. *Northway* posed the issue of what is the standard of materiality under the proxy rules. Is it what an investor "could" consider important or is it a lesser standard of "may" or a higher standard of "would." In its analysis the Court stated: [T]he question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor. *Northway* at 445. Thus, the analysis is objective although characterized as a "mixed question of law and fact." *Id.* at 450. Moreover, it focuses on the investor, not the issuer or the accountant. In selecting "would" as the materiality standard, the Court stated:

> "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of the information made available." *Id.* at 449.

1. Although *Northway* involved proxies, other courts have applied the *Northway* materiality standard in contexts other than proxy solicitations. For example, in *Flamm v. Eberstadt*, 814 F.2d 1169, 1174 (7th Cir. 1987), the court reasoned that "*Northway* dealt with 'materiality' under the proxy rules, but like every other court of appeals we have taken the definition as suitable for the term wherever it appears in securities law." In *Steadman v. SEC*, 603 F.2d 1126 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981), the court applied the definition of materiality to Section 17(a)(2) of the Securities Act. In *Seaboard World Airlines, Inc. v. Tiger International Inc.*, 600 F.2d 355 (2d Cir. 1979), the court applied the *Northway* definition of materiality to Section 14(e) of the Exchange Act. In *Kirsch Co. v. Bliss & Laughlin Industries, Inc.*, 495 F. Supp. 488 (W.D. Mich. 1980), the court applied the *Northway* standard to Section 13(d) of the Exchange Act. Finally, in *Basic*, the Court expressly adopted the *Northway* standard in the context of Section 10(b) of the Exchange Act as well as Rule 10b-5 thereunder. *Basic* at 983. The Court in *Basic* also stated that it had been careful in *Northway* "not to set too low a standard of materiality," because it was "concerned that a minimal standard might bring an overabundance of information within its

reach and lead management 'simply to bury the shareholders in an avalanche of trivial information – a result that is hardly conducive to informed decision making.' " *Basic* at 231 *citing Northway* at 448-449.

2. In adopting the integrated disclosure system in the early 1980's, the Commission adopted the *Northway* standard in Rule 405 under the Securities Act and Rule 12b-2 under the Exchange Act.

B. Having decided the standard of materiality in *Northway,* the Court in *Basic* addressed the method to arrive at the answer under that standard in the context of merger discussions.

1. The Court recognized that application of the *Northway* standard to preliminary merger negotiations was not self-evident. "Where the impact of a corporate development on the target's fortune is certain and clear, the *Northway* materiality definition admits straightforward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the 'reasonable investor' would have considered the omitted information significant at the time." *Basic* at 232.

2. In *Basic,* the Court clarified its position regarding the circumstances that make corporate developments material. If a significant corporate development is "certain and clear," the corporation must disclose it. However, when its occurrence is speculative, as is true with merger negotiations, materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'" *Basic* at 238 *citing SEC v. Texas Gulf Sulphur Co.,* 401 F.2d, 833, 849 (2d Cir. 1968), *cert. denied,* 394 US 976 (1969). Thus, the Court adopted the probability/magnitude test of *Texas Gulf* which the Commission had supported in its amicus brief. *Basic* at 239, n.16.

3. The Court emphasized that materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. *Id.* at 240. In a footnote, the Court stated it finds "no authority in the statute, the legislative history, or our previous decisions for varying the standard of materiality depending on who brings the action or whether insiders were alleged to have profited." *Id.* at 240 n.18. Although *Basic* involved the materiality of information regarding preliminary merger negotiations in the context of public announcements by the corporation, the same standard would apply to determine whether an insider traded while in possession of material non-public information.

4. In arriving at its holding, the Court in *Basic* rejected the standard that had been employed by the Sixth Circuit, that "information becomes material by virtue of a public statement denying it." The Court reasoned that application of such a rule "fails to recognize that, in order to prevail on a Rule 10b-5

claim, a plaintiff must show that the statements were misleading as to a material fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant." *Id.* at 238.

5. Once a determination has been made that the event or statement is material, disclosure is required only when there exists a duty to disclose. The *Basic* court did not discuss when a duty to disclose arises, but acknowledged that there is no general duty under the federal securities laws to disclose information merely because it is deemed to be material. In stating that "[S]ilence absent a duty to disclose is not misleading under Rule 10b-5," the Court in *Basic* viewed "no comment" statements as "the functional equivalent of silence" and thereby endorsed the Commission's position in *In re Carnation Co.*, Release No. 34-22214 (1985). *Basic* at 239, n.17.[7]

C. SAB 99 states that the "total mix of information" test of *Northway* "includes the size in numerical and percentage terms of the misstatement"... and "the factual content in which the user of financial statements would view the financial statement item." SAB 99 at 3. To the Staff, the analog in the accounting literature is qualitative[8] factors. SAB 99 is not the first time that the Staff has embraced qualitative factors as being equal to quantitative factors in determining materiality. The first, and until SAB 99 the last, time was in the late 1970's. *See* John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 Cath. U. L. Rev. 41, 46 (1998).

1. In the wake of Watergate, the Commission took the position that a conviction for making illegal campaign contributions is a material fact requiring disclosure. *See* Release No. 33-5466 (Mar. 8, 1974). The Commission decided that a conviction is material to an evaluation of the

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[7] Issuers have a duty to correct or update prior statements that have subsequently become misleading if investors are still reasonably relying on the prior statements. *See Ross v. A.H. Robins Co.*, 465 F. Supp. 904 (S.D.N.Y.), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980). In *Ross*, the plaintiff alleged that the defendant, a maker of a contraceptive device, represented that the device was safe and effective, but failed thereafter to make corrective disclosure after conducting research which indicated that the device was harmful to women. The court held that there was a duty to correct or revise a prior statement which was accurate when made but which had subsequently become misleading. The duty exists so long as the prior statements remain alive in the marketplace. *See Ross*, 465 F.Supp. at 908. The *Ross* court recognized that the passage of time may result in a statement becoming immaterial and any duty to correct or update the fact would disappear. The duty to update should be contrasted with the duty to correct a statement that was inaccurate when made. *See Sharp v. Coopers & Lybrand*, 83 F.R.D. 343 (E.D. Pa 1979) (accountant had duty to correct opinion letter after learning that it was inaccurate).

[8] As used in SAB 99 "'qualitative' materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries." SAB 99 at 9, n.5.

integrity of the management since it relates to the operation of the corporation and the use of corporate funds.

2. In 1975, a time when making foreign payments was not illegal, the Commission asserted that disclosure was required because of the effect of making questionable payments on the financial statements. *See* Fedders, 48 Cath. U.L. Rev. 41, 51.

3. While the Commission was experimenting with qualitative materiality, courts continued to follow a quantitative approach.

   a. *Berman v. Gerber Products Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978), involved a bidder's failure to disclose bribes in a Schedule 14D-1. The target company argued that the bidder had failed to disclose information regarding questionable payments in its tender offer materials in violation of Section 14(e) under the Exchange Act. The court in *Berman* reasoned that the questionable payments might bear on management integrity and, therefore, may be worth disclosing, but found that their omission was not materially misleading.

   b. In *Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co.*, 475 F. Supp. 328 (S.D.N.Y. 1975), a union alleged that the company's proxy solicitation was materially deficient in failing to disclose that board nominees had participated in a conspiracy to thwart the labor laws of the U.S. In dismissing the complaint, the court concluded that the principle that illegal foreign payments need not be disclosed so long as they are intended for the corporation's benefit was equally applicable to the conspiracy alleged in Amalgamated.

4. The Commission's focus on qualitative materiality as co-equal to quantitative materiality largely disappeared in the 1980's, and quantitative materiality re-emerged as the primary standard. *See generally*, Fedders, 48 Cath. U. L. Rev. 41, 79-84.

D. The Foreign Corrupt Practices Act (the "FCPA") enacted in 1977, added Section 13(b)(2)(A) and (B) to the Exchange Act to assure that companies make and keep their books, records and accounts in reasonable detail to facilitate their compliance with the disclosure obligations under the securities laws. Rule 13b2-1 states that "[n]o person shall directly or indirectly falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A)," and Rule 13b2-2 prohibits a director or officer from making a materially false or misleading statement or omitting to state any material fact in connection with any audit or preparation or filing of any report required to be filed with the Commission.

III. SAB 99

A. The Staff issued SAB 99 in response to two perceived concerns. First, SAB 99 levels the playing field by addressing what the Staff sees as the increasing practice by registrants and their auditors of using quantitative thresholds as rules of thumb in preparing and auditing financial statements. Second, SAB 99 addresses what the Staff sees as the increasing practice of some registrants to use what the Staff deems to be immaterial audit adjustments to financial statements to affect or "manage" reported earnings. Thus, SAB 99 resulted from Chairman Levitt's NYU Speech.

B. SAB 99 came less than a year after the Big Five Audit Materiality Task Force recommended the development of guidance covering the auditor's consideration of qualitative factors when evaluating the materiality of proposed financial statement misstatements. *See* Letter from Robert H. Herz, Big Five Audit Materiality Task Force, to Lynn E. Turner, Chief Accountant, Securities and Exchange Commission (Oct. 9, 1998) (the "Big Five Letter"), available http://www.aicpa.org/members/div/auditstd/big5.htm, which is attached as Attachment A to this outline. The Task Force set out to identify and understand practice issues that had emerged relating to audit materiality, with a particular focus on recent concerns expressed by the Staff, and to formulate responses addressing these issues. The Task Force developed four principal recommendations to strengthen financial and audit effectiveness:

1. Adopt a set of audit requirements aimed at encouraging audit clients to record proposed financial statement misstatements.
2. Develop guidance covering the auditor's consideration of qualitative factors when evaluating the materiality of financial statement misstatements.
3. Commit each of the Big Five firms to review the adequacy of its consultation requirements and to issue a communication to its audit personnel discussing the importance of effective evaluation of proposed financial statement misstatements.
4. Sponsor audit research to understand better whether the evaluation of materiality by the auditor needs to be updated for changing investor expectations.

C. SAB 99 came in the wake of two settlements in enforcement actions. On March 25, 1998, the Commission announced a settlement had been reached in the matter of Sensormatic Electronics. *See In re Sensormatic Electronics Corp.*, Release No. 34-39,791 (Mar. 25, 1998), available at <www.sec.gov/enforce/adminact/337518.txt>. More recently, on June 30, 1999, the Commission reached settlement in its financial fraud case against W.R. Grace & Co. ("Grace"), its officers, and outside auditors. *See* In re W.R. Grace & Co., Exchange Act Release No. 41,578 (June 30, 1999), available at <www.sec.gov/enforce/adminact/34-41578.htm>.

1. Through its fiscal years 1994 and 1995, Sensormatic engaged in the practice of managing its quarterly revenue and earnings reports in order to reach

budgeted earnings goals and thereby meet analysts' quarterly earnings projections. Sensormatic's earnings were determined primarily by the recognition of revenue from the sale of electronic security system equipment that the company manufactured and marketed. Among other things, Sensormatic engaged in the practice of shutting down the computer clock on the last day of the quarter while still shipping goods so that out-of-period shipments, and consequently revenue, would be recorded in the prior quarter. The overstatement reached $30 million in a single quarter. The Chairman of Sensormatic, who paid a $50,000 fine to settle with the Commission, maintained that the practice had no material effect on the company's financial condition. Investors viewed Sensormatic as a growth company. This view was fostered by the company's own press releases that described its significant growth. In preparation for the end of each quarter, an employee would produce weekly memoranda containing the sales goals that needed to be met in order to reach the company's budgeted earnings goals. These memoranda were circulated to top management, including the Chief Financial Officer. At the beginning of the last month of each quarter, the company typically was short of its sales goals. When senior management determined that Sensormatic could not attain budgeted goals, the company engaged in a variety of improper revenue recognition practices which did not conform to GAAP. Sensormatic's major non-conforming practice, was out-of-period shipments, whereby the company recognized revenue in one quarter on items that were actually shipped in the next. Second, Sensormatic recognized revenue when customer shipments were made to a warehouse leased by it, rather than directly to the customer. Third, the company engaged in slow shipping, whereby Sensormatic recognized revenue when it shipped goods at the end of the quarter, but requested the carrier to delay delivery beyond normal transit times to meet customers' requested delivery date in a subsequent quarter. Finally, Sensormatic recognized revenue when goods were shipped to customers whose contracts included FOB destination terms. According to the settlement, Sensormatic engaged in these practices to smooth its reported earnings over the course of a year and obscure its seasonally weaker third quarter. Management knew that the company's stock, which traded at a high price to earnings ratio, was particularly sensitive to quarterly earnings announcements. Smoothing reported earnings meant that analysts' forecasts would be met consistently.

2. According to the settlement in Grace, a division of Grace subject to segment reporting known as National Medical Care ("NMC"), made more in profits and had greater revenue growth than it had expected beginning in 1991 and continuing through 1992. NMC deliberately underreported its earnings, hiding the excess in a so-called cookie-jar reserve account for which there was no corresponding exposure contrary to GAAP. The reserve grew over time to $60 million. In 1994, when Grace's profits were declining, NMC started reintroducing the reserve into reported earnings (thereby

compounding the existing irregularity). The reversal was described in Grace's annual report as a "change in estimate." At the time, Grace's auditor Price Waterhouse (now PricewaterhouseCoopers LLP, "PWC") agreed with the position because the amounts were immaterial. The Commission disagreed on the grounds that the "change in estimate" statement was materially false and misleading. Grace was charged with engaging in fraud by managing the earnings reported in quarterly and annual financial reports. For most of the periods at issue, the false report consisted of a "smoothing" of the earnings of the segment. The Commission's position in Grace is that misstatement in the financial statements by means of an intentional misapplication of GAAP will lead to fraud charges even if the financial impact is material only to a corporation's segment, rather than to the corporation taken as a whole. In Grace, the Commission did not allege that accounting irregularities were material to the parent company; rather, they were material only to the NMC segment. The Commission found a basis for materiality in the efforts by former Grace and NMC senior management to manipulate NMC's and Grace's reported earnings. The Commission found that the two PWC audit partners knew of the improper diversion of revenue into the reserves in 1991 and 1992 and told management that the accounting was out of conformity with GAAP. After discussion with management over the irregularity, the auditors issued an unqualified audit opinion. In addition, the Commission was critical of the PWC engagement partner who failed to resolve the reserve problem of which he was aware.

D. SAB 99 may be divided into three topics: the discussion of materiality; issues under the FCPA; and the Staff's views of the auditor's duties under Section 10A of the Exchange Act.

1. Materiality under SAB 99

a. In its analysis of materiality, SAB 99 compares the caselaw under materiality to the FASB Statement of Financial Accounting Concept No. 2, Qualitative Characteristics of Accounting Information (1980). ("Concepts Statement No. 2).

(1) According to Concepts Statement No. 2: "[t]he omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item." Concepts Statement No. 2 at 132. This is similar to the probability/magnitude test of *Basic*.

(2) In *Northway* the Court held that "a fact is material if there is a substantial likelihood that the fact would have been viewed by the

reasonable investor as having significantly altered the total mix of information made available." *Northway* at 449. But *Northway* does not include quantitative or qualitative factors in its "total mix" discussion. Materiality "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him." *Id.* at 450. The "total mix" of *Northway* is substantially the same concept as the "surrounding circumstances" of the accounting literature. While SAB 99 correctly compares the "total mix" of the caselaw to the "surrounding circumstances" of the accounting literature, it makes a leap of faith concluding that qualitative factors are necessary or appropriate in assessing materiality. SAB 99's citation to cases to support this position does not include any case before 1996. SAB 99 at 9, n.6. Recognizing that materiality cannot be reduced to a numerical formula does not lead to the conclusion that qualitative factors must be included in the analysis. Notwithstanding this point, SAB 99 asserts that the "shorthand" in the accounting literature for the "total mix" analysis under the caselaw is an analysis of both quantitative and qualitative factors. SAB 99 at 3. SAB 99 considers both quantitative and qualitative factors to be of equal weight in conducting an analysis of materiality.

b. In rejecting the use of a 5% threshold as a quantitative rule of thumb to determine materiality, SAB 99 reminds registrants and auditors that "exclusive reliance on this or any other percentage or numerical threshold has no basis in the accounting literature or the law." SAB 99 at 2. While a quantitative rule of thumb or bright line test or percentage safe harbor is not enough under either caselaw or accounting literature, the Staff is comfortable in using it as the first step in assessing materiality. The first step of quantitative analysis is followed by the second step of considering "all the relevant circumstances," which under SAB 99 is focused exclusively on qualitative factors.

c. Following the logic of SAB 99 results in the conclusion that there are circumstances in which a misstatement below 5%, or 3%, or any percentage, could be material because the application of one or more qualitative factors or the intent of the person responsible for the financial statements could make an otherwise immaterial item material. The Staff's non-exclusive list includes:[9]

(1) Whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate, and if so, the degree of imprecision inherent in the estimate.

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[9] The list should be compared to the list of qualitative factors included as an appendix in the *Big Five Letter*, attached as Attachment A.

(2) Whether the misstatement masks a change in earnings or other corporate trends.

(3) Whether the misstatement hides a failure to meet analysts' consensus expectations for the business.

(4) Whether the misstatement changes a loss into income or vice versa.

(5) Whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability.

(6) Whether the misstatement affects the registrant's compliance with regulatory requirements.

(7) Whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements.

(8) Whether the misstatement has the effect of increasing the management's compensation.

(9) Whether the misstatement implicates the concealment of an unlawful transaction.

d. Significantly, SAB 99 identifies possible market reaction as another factor in determining materiality. The Staff arrives at this position by an indirect path:

(1) "Consideration of potential market reaction to disclosure of a misstatement is itself 'too blunt an instrument to be depended on' in considering whether a fact is material." SAB 99 at 4, *citing* Concepts Statement No. 2 at 169.

(2) "When, however, management or the independent auditor expects . . . that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account in considering whether a misstatement is material." SAB 99 at 4.

(3) Thus, potential market reaction may or may not be a factor in determining materiality based on the expectation, the mind set, or the mens rea of the company and its auditor. What if they disagree? What if there is an internal disagreement between the senior management and the board of directors of the company, despite a demonstrated pattern of significant market reaction? This factor in SAB 99 turns Concepts Statement No 2 on its head and puts companies and their

advisors at risk of being second guessed in making the materiality determination. Following SAB 99 would mean that any potential impact, real or believed, has to be included in the materiality analysis, but the absence of any market impact does not alone provide a basis for a conclusion that the fact or event is not material.

(4) A recent example of the difficulty in anticipating market reaction to a corporate development may be found in the announcement of the findings of fact by Judge Penfield Jackson that indicated Mircrosoft Corporation was a monopoly and had used its monopoly position to stifle competition. On the day of the announcement, Microsoft declined $1.60 per share or 1.8 %. The following week Microsoft regained the lost ground by announcing an agreement with Tandy Corporation to market products in Radio Shack stores. From the date of the Judge's decision to mid-November, Microsoft common stock declined over 4%. Assume that Microsoft, as a technology company, has a pattern of volatile market movements. The most logical position for anyone advising Microsoft about the market reaction prior to the public announcement by the Judge would have been a decline in the market price of between 5% to 10% per share. Yet, the market price did not decline by more than 1.8%. Does that make the announcement of a finding of monopoly status immaterial? Under SAB 99, an argument could be made that since the market reaction factor had not been met, the fact was not material. Yet, it was indeed material.

e. Since qualitative factors will always play a role in assessing materiality under SAB 99, a registrant and its auditors should not assume that even small intentional misstatements are immaterial. Significantly, under SAB 99 intent may make an otherwise immaterial fact or event material.

(1) "While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. SAB 99 at 4. Thus the Staff concludes that earnings management, no matter how small, can be material. In addition, this standard can lead to making any small intentional misstatement material because of the intent of the person.

(2) The Staff provides no support either in caselaw or the accounting literature for its assertion of intent as a factor in determining materiality. Again, the SAB does not recognize either the difficulty of determining intent or the multiplicity of "intents" that can be involved. Thus, SAB 99 puts the auditor to the task of auditing the intent of his/her client.

(3) Not only can intentional immaterial misstatements be material, but SAB 99 asserts that they are also unlawful.

f. When a misstatement involves a segment of the registrant's operations, the registrant in assessing materiality to the financial statements taken as a whole should consider not only the size of the misstatement but also the significance of the segment information to the financial statement taken as a whole. For example, if management has represented a segment to be important to the future profitability of the company, then a misstatement of that segment's profitability is more likely to be material than a financial statement misstatement in a segment that management has not identified as especially noteworthy.

g. After assessing each item separately under a quantitative and then qualitative analysis, SAB 99 states that registrants must then analyze the aggregate effect of all of the immaterial items.

(1) Both qualitative and quantitative factors should be considered, especially in relation to individual line item amounts, subtotals, or totals in the financial statements. Factors to be considered include the following:

(a) The significance of an item to the corporate entity.

(b) The pervasiveness of the misstatement.

(c) Effect of the misstatement on the financial statements taken as a whole.

(2) The aggregate effect of a series of individually immaterial misstatements may result in the financial statements taken as a whole to be materially misleading. Thus, SAB 99 appears to reject a netting process in which one or more negative misstatements are netted against one or more positive misstatements, all of which are individually immaterial.

(3) SAB 99 thus provides a procedure for assessing the materiality of multiple misstatements:

(a) Consider whether each misstatement is material, irrespective of its effects when combined with other misstatements.

(b) Consider whether the misstatement of individual amounts causes a material misstatement of the financial statements taken as a whole.

(c) Consider both quantitative and qualitative factors with respect to both (a) and (b), above.

(d) If the misstatements of an individual amount renders the entire statement materially misstated, then such effect cannot be eliminated by other misstatements whose intended effect may be to diminish the impact of the misstatement to other financial statement items.

(e) Registrants should assess the effect of the quantitative aggregation of individual immaterial misstatements. There may be a situation where an individual misstatement by itself is immaterial, but when aggregated with other misstatements, they render the financial statements taken as a whole to be materially misleading.

(f) The Staff believes that particular attention should be paid to the situation in which a misstatement of an estimated amount is offset by a misstatement of an amount capable of precise measurement.

(4) In addition to the aggregate assessment, SAB 99 appears to require the materiality analysis to include the effect of a misstatement in the current period together with its effect from prior periods. "This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year." SAB 99 at 6. Thus, SAB 99 appears to support the "iron curtain" (confining the error to one period) approach rather than the "roll-over" (rolling the error into the next period) method to immaterial errors that cover multiple periods.

h. While SAB 99 discusses qualitative factors, segments aggregation and netting as separate factors, it does not provide guidance as to how to analyze these factors together. For example, if materiality is determined by the total mix of information as *Northway* and SAB 99 state, do you analyze each misstatement within each line item of a segment without any aggregation or netting? Or can you take the approach that since the amount of the misstatements in the aggregate is neither quantitatively nor qualitatively material to the financial condition, results of operations or liquidity of the company taken as a whole, the misstatements are immaterial?

i. An analysis of materiality under SAB 99 could include the following steps:

(1) If an item is quantitatively material, it will be material regardless of whether or not one or more qualitative factors apply;

(2) Even if an item is quantitatively immaterial, it may still be material if one or more qualitative factors apply; and

(3) Intent can be viewed as constituting evidence of materiality.

2. Separate from the discussion of materiality, SAB 99 states that an immaterial, misstatement, whether intentional or unintentional, can still constitute a violation of the FCPA – the books and records provisions of the Exchange Act.

a. The Staff reminds registrants that they must comply with Sections 13(b)(2) to (7) of the Exchange Act even if financial statement misstatements are immaterial.

b. These provisions require each registrant with securities registered pursuant to Section 12 of the Exchange Act, or required to file reports pursuant to Section 15(d) of the Exchange Act, to make and keep books, records, and accounts, which, *in reasonable detail,* accurately and fairly reflect the transactions and dispositions of assets of the registrant. The registrant must also maintain internal accounting controls that are sufficient to provide *reasonable assurances* that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. Reasonableness, rather than materiality, is the standard. SAB 99 also points out that criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records, or accounts. Rule 13b2-1 states that "[n]o person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act."

c. The Staff asserts that determinations of what constitutes "reasonable assurance" and "reasonable detail" are based *not* on a materiality analysis, but rather on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.

d. The reasonableness standard in Section 13(b)(2) of the Exchange Act is not an absolute standard for corporate records. The limited authoritative guidance that exists on the reasonableness standard in this context suggests that reasonableness reflects a judgment as to whether a registrant's failure to correct a known misstatement implicates the purposes underlying the provisions of Section 13(b)(2) – (7) of the Exchange Act.

e. Registrants and their auditors should consider a number of factors in assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate in *reasonable detail.*

(1) The significance of the misstatement – as measured by its effects.

(2) How the misstatement arose – an immaterial misstatement arising from an effort to manage earnings is a violation, while one arising from the normal course of business will not cause the books to be inaccurate in reasonable detail.

(3) The cost of the misstatement[10] -- the Staff does not expect registrants to make major expenditures in correcting a small misstatement, and, conversely, finds it unlikely to be reasonable that a registrant would fail to correct a known misstatement where there is little cost or delay in doing so.

(4) The clarity of authoritative accounting guidance with respect to the misstatements – in gray areas, failure to correct a known misstatement may not render the registrant's financial statements inaccurate in reasonable detail but in areas free from doubt "there is little ground" for leaving a misstatement uncorrected. SAB 99 at 7.

(5) Recognizing that there may be other indicators of reasonableness, the Staff will continue to defer to "judgments that 'allow a business, acting in good faith, to comply with the Exchange Act's accounting provisions in an innovative and cost-effective way.'" *Id., citing* Speech by then Chairman Harold Williams, 46 FR 11546.

3. Under Section 10A(b) of the Exchange Act, an auditor upon discovery of "an illegal act" has to take certain actions which can include informing management, the audit committee or the board of directors, unless "the illegal act is clearly inconsequential." The statute specifies that the auditor's obligations are triggered irrespective of whether the illegal acts are perceived to have a material effect on the financial statements of the registrant.

a. Since the obligations imposed on an auditor by Section 10A(b)(1) are triggered regardless of the materiality of the illegal misstatement, the Staff reminds the auditor of his/her obligation to report the illegal act to the audit committee irrespective of any "netting" of the misstatements with other financial statement items.

b. According to the Staff, the requirements of Section 10A are consistent with the auditing literature. *See* Statement on Auditing Standards ("SAS") No. 54, Illegal Acts by Clients; SAS 82, Consideration of Fraud in a Financial Statement Audit. SAB 99 points out that pursuant to paragraph 38 of SAS 82, if the auditor determines that *fraud* might exist, the auditor must discuss the matter with the

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[10] It should be noted that while cost of compliance is a factor for FCPA compliance under SAB 99, it is not mentioned in the Staff's materiality discussion.

appropriate level of management. The auditor is under a continuing obligation to report directly to the audit committee any fraud involving senior management as well as any fraud that causes a material misstatement of the financial statements.

(1) Paragraph 4 of SAS 82 states that misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive statement users.

(2) SAS 82 goes on to state that fraudulent financial reporting may involve, among other things, intentional misapplication of accounting principles.

(3) Therefore, the implication drawn by the Staff is that immaterial misstatements may constitute fraudulent financial reporting.

(4) Auditors that learn of intentional financial statement misstatements may be required, depending upon the situation, to undertake several procedural re-evaluations, and consider whether to resign.

(5) An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course of examining the registrant's financial statements.

E. The Staff also takes the position that authoritative literature takes precedence over industry practice that is contrary to GAAP.

IV. ISSUES RAISED BY SAB 99

A. Does SAB 99 interpret materiality in accordance with caselaw and the accounting literature or does SAB 99 announce a new standard of materiality?

1. SAB 99 emphasizes and repeats that it is meant only to reaffirm existing concepts of materiality in the caselaw and accounting and auditing literature.

   a. To that end, SAB 99 cites as its main sources only authoritative auditing or accounting literature, as well as longstanding caselaw.

   b. The qualitative factors announced in SAB 99 are all available in accounting and auditing literature.

2. Concepts Statement No. 2, states that materiality judgments are primarily quantitative in nature and recognizes that materiality judgments are concerned with thresholds. The significance of a financial statement item is

reflected in and reflects the threshold used to measure its materiality. It provides examples of thresholds and screens. The relative, rather than the absolute size of an item, determines whether it should be deemed material in a given situation. Concepts Statement No. 2 takes the position that materiality judgements can properly be made only by those with all the facts.

3. SAB 99 also cites Accounting Principle Board Opinion No. 20 (1971) on Accounting Changes ("APB No. 20") to support the proposition that numerous factors should be considered in determining whether a quantitatively small misstatement is material. Paragraph 38 of APB No. 20 states that "[m]ateriality should be considered in relation to both the effects of each change separately and the combined effect of all changes."

4. SAB 99 represents a mixture of new and old legal and accounting concepts relating to materiality that on balance may be viewed as resulting in a new and different test. This is particularly the case with respect to analyzing materiality issues which involve more than one analysis described in SAB 99, such as line items of a segment that involve a number of quantitatively immaterial errors that in the aggregate or when netted do not change the total mix of information about the registrant.

   a. The standard of *Northway* coupled with the probability/magnitude methodology of *Basic* is tempered under SAB 99 by a qualitative factors test. While this combination can be reconciled with "total mix of information" under *Northway* and the "surrounding circumstances" of Concepts Statement No. 2 from a theoretical standpoint, it cannot be reconciled from a practical point of view. It is dictating a two-step analysis for materiality that is not found in caselaw. The various tests under caselaw and the accounting literature are all intended to meet the standard of what a reasonable investor would consider important. How the registrant and its auditors get there should be up to them. Having set the procedure, SAB 99 also minimizes or eliminates the ability of registrants and their advisors to make judgments. In response to Chairman Levitt's criticism of flexibility in the NYU Speech, SAB 99 leaves little room for judgment in an area that caselaw and the accounting literature recognize is dominated by judgment calls.

   b. Not only can the mixture be viewed as creating a new standard, but SAB 99 confuses intent with materiality. Intent deals with mens rea or the state of mind of the actor. Materiality concerns the fact, event or item itself. For example, intent and materiality are separate elements in proving a cause of action under Rule 10b-5. While the Staff has disavowed it, the language of SAB 99 can make an otherwise immaterial item material if the actor has the wrong intent.

c. Having to consider the prospective effect of an item on the market price is a new standard which brings an unknowable variable into the traditional analysis of the "total mix" of information, one that takes the lawyer and the accountant as advisors to registrants on materiality into the realm of investment banking.

B. Is SAB 99's position on materiality limited to the preparation and audit of financial statements?

1. Harvey Goldschmid, General Counsel of the Commission, is reported to have said that although SAB 99 focuses on accounting practices, "the key definitions of materiality come from the Court, and therefore the bulletin has implications for lawyers in all kinds of areas" He is reported to have added that SAB 99 "reflects a lot of commission thinking which hopefully will provide useful guidance." Ellen Rosen, *Is No Matter Too Small to be 'Material'?*, Nat'l L.J., Sept. 20, 1999, *available in* LEXIS, All Sources Library, News File.

2. SAB 99 discusses *Northway* and *Basic,* which established the law of materiality. SAB 99's focus on qualitative factors is not found in either case.

3. The standard of materiality in SAB 99 addresses materiality in preparing or auditing financial statements. Although SAB 99 reflects the definition of materiality in *Northway*, as refined in *Basic*, the SAB 99 standard is formulated in the language of financial statement misstatements, rather than proxy solicitations or merger negotiations or disclosure generally. As such, when *Basic* discusses the probability and magnitude of an occurrence, in the context of SAB 99 this may mean something completely different than what it means in the context of preliminary merger negotiations. Nevertheless, SEC officials have said they expect the SAB 99 standard to extend beyond financial reporting and to be considered in connection with other securities laws, including insider trading, and disclosure generally. *See* Liz Skinner, *New SEC Rules Good News for Investors*, Arkansas Democrat-Gazette, Aug. 16, 1999, *available in* LEXIS, All Sources Library, News File.

4. Given the overlap between caselaw and the accounting literature about the same term, materiality, it is inevitable that Harvey Goldschmid's prediction will be realized and SAB 99 will expand beyond financial statements.

C. Will SAB 99 be used by the SEC's Division of Enforcement? Yes. In late October 1999, the SEC's Division of Enforcement began citing SAB 99 as authority for violations of accounting requirements in a case that involved a fact pattern that occurred before SAB 99 was published.

D. Will the Commission endorse SAB 99 and file *amicus curiae* briefs to convince courts to adopt SAB 99? Yes. Have any courts endorsed SAB 99 in a non-financial statement context? Yes.

1. While a staff accounting bulletin represents only the views of the Staff, an *amicus* brief represents a Commission position. In October 1999, the Commission filed an *amicus* brief in the Court of Appeals for the Second Circuit in *Ganino v. Citizens Utilities Co.*, a copy of which is attached as Attachment B. The Commission's brief cited SAB 99 as well as Chairman Levitt's speech to support the position that: exclusive reliance on quantitative analysis to determine materiality without considering all relevant factors is inappropriate; and assessing materiality requires consideration of the impact of the item on a quarter as well as its impact on the entire year. In September 2000, the Second Circuit issued its opinion in *Citizens Utilities*, in which it approved the use of SAB 99 in a non-financial statement context.[11] A copy of the Second Circuit's opinion is attached as Attachment C.

2. In *Citizens Utilities*, plaintiffs-shareholders alleged in their complaint that Citizens Utilities Co., a publicly traded company, fraudulently inflated its share price by, among other things, misrepresenting the source of income in its Form 10-Q for the second quarter of 1996 and deceptively underreporting fee revenue earned and received in 1995 so that it could report the fees in a later period, such as 1996, when Citizens needed to use them in order to manage earnings. Citizens had had over 50 consecutive years of increased revenue, earnings and earnings per share. Citizens moved to dismiss the complaint on the grounds that the amount of the fees that were allegedly misrepresented was immaterial as a matter of law since it comprised a de minimus 1.7% of Citizens' total pre-tax revenues for 1996. The district court granted the motion to dismiss, quoting a newspaper article that observed that "'most auditors – and their corporate clients – define materiality as any event or news that might affect a company's earnings, positively or negatively, by 3% to 10%....[it] has become standard practice in corporate America. Thus, if a particular charge or event doesn't meet the 3% to 10% level, companies feel they don't have to disclose it.'"[12] Accordingly, the district court held that the amount at issue -- 1.7% of Citizens' revenues for the relevant time period -- was immaterial as a matter of law and, furthermore, that the lack of change in Citizens' stock price following the filing of the information about the source of the income in the Form 10-Q for the second quarter of 1997 was evidence of the immateriality.

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[11] *Ganino v. Citizens Utilities Co.*, 228 F.3d 154 (2d Cir. 2000).

[12] *Ganino v. Citizens Utilities Co.*, 56 F. Supp. 2d 222, 226 (D. Conn. 1999).

The Second Circuit reversed, holding that following the Supreme Court's decision in Basic v. Levinson, "we have consistently rejected a formulaic approach to assessing the materiality of an alleged misrepresentation."[13] The Second Circuit also observed that, while SAB 99 does not have the force of law, it is "thoroughly reasoned and consistent with existing law – its non-exhaustive list of factors is simply an application of the well-established Basic analysis to misrepresentations of financial results – we find it persuasive guidance for evaluating the materiality of an alleged misrepresentation."[14] SAB 99, the Second Circuit noted, stated that various "qualitative factors may cause misstatements of quantitatively small amounts to be material." The Second Circuit found particularly relevant SAB 99's statements of whether the "misstatement masks a change in earnings or other trends" and whether the "misstatement hides a failure to meet analysts' consensus expectations for the enterprise."[15] But for the inclusion of the 1.7% fees in revenue, the over 50-year trend of increased revenue and earnings would not have continued in 1996.

Endorsing and applying the principles outlined in SAB 99 and in the case law, the Second Circuit therefore held that the plaintiffs-shareholders had alleged material misrepresentations and that the district court erred in holding that these amounts were immaterial as a matter of law.

E. What are the effects of SAB 99?

1. Audits will take longer and cost more;

2. There will be more disclosure of less meaningful information;

3. The mixed question of law and fact which materiality represents could become a foggier, even more difficult analysis; and.

4. SAB 99 will be used as an enforcement tool by the Commission, which could lead to litigation by a defendant seeking a determination that it is invalid.[16]

5. SAB 99 and Regulation FD should be viewed together, rather than separately. Materiality is the major element to determining whether

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[13] *Ganino*, 228 F.3d at 162.

[14] *Id.* at 163.

[15] *Id.*

[16] Staff accounting bulletins are intended to be statements or interpretations of existing rules or principles involving financial statements. Thus, a staff accounting bulletin cannot constitute rulemaking nor can its effect extend beyond financial accounting. Otherwise, the staff accounting bulletin is invalid.

disclosure is required under Regulation FD. If SAB 99 represents a new materiality standard -- one that lowers the threshold of materiality -- SAB 99 could have a synergistic effect on disclosure under Regulation FD, resulting in a profusion of public announcements of unimportant information. This effect would result in higher costs of compliance, less meaningful information to investors and more, rather than less, investor confusion.

PRICEWATERHOUSECOOPERS

ATTACHMENT A

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October 9, 1998

Mr. Lynn E. Turner
Chief Accountant
The U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Turner:

Enclosed are the materials relating to the Big Five Audit Materiality Task Force that David Landsittel and I discussed with you in our telephone call on October 8, 1998. As noted in the enclosed paper entitled, "Status Report and Initial Recommendations, August 1998", the Task Force was formed at the direction of the (then) Big Six Professional Practice Partners in order to identify and understand practice issues that have emerged relating to audit materiality, with a particular focus on recent concerns expressed by the SEC staff, and to formulate responses addressing these issues. The Task Force is chaired by David Landsittel (formerly of Arthur Andersen and former Chair of the Auditing Standards Board), and includes Jay Brodish (PricewaterhouseCoopers), Andrew Capelli (KPMG Peat Marwick), Edmund Noonan (formerly of KPMG and former Chair of the Auditing Standards Board), David Pearson (formerly of Ernst & Young), Robert Steiner (Deloitte & Touche), and myself on behalf of the Professional Practice Partners.

As further described in the attached materials, the Task Force has developed four principal recommendations which we believe will serve to strengthen financial reporting and audit effectiveness, as follows:

1. Adopting a set of audit requirements aimed at encouraging audit clients to record proposed audit adjustments. Our suggested approach is described in detail in Exhibit A.

2. Developing guidance covering the auditor's consideration of qualitative factors when evaluating the materiality of proposed audit adjustments. Our draft guidance is contained in Exhibit B.

3. Committing each of our firms to: a) review the adequacy of its consultation requirements dealing with the auditor's consideration of proposed audit adjustments; and, b) issue a communication to its audit personnel discussing the importance of effective evaluation of these proposed adjustments and the consultation process when issues arise in this regard. Exhibit C is a copy of the Ernst & Young policy in this area which we believe provides a good example of the type of requirements that all our firms should have in place.

4. Sponsoring audit research to better understand whether the evaluation of materiality by the auditor needs to be updated for changing investor expectations. Exhibit D describes a research project currently under way by Professors William Kinney (University of Texas), David Burgstahler (University of Washington), and Roger Martin (Michigan State University) that we are sponsoring.

Each of our firms supports the principal recommendations of the Task Force and intends to adopt them as soon as possible. We would be very pleased to meet with you and members of your staff to further discuss the work and recommendations of the Task Force.

Sincerely,

Robert Herz

Robert H. Herz

RHH/lh

Enc.

Cc: Jane B. Adams – U.S. Securities & Exchange Commission
Michael A. Conway – Chair, SEC Practice Section Executive Committee
Jerry D. Sullivan – Public Oversight Board
Arleen R. Thomas – AICPA
Big Five Audit Materiality Task Force

Big Five Audit Materiality Task Force
Status Report and Initial Recommendations
August 1998

In March 1998, the Big Six Professional Practice Partners each appointed a representative from their respective firms to form a task force to examine concerns that have been expressed about the application of materiality standards and concepts by auditors in a financial statement audit – including the recording or non-recording of audit adjustments. The task force has met on three occasions since that time and formulated four recommendations for action, as outlined below.

Background and Brief Analysis of Issues

In our initial discussions the task force formulated a mission consistent with the communications it had received from the Big Six Professional Practice Partners, as follows:

> *To identify and understand practice issues that have emerged relating to audit materiality, with a particular focus on recent concerns expressed by the SEC staff, and to formulate responses addressing these issues.*

In order to understand issues and concerns, our task force reviewed carefully comments made by various SEC staff representatives raising concerns about the auditor's application of materiality at an annual conference sponsored by the AICPA in December 1997. In this forum the SEC staff raised two issues – specifically, (a) whether there is a need to evaluate the effects of financial statement misstatements identified in an audit more rigorously in light of the high multiples currently existing because of rises in stock prices in recent years, and (b) whether there is too much auditor tolerance for misstatements that are intentionally made by management to "manage" reported earnings.

In both cases, the SEC staff observed that traditional audit materiality thresholds may need to be reexamined. In the first instance, the notion is that a small difference between expected and reported earnings seemingly triggers a significant investor response. In the latter instance, the SEC staff noted examples where registrants go out of their way (including adding costs to develop systems) to intentionally develop misstated results – a concern even if the magnitude of misstatement is less than traditional quantitative materiality thresholds.

Our task force supplemented our understanding of the SEC staff's observations by obtaining an inventory of restatements of financial statements of SEC registrants during the last two years and examining examples of those where the restatement was initiated by the SEC staff. We did not observe a significant number of instances where the restatement request involved an ad-hoc application by the SEC staff of a more rigorous materiality perspective than might be deemed "traditional" – although there were a couple of instances noted where restatement to correct intentional management of earnings was required even though the amounts involved may not have been material by traditional standards.

An additional analytical step taken by our task force involved a review of materiality policies included in the reference materials of each of our respective firms. That analysis was particularly helpful in providing insights regarding the qualitative factors to be considered in evaluating the effects of unadjusted misstatements – see our second recommendation below.

One important conclusion of our task force stemming from the above analysis is that the practice issues of concern relate, for the most, part to *evaluation* materiality rather than *planning* materiality. That is, the concern of the SEC staff and others in the materiality area involves a question of whether appropriate audit judgments are applied in evaluating the significance of known issues and errors, not a concern about insufficient audit scopes to uncover issues and errors in the first place. Our recommendations below focus on this concern.

Our Initial Recommendations

At this point our task force has developed four recommendations which we believe will serve to strengthen financial reporting and audit effectiveness. They are describe below and in the referenced attachments.

1. *Adopt audit requirements aimed at encouraging audit clients to record adjustments to eliminate misstatements identified by the auditor even if management and the auditor believe they are immaterial.*

The most effective way to eliminate concerns about the auditor's evaluation of unadjusted misstatements is to encourage management to record such adjustments to eliminate the misstatements - even if it is agreed that the amounts involved might be evaluated as immaterial. Designing an approach to encourage this result is also consistent with the task force's view that the issues and concerns involve management's responsibility and should not merely focus on the auditor.

The task force proposes a three-part package to encourage close consideration and recording of identified misstatements - specifically:

- Obtaining an appropriate commitment from management to (a) consider and record adjustments to eliminate misstatements and (b) conclude affirmatively regarding the immaterial effects of any unadjusted misstatements – through an explicit acknowledgement of that responsibility in the audit engagement letter

- Obtaining a more explicit representation by senior management in the management representation letter regarding its consideration of unadjusted misstatements and its conclusion regarding their immateriality

- Enhancing the quality of communications with audit committees regarding unadjusted misstatements and the auditor's application of the concept of materiality in an audit of financial statements.

These steps are described in more detail in the accompanying "white paper" (exhibit A). Subject to an exposure for "fatal flaw" review, the task force recommends adoption of the above requirements at this time by voluntary action of each of our firms. Subsequently, we should recommend profession-wide adoption through amendments or interpretations of corresponding auditing standards by the Auditing Standards Board. Less desirably, the recommended steps could be implemented by a "Notice to Practitioners" or by action of the SECPS Executive Committee.

2. *Develop guidance covering the auditor's consideration of qualitative factors when evaluating the materiality of unadjusted misstatements.*

SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance to the auditor on considering materiality in planning the financial statement audit and evaluating audit findings. It recognizes that such considerations involve the application of professional judgment by the auditor, and include, in the evaluation stage, both quantitative and qualitative considerations. However, SAS No. 47 does not provide further guidance or examples of the types of qualitative factors the auditor should consider.

Big Six audit reference material in this area provides insights about the types of factors that should be considered; however, as you would suspect, each firm's guidance differs in this regard. Our task force developed a list of those qualitative factors that we believe are important to the auditor when applying professional judgment in this area, and that guidance is attached as Exhibit B.

We recommend that the substance of the attached Exhibit B be adopted by each or our firms voluntarily at this time. Subsequently, we should recommend that the SECPS Executive Committee oversee the development of a Practice Alert that describes qualitative factors to be considered by the auditor when evaluating the materiality of unadjusted misstatements, using the attached Exhibit as a starting point. Such guidance would add assurance that auditors appropriately consider such factors when applying professional judgment in this important area.

3. *Commit each of our Firms to (a) review the adequacy of its consultation requirements dealing with the auditor's consideration of unadjusted misstatements and (b) issue a communication to its audit personnel discussing the importance of effective evaluation of misstatements and the consultation process when issues arise in this regard.*

Each of our firms has in place a consultation process that provides an important internal safeguard to assure audit effectiveness. Our task force has concluded that consultation is particularly effective as a means of assuring that appropriate professional judgment is applied when evaluating the effects of unadjusted misstatements. Each of our firms should take appropriate steps to assure itself that an appropriate consultation process is in place to deal with issues in this important area.

In addition, communication to our audit personnel of "best practices" and other issues that are important to an effective consideration of misstatements identified in the performance of audit work, including reemphasizing the importance of seeking consultation when appropriate, would serve as an effective reinforcement to assure audit effectiveness. Ernst & Young has recently issued such a communication and a copy is attach as Exhibit C. While the form and content of such communication would vary from firm to firm, our task force recommends that each of our respective firms commit to issue a communication to audit personnel covering this important area prior to the upcoming busy season.

4. *Sponsor audit research to enable us to better understand whether the auditor's evaluation of materiality needs to be updated to recognize a more precise investor consideration of differences between earnings expectations and subsequently reported earnings in today's marketplace.*

Our task force has discussed extensively the possible need for additional research to enable us to better assess the extent and validity of the issues and concerns that have been raised regarding audit materiality.

After discussing several possible research options, we concluded to recommend an initial focus on one area - specifically, research aimed to provide us with a better understanding of whether the auditor's evaluation of materiality needs to be updated to recognize a more precise investor consideration of differences between earnings expectations and subsequently reported earnings in today's marketplace. Such information will help us further assess the SEC staff's notion that in light of the high current market multiples, small differences between expected and reported earnings seemingly trigger a significant investor response.

Subject to receiving approval from the Big Five Professional Practice Partners, we have engaged Professor William Kinney, a nationally known academic leader in accounting and auditing, to design and complete research responsive to the above-described information need. Professor Kinney has discussed a specific research approach and plan-of-attack with our task force and provided a related written proposal, attached as Exhibit D. The research would be co-sponsored by the University of Texas Research Center for Business Measurement and Assurance Services, eliminating any issues that could be raised about the appearance of lack of independence.

The task force may ultimately recommend further research efforts, depending upon the results of the above-described initiative and further discussions and developments.

Future Task Force Activities

Our next task force meeting has been scheduled for October 6. At that time we plan to discuss and respond to the feedback and suggestions about our efforts and recommendations that we anticipate receiving from the Big Five Professional Practice Partners as a result of their upcoming August 27 meeting, and subsequently, through "fatal flaw" review by each of our firms.

Our October meeting will also serve as a checkpoint on progress being made on the Kinney research. Of course, we intend to continue to monitor that research and will ultimately need to review the research results, including assessing whether those results should lead to further research or additional recommended actions by our profession.

Another issue that needs to be considered is a strategy for communicating of our efforts to others. Of course, if our initial recommendations are accepted, communication to others within our profession – for example, the Auditing Standards Board and the SECPS Executive Committee – will be necessary.

In addition, we need to consider communicating our efforts and recommendations to representatives of the SEC Staff. Finally, our task force members have observed the possible need to discuss our efforts with representatives of the Financial Executives Institute and/or other stakeholders who should have an interest in working with us to address the concerns and our recommendations.

THE BIG FIVE AUDIT MATERIALITY TASK FORCE

David L. Landsittel, Chair
Jay D. Brodish
Andrew J. Capelli
Edmund R. Noonan
David B. Pearson
R. C. Steiner
Robert H. Herz, Ex Officio

DISPOSITION OF AUDIT DIFFERENCES IN A FINANCIAL STATEMENT AUDIT

The Big Five Audit Materiality Task Force has been considering various issues concerning the auditor's evaluation of audit differences identified in the conduct of an audit and is examining alternative actions designed to encourage clients to record audit differences, even if evaluated by management as immaterial, prior to the issuance of the financial statements. Audit differences are financial statement misstatements identified by the auditor in basically two ways—those revealed through auditing procedures performed and those revealed to the auditor by the client.

The following approach, which includes three elements, met with considerable support from the Task Force. These elements include:

- Obtaining a commitment from management of the client, through the audit engagement letter, concerning the disposition of audit differences noted in the course of the audit;
- Documenting, through the representation letter, management's consideration and disposition of audit differences noted in the audit; and
- Improving communications with audit committees concerning audit findings and the auditor's application of the concept of materiality in an audit of financial statements.

Hereinafter, audit differences are referred to as "financial statement misstatements."[1]

Obtaining Management's Commitment

This element involves obtaining, via the audit engagement letter, (1) management's acknowledgment that, as a result of the audit, the auditor may bring to the attention of management certain financial statement misstatements, identified in the course of the audit; and (2) management's agreement to record adjustments necessary to correct the financial statements or to conclude affirmatively by written representation to the auditor that, in management's judgment, the effects of any unrecorded financial statement misstatements identified by the auditor are, both individually and in the aggregate, immaterial to the financial statements taken as a whole.

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1 Various alternative terms are used in referring to financial statement misstatements identified by the auditor—for example, "audit differences" and "proposed audit adjustments." Our use of "financial statement misstatements" in this paper is not intended to preclude use of comparable alternative terms in individual firm policies or audit engagement communication circumstances.

Statement on Auditing Standards ("SAS") No. 83, "Establishing an Understanding With the Client," requires that the auditor establish an understanding with the client concerning the services to be performed for each engagement. That understanding "should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement." Further, the auditor "should document the understanding in the working papers, preferably through a written communication with the client." SAS 83 also specifies a number of matters that generally should be addressed in establishing the understanding with the client, including acknowledgment of management's responsibility for the entity's financial statements. The responsibility for management's actions with respect to financial statement misstatements identified by the auditor is not specifically addressed.

The Task Force believes that the requirement of SAS 83 for establishing an understanding with the client should include obtaining explicit acknowledgment of a responsibility on the part of management to adjust the financial statements for material misstatements and to conclude affirmatively that the effects of any unadjusted misstatements identified by the auditor are, both individually and in the aggregate, immaterial to the financial statements taken as a whole.

An example of the wording that could be used in an engagement letter follows:

> During the course of our audit, financial statement misstatements may be identified, either through our audit procedures or through communication by your employees to us and we will bring these misstatements to management's attention as proposed audit adjustments. Management is responsible for recording such adjustments in the financial statements or otherwise concluding and confirming in a representation letter provided to us at the conclusion of our audit, that the effects of the unrecorded adjustments are, both individually and in the aggregate, immaterial to the financial statements taken as a whole. At the conclusion of our audit, we will communicate to the audit committee all such unrecorded adjustments.

Representation Letter

The Task Force members believe that in addition to obtaining management's commitment to adjust misstatements identified in the audit, the written acknowledgment of its responsibility for unadjusted misstatements by the appropriate level of management is important to avoid any misunderstanding concerning the nature and amount of the unadjusted misstatements. In some instances, misunderstandings in communicating audit differences have led to underestimation of the significance of such audit differences. In other instances, members of a client's senior management other than the financial management (i.e., Controller or CFO) may have an interest in, or a need to be aware of, unadjusted misstatements affecting the financial statements.

To address those and other concerns, the Task Force recommends that the management representation letter include an explicit representation that senior management (as well as financial management) has considered the financial statement misstatements identified by the auditor and has concluded that such misstatements are, both individually and in the aggregate, immaterial to the financial statements taken as a whole. In addition, a summary of the audit differences (i.e., financial statement misstatements) not recorded and deemed immaterial would be presented in the representation letter or an attachment thereto.

An example of the wording that could be used in a representation letter (using the approach in SAS 85, Appendix A, paragraph 6, item 4) follows:

> 4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements. Insert new language: *All financial statement misstatements identified and discussed with us in the course of the audit have been recorded except for those summarized in the accompanying [Schedule of Unrecorded Audit Adjustments]. In our opinion, the effects of not recording such identified financial statement misstatements are, both individually and in the aggregate, immaterial to the financial statements of the Company taken as a whole.*

Communication With Audit Committees

The third element of the Task Force's action plan to encourage clients to correct misstatements noted in the audit is to enhance the quality of communications with audit committees with respect to unadjusted misstatements and the auditor's application of the concept of materiality in an audit of financial statements. The intent is to present to the audit committee essentially the same schedule or summary of unadjusted misstatements that management has represented as being immaterial to the current financial statements. This would be an extension of the present requirement in SAS 61 (AU 380.08) to "... inform the audit committee about adjustments arising from the audit that could, in [the auditor's] judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process."

The schedule or summary of unadjusted misstatements would be the same as that represented by management as immaterial, although the format might be different for an audit committee presentation. It is not anticipated that the schedule or summary of unadjusted misstatements would contain differences that are clearly inconsequential when measured by an amount set forth in the representation letter.

The Task Force believes that presenting quantified information to the audit committee would encourage discussion about reportable conditions or deficiencies in controls below the reportable condition threshold that could reduce the potential for misstated financial statements in the future. The Task Force also believes that a requirement to present quantified information to the audit committee would have the beneficial effect of encouraging the recording of recurring misstatements (or adopting accounting practices to eliminate recurring misstatements) to avoid management's having to report those matters to the audit committee year after year.

* * * * *

The Task Force believes the action steps outlined above should be considered as a package designed to encourage clients to record audit differences. The Task Force believes the approach will result in improved financial reporting by aiding independent auditors in reducing unadjusted misstatements in financial statements.

auditacf on October 7, 1998 at 2:50 PM

Materiality in a Financial Statement Audit –
Considering Qualitative Factors when Evaluating Audit Findings

SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, (AU Section 312), as amended by SAS No. 82, provides guidance to the auditor on considering materiality in planning the financial statement audit and in evaluating audit findings. It recognizes that such consideration is a matter of professional judgment and restates a FASB Statement of Financial Accounting Concepts No. 2 definition of materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement" (paragraph 10).

SAS No. 47 (as amended) also recognizes that materiality judgments involve both quantitative and qualitative considerations (paragraph 10). It further notes that in planning the audit it is ordinarily not practical to design procedures to detect misstatements that could be qualitatively material (paragraphs 20 and 22). Importantly, however, the statement notes that, in evaluating audit findings, "qualitative considerations" do influence the auditor in reaching a conclusion about whether misstatements are material (paragraph 34).

SAS No 47 does not provide further guidance or examples of the types of qualitative factors that the auditor should consider. While, in the final analysis this is a matter of auditor professional judgment, the following qualitative factors may be important to the auditor when applying professional judgment in this area:

1. The potential effect of the misstatement on trends – especially trends in profitability.

2. The potential effect of the misstatement on the company's compliance with loan covenants, other contractual agreements and regulatory provisions.

3. The significance of the misstatement relative to known user-needs, for example:

   - The significance of earnings and earnings per share to public-company investors and the significance of equity amounts to private-company creditors.
   - The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement).
   - The magnifying effects of misstatements of earnings when contrasted with consensus expectations for enterprises with high price/earnings multiples..

   Obtaining the views and expectations of the client's audit committee and/or management, while not a principal factor in establishing materiality, may be helpful in gaining or corroborating an understanding of user needs such as those illustrated above.

4. The definitive character of the misstatements – *for example*, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation or uncertainty.

5. The significance of the financial statement element affected by the misstatement – for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit such as an extraordinary item.

6. The motivation of management with respect to the misstatement – *for example*, (a) an intentional misstatement to "manage" earnings and/or "smooth" earnings trends, (b) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates and (c) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process.

7. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.

8. The potential offsetting effects of individually significant but unlike misstatements – *for example*, the offsetting of "hard" debits with "soft" credits.

9. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because, for example, of a cumulative effect that builds over several periods.

10. The effects of misclassifications – for example, misclassification between operating and non-operating income or recurring and non-recurring income items.

11. The sensitivity of the circumstances surrounding the misstatement – *for example*, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions and conflicts of interests. (From a company perspective, the accounting provisions of the Foreign Corrupt Practices Act do not explicitly provide for a materiality consideration for certain misstatements).

12. The cost of making the correction. It may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in 6 (a) above.

13. The effect of the misstatement on segment information – for example, the significance of the matter to the importance of a particular segment to the future profitability of the entity, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole (see SAS No. 21, paragraph 8).

14. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

Some of the above-mentioned qualitative factors may have quantitative elements that, in turn, would affect planning materiality – for example, quantitative materiality thresholds specified in statutory or regulatory reporting requirements (item 7 above).

In addition, SAS No. 47 observes that the extent of misstatements detected may alter the auditor's initial judgments about the levels of inherent and control risks, and accordingly, may result in a need for the auditor to reevaluate the nature, timing and extent of the auditing procedures to be applied based upon a revised consideration of audit risk and (planning) materiality (paragraphs 33 and 39). For example, a misstatement that provides indication of a control weakness or an apparent intentional misstatement may represent a "tip of the iceberg" raising the need for such a reevaluation (see SAS No. 82 paragraphs 33 - 36).

Finally, SAS No. 83, *"Establishing an Understanding with the Client,"* requires the auditor to establish an understanding with the client concerning "...the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement." That understanding could include obtaining an explicit acknowledgement of management's responsibility to adjust the financial statements for material misstatements and to conclude affirmatively that the effects of any unadjusted misstatements identified by the auditor are, individually and in the aggregate, immaterial to the financial statements taken as a whole.

Reference is also made to the AICPA Division for CPA Firms Professional Issues Task Force Practice Alert 94-1 for additional commentary regarding *"Dealing with Audit Differences."*

Other Information Releases
Date Published: 06/12/98

Revisions to Requirements to Consult on Audit Differences

Audit Release

DISTRIBUTION	AABS Partners through Managers
DATE	6/12/98
ISSUER	Robert K. Herdman
FUNCTION	AABS Standards and Professional Matters
SUPERSEDES	SCORE Retrieval File No. EE0429

REVISIONS TO REQUIREMENTS TO CONSULT ON AUDIT DIFFERENCES

Executive Summary

This Audit Release describes revisions to the consultation requirements regarding audit differences that were established in our Audit Release, *Communicating and Consulting With Respect to Audit Differences* (SCORE Retrieval File No. EE0429 - dated November 17, 1997). The revisions are to:

- Require consultation whenever the gross or net unrecorded differences, in the aggregate, or any individual gross unrecorded difference exceeds five *percent* of pretax income when planning materiality is based on pretax income or an amount that represents the low end of the range of acceptable values for planning materiality (e.g., one-half of one percent of sales; one percent of gross margin; one percent of equity) when planning materiality is based on other measures. *Previously the threshold for consultation was 75 percent of planning materiality.*

- Require consultation with the Regional Director of Accounting and Auditing (RDAA) for all clients with unrecorded differences of this magnitude. Previously consultation was required only for SEC and close-monitoring clients, although consultation with the Area Accounting and Auditing Consultant was encouraged for other clients.

These new requirements are effective for audits of financial statements for periods ending on or after June 30, 1998. *Consultation should occur timely so that we can formulate an action plan with the client about handling unrecorded differences before management has "locked in" the company's operating results for a reporting period.* If consultation with the RDAA has not occurred already based on Audit Release No. EE0429 - an engagement team should consider the magnitude of the *prior year's* unrecorded differences and start discussions with the RDAA *now* if the threshold for consultation likely will be exceeded in the current year.

Further Discussion

Our experiences during the last six months indicate that the vast majority of our clients do not have significant unrecorded audit differences. However, in those situations where such differences do exist, we should continue our efforts to eliminate them or at least substantially reduce their magnitude. Several effective approaches that teams have used to encourage management to record audit differences were described in Audit Release No. EE0429 - and are summarized in the Attachment to this Release (see electronic file attached below). Early communication is essential, and we should be encouraging our clients now - early in the year - to take advantage of the continued strong economy to record differences that have accumulated in prior periods.

When consultation on unrecorded audit differences is required, the engagement team's discussion with the RDAA ordinarily should include our plans for discussing the differences with the client, including, where applicable, the audit committee (or equivalent); our plans for encouraging the client to record the differences; the client's plans, if any, for preventing their recurrence in future years; and whether we should continue to be associated with the client if it is unwilling to record the differences.

The discussion also ordinarily should include:

The nature, probable causes (e.g., unintentional errors, deficiencies in controls, fraud, judgmental differences) and amounts of the individual items,

Whether the scope of this year's audit is likely to be adequate considering the potential for differences, both detected and undetected (tolerable error is our best, though not exact, estimate of the amount of possible undetected differences), and

Whether we will insist that the client correct some or all of the audit differences before we will issue an unqualified report.

These consultations should be documented in accordance with Chapter 31 "Consultation and Differences of Professional Opinion" of the *Audit Manual - Volume II*. Once the consultation requirement is triggered and the initial discussion takes place, the engagement team should continue to apprise the RDAA of the status of planned actions and the resolution of the matter.

This Release will be included in a future update to the EY/AART infobase under Chapter 17, "Current Auditing Developments," of the *Audit Manual - Volume II*. Also, we will be updating our guidance in Work Step 4 of Activity 17, *Conduct the Wrap Up Event*, of the *Audit Process* to incorporate the provisions of this Release and Audit Release No. EE0429 - and including the Attachment as an exhibit to Activity 17.

* * * * *

Properly handling audit differences has always been one of the most important aspects of an audit and is critical to formulating our opinion on the client's financial statements. This is especially true at the present the SEC has recently expressed concerns regarding materiality, particularly whether the materiality threshold for recording identified adjustments should be lower when companies are intentionally misstating income to meet "consensus estimates" of earnings and whether the current materiality model remains appropriate in today's markets in which P/E ratios are substantially higher than they have been historically. We need to stay focused on identifying, analyzing, evaluating, communicating, and resolving audit differences.

Attachment (see below)

For Further Information:
SCORE No.: EE0471

Attachments:

EE0471at

EXAMPLES OF COMMUNICATING AUDIT DIFFERENCES

Properly communicating audit differences to management and/or the audit committee is extremely important in our efforts to provide value to our clients and to maintain or reduce the firm's risks.

Most engagement teams follow the practice of communicating all audit differences to management as soon as the differences are identified. The level of management varies depending upon the circumstances (e.g., the client's size and organization structure, and the nature and significance of the differences). Generally the engagement team immediately reports the differences to the controller and frequently to the CFO. In some situations, the team also reports them immediately to the COO and/or the CEO. Most engagement teams also follow the practice of strongly encouraging management to record all the audit differences, or at least all those that meet the criteria for inclusion on the Summary of Audit Differences (SAD). However, some engagement teams only encourage management to record errors, but not judgmental differences unless the judgmental differences are "significant" or "material."

Among the reasons given to management for recording the differences are:

It's the "right thing to do."

It will result in "better financial reporting."

The audit committee will have a more favorable impression of management if we can report to the committee that we are not aware of any adjustments that have not been recorded in the financial statements.

Having no unrecorded differences is indicative of doing a good job.

The company's culture recognizes the importance of maintaining accurate books and records to support financial data including tax returns, special reports, etc.

There won't be any potential effects on the next year to be concerned about.

One of the advantages of performing quarterly or interim work is that clients are more likely to record differences that are brought to their attention early in the audit rather than later when the books have been closed or are close to being closed.

One of the most effective practices deals with situations where an immaterial difference arises after management has "locked into" its results for a quarter or year, and therefore is reluctant to make the adjustment currently. In such cases, achieving agreement that the cause of the difference will be fixed and the difference recorded in the following period prevents situations where unrecorded differences start to accumulate to the point where several of them combine to create a material gross difference.

Practices with respect to communicating audit differences to audit committees include:

Reporting each significant item and the total number of proposed adjustments as well as their total dollar amount and effect (increase or decrease) on net income.

Reporting the total on the SAD, even though it is not significant, along with the two or three largest items on the SAD even though none of them are significant.

Describing the audit differences and the steps management plans to take to prevent their recurrence in future years.

Reporting that none of the audit differences are significant either individually or in the aggregate *and* then defining "significant"; e.g., less than one percent of income before income taxes.

Reporting that the unrecorded audit differences are immaterial individually and in total, both before and after the turnaround effects of the prior year's audit differences.

Reporting that there are no recorded or unrecorded audit differences resulting from the audit.

Providing the entire SAD, with a meaningful explanation of each item, to the audit committee.

Reporting that all audit adjustments were posted and describing the two or three most significant.

Reporting that the waived audit adjustments, individually and in the aggregate, are not material and having management discuss the individual audit differences and its plans for preventing their recurrence.

Reporting the effects of the SAD items for the past three years and describing the current year's differences and their individual effects.

The most appropriate practice obviously depends upon the circumstances, and some of those described above will be appropriate only in certain limited circumstances.

One practice that almost always is *inappropriate* is only to report to the audit committee that "the net effect on the current year's income statement of recording the items on the SAD would not be material/significant after considering the turnaround effects of the prior year's adjustments." Such a statement is ambiguous and leaves open the question whether the gross effects of the audit differences (i.e., before the turnaround effects of the prior year's differences) are material/significant.

We should avoid instances where the members of the client's board of directors/audit committee/senior management are unaware of significant gross audit differences that we have identified during our most recent and prior years' audits. This is particularly troublesome if there is a change in management personnel (e.g., a new CFO), and that person, as well as the members of the audit committee, are surprised to learn that there have been large unrecorded audit differences in recent years. Even if the "net" effects (i.e., after the turnaround effects of the prior year's differences) of the audit differences are not material, a situation where the current year's gross effects are material to the current year's results of operations could be very disconcerting to our client and embarrassing/costly for us.

July 17, 1998

To: David Landsittel

From: Bill Kinney

Re: proposed research on Materiality and Stock Prices

As we discussed on the phone today, the First Call data base is available at the University of Texas at Austin, as is the necessary stock return data. In addition, Professors David Burgstahler (University of Washington) and Roger Martin (Michigan State University) are available and interested in working on the project. David was my co-author on the original stock price and materiality study in the 1980s, and Roger has extensive experience with the data tapes.

Discussions with David, Roger, and my research assistant leads me to believe that the project that we discussed in June can be completed by about December 1 of this year. The project is outlined below.

As you know, the University of Texas has established a research center for Business Measurement and Assurance Services (BMAS), with four of the five big six firms as contributing members. I am director of the center, and both the Accounting Department Chairman and I believe that this project is appropriate for BMAS support. I propose that BMAS conduct the study with direct costs shared – 50% from BMAS and 50% from the Task Force.

Direct costs would be up to two months salary for David and Roger, some research assistance, and limited phone consultations. I would serve as a co-author, but would not charge the project for my services.

The total direct cost of the project would likely be between $50,000 to $60,000. Thus, the Task Force's portion would likely be from $25,000 to $30,000. This total is in line with prior CPA firm supported academic research projects such as those of the KMPG Research Opportunities in Auditing program and the Ernst and Young tax research program.

As a project supported by the University and BMAS, publication rights to the final project would lie with BMAS and the University. Likely publication outlets would include submission to the 1999 *Journal of Accounting Research* Conference to be held at the University of Chicago in May 1999. The title of the Conference is "Credible Financial Reporting."

I could continue as an advisor to the Task Force as the Task Force wishes.

Materiality Project Outline

William Kinney, David Burgstahler, and Roger Martin
July 17, 1998

Researchers will update the Kinney and Burgstahler materiality and stock prices study of 1989 using First Call composite expectations of earnings. Specifically, for 1992 and 1997, the last composite forecasts before release of annual earnings will be obtained for all *firms* listed by First Call and compared with the earnings announced by the firms. Differences will be related to market-adjusted stock returns for the intervening period, with special attention to the three day window surrounding the earnings announcement.

Using the Kinney-Burgstahler method, the measure of materiality implicit in stock price changes will be assessed for 1992 and 1997. Differences, if any, between 1992 and 1997 materiality measures will be analyzed as to cause, as will market response time to adjust to the "information" in earnings as announced. Results will also be compared to those of the early 1980s as reported in the Kinney-Burgstahler manuscript. Finally, sensitivity of the measure to implicit earnings multiples will be assessed.

To the extent possible, reactions quarterly earnings announcements of earnings for 1992 and 1997 will also be collected and compared. Quarterly results cannot be compared with the 1980s since the original data were collected only for annual earnings.

ATTACHMENT B

99-7904

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

JOSEPH A. GANINO, ROBERT L. CREIGHTON, LOUISE A. CREIGHTON, WILLIAM J. FRAY, THE ESTATE OF NORMAN GARAND, THE GARAND FAMILY PARTNERSHIP, A. JOHN KALIL, REZA NAJAFZADEH, JEFFREY P. NORTON, REBECCA L. NORTON, JOHN NORTON, MATTHEW NORTON, LAURA NORTON, ALICE M. TOBIN AND BRANTLEY H. TUDOR

Plaintiffs-Appellants,

v.

CITIZENS UTILITIES COMPANY, LEONARD TOW, LIVINGSTON F. ROSS AND ROBERT J. DESANTIS,

Defendants-Appellees.

On Appeal from the United States District Court
for the District of Connecticut

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
AMICUS CURIAE, IN SUPPORT OF APPELLANTS
ON THE ISSUES ADDRESSED

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UNITED STATES COURT OF APPEALS
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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, submits this brief as amicus curiae to address important legal issues concerning materiality presented in this private action brought under the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

Contrary to the district court's decision, the Commission believes that misstatements of items in a company's financial statements are not immaterial simply because they fall below a numerical or percentage threshold; depending on the facts and circumstances, even a small overstatement can be material. We also believe that the district court erroneously disregarded the impact of the alleged overstatement in this case on the company's quarterly income as reported in the company's quarterly financial statements filed with the Commission and disseminated to the public. The decision could be read as holding that an overstatement of quarterly income that is important to investors is nonetheless immaterial unless there is a subsequent material overstatement of annual revenue in the company's year-end financial statements. 1/

Private actions under the federal securities laws serve important functions in compensating investors who have been harmed by securities law violations and in providing an effective weapon in the enforcement of the securities laws as a

1/ In general, a company's income (also referred to as earnings) is computed by deducting its expenses from its revenue.

necessary supplement to Commission actions. Moreover, since the Commission is required to establish materiality in its own enforcement cases under Section 10(b), the district court's analysis of materiality, if adopted by this Court, could have an adverse effect on the Commission's ability to enforce this provision.

STATEMENT OF THE ISSUES

1. Whether a misstated item in a financial statement is immaterial simply because it falls below a percentage benchmark, notwithstanding other facts and circumstances that indicate the misstatement is important to investors.

2. Whether an overstatement of quarterly income that is important to investors is nonetheless immaterial unless there is a subsequent year-end material overstatement of annual revenue.

The Commission takes no position on any other issue in the case, including whether the allegations in the complaint are sufficient to withstand the defendants' motion to dismiss under Fed. R. Civ. P. 12(b)(6).

STATEMENT OF THE CASE

A. FACTS

The facts alleged in the complaint that are relevant to the issues addressed by the Commission may be summarized as follows:

Defendant Citizens Utilities Company ("Citizens") is a diversified communications and public services company. Its stock is traded on the New York Stock Exchange. As of 1995, Citizens had reported 50 consecutive years of increased revenue, earnings and earnings per share and the company repeatedly emphasized this fact in its public comments (Complaint ¶ 22). The year 1995, however, was the first year in which Citizens could not include approximately $38 million in revenue from Pacific Bell (Complaint ¶ 60). In order to report increasing earnings, the company had to find another source of revenue (Complaint ¶ 60).

Hungarian Telephone & Cable Corporation ("HTCC") is a U.S. company formed in 1992 that seeks to provide telephone services in Hungary pursuant to telecommunications concessions from the Hungarian government (Complaint ¶ 20). As of 1995, HTCC had been unprofitable since its inception and did not have the funds required to satisfy its concession contracts (Complaint ¶ 21). It therefore looked for a source of financing. Beginning in May 1995, HTCC and Citizens, through a subsidiary CU Capital Corporation ("CUCC"), entered into a series of agreements under which Citizens funded HTCC's construction costs and other construction-related obligations under the concession contracts (Complaint

¶ 23). Among the numerous transactions between Citizens and HTCC, HTCC paid Citizens $10.1 million in the form of stock and options as compensation for loans arranged by Citizens and for guarantees provided by Citizens in connection with the loans (Complaint ¶¶ 36, 39). It is this payment that is primarily at issue in this case.

HTCC paid this amount to Citizens in 1995 and recorded the payment in its financial statements for that year. Citizens disclosed receiving the payment in its Form 10-K annual report for 1995 but did not include the payment in its 1995 financial statements (Complaint ¶ 34). Although at the beginning of 1995 Citizens was concerned about not meeting earnings objectives, by the end of that year Citizens had obtained approximately $46 million in one-time revenue items without including the $10.1 million received from HTCC (Complaint ¶ 60). Plaintiffs allege that Citizens delayed recognition of the income from HTCC because had it recognized the income in 1995, it would have so increased its earnings that it would have been difficult to report increased earnings in 1996 (Complaint ¶ 34). Moreover, plaintiffs allege, the company was concerned that it would not have sufficient income in 1996 to meet analysts' earnings expectations and to show an increase in earnings over 1995. Accordingly, defendants improperly failed to recognize the $10.1 million in 1995 and improperly recognized this payment in the first two quarters of 1996 – $6.9 million in the first quarter and $3.2 million in the second quarter (Complaint ¶ 36). 2/

Citizens did not disclose to investors its delayed recognition of the $10.1 million when it included this payment in its 1996 quarterly and annual financial statements. Without this income, plaintiffs allege, Citizens would have missed analysts' quarterly earnings projections (Complaint ¶¶ 34, 36). According to the complaint, "The consensus estimates by Merrill Lynch and other analysts for income for the first six (6) months of 1996 were met and exceeded only as a result of this additional HTCC-related income, and the increase in income for the first six months of 1996 compared to the first six months of 1995 was due <u>entirely</u> to the income recognized from HTCC" (Complaint ¶ 36).

The market was not aware that Citizens reported the $10.1 million payment in 1996 solely to permit Citizens to meet analyst earnings target for 1996 and to show an upward trend in earnings over the prior year (Complaint ¶ 36). Indeed, on

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2/ We note that defendants argued in their reply brief below (pp. 12-13) that it was proper under generally accepted accounting principles ("GAAP") to defer until 1996 the recognition of the payment that Citizens received from HTCC in exchange for Citizens' loan guarantees. The district court did not address this argument, and we take no position on whether it was appropriate for Citizens to recognize the $10.1 million in 1996.

March 16, 1997 Citizens issued a press release reporting 1996 earnings of 77 cents per share and stating that these "record results represented the Company's 52nd consecutive year of increased revenue, earnings and earnings per share." Citizens' earnings were precisely in line with Merrill Lynch analysts' forecasts (Complaint ¶ 40). Thus, Citizens appeared to be continuing its 50-year trend of showing increased earnings.

Subsequently, on April 30, 1997, Citizens announced the end of this upward trend and caught analysts by surprise when it disclosed lower than expected earnings for the first quarter of 1997. On May 13, 1997 Merrill Lynch released a research report discussing Citizens' investment in HTCC and stating that Merrill Lynch's "additional earnings estimate reductions relate to a lowering of [Merrill Lynch's] expectations for other income" (Complaint ¶ 47). This was confirmed on August 7, 1997 when Citizens filed its Form 10-Q for the second quarter of 1997 disclosing that the decreased 1997 investment income as compared to similar periods in 1996 was due to "income earned in 1996 for financial support provided to [HTCC]." It acknowledged that income for the first two quarters of 1996 included material income from HTCC (Complaint ¶ 48). Plaintiffs allege that had Citizens properly recognized the $10.1 million in 1995, it would have failed to meet earnings expectations in the first two quarters of 1996, the stock price would have dropped and plaintiffs would not have overpaid for stock they purchased (Complaint ¶ 69). 3/

B. PROCEDURAL HISTORY

Defendants moved to dismiss the complaint, arguing that the overstatement was immaterial as a matter of law because the $10.1 million payment from HTCC represented less than 2% of Citizens' revenue for 1996. Plaintiffs opposed defendants' motion, arguing that the overstatement should not be deemed immaterial as a matter of law simply because it fell below a threshold percentage. In any event, plaintiffs argued, the court should look at the impact of the overstatement on the company's income, not just at its impact on revenue. Plaintiffs argued that the overstatement constituted as much as 17.78% of income for the first quarter and thus was not immaterial.

3/ Plaintiffs also allege other improprieties arising from Citizens' relationship with HTCC, alleging inter alia that Citizens secretly controlled HTCC (¶¶ 24, 30) and that because of its control, Citizens should have reported HTCC's financial results using principles of equity accounting (Complaint ¶¶ 31, 55). Citizens, however, allegedly expected that HTCC would continue to report substantial losses for 1995 and 1996 and did not want to include those losses in Citizens' financial statements (Complaint ¶ 24). The equity accounting allegation is separate from plaintiffs' allegation that Citizens improperly shifted 1995 income to 1996 and thereby secretly inflated its income for the first two quarters of 1996.

According to the plaintiffs, income for the first and second quarters was overstated by 17.78 % and 6.9 % respectively. The district court, however, disregarded these percentages entirely and held that the alleged overstatement was immaterial. Reflecting a misunderstanding of the issue, the court stated (emphasis added):

> [A]lthough defendants assert that the amount of plaintiffs' alleged nondisclosure amounts to $6.9 million, or approximately 2 % of Citizens' revenues, plaintiffs allege that this statement was inaccurate by 15.78 % <u>because Citizens used GAAP principles, rather than Equity Accounting</u>.

In a footnote, the court explained:

> Equity Accounting compares HTCC's gross pre-tax revenues to Citizens' net after-tax revenues. Each of the percentages set forth by plaintiffs use this accounting principle. The Court finds, however, that this approach is economically unsound and fails to take into account generally accepted accounting principles. As defendants have noted, such reasoning is to compare apples with oranges.

The court mistakenly believed that the plaintiffs' argument that income was overstated by 6.9 % to 17.78 % depended on equity accounting. 4/ In fact, the

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4/ The court was confused. Contrary to the district court's description, equity accounting, itself a GAAP principle, is a form of accounting to be used when one company's ownership interest in another company is between, typically, 20% and 50%. In that circumstance, the investing company is required to report its percentage share of the other company's income on its income statement. Equity accounting does not compare HTCC's gross pre-tax (continued...)

plaintiffs' percentages differed from the defendants' percentages not because the parties used different accounting principles but because the parties compared the overstatement to different items in Citizens' financial statements. Defendants compared the $10.1 million overstatement to annual revenue for 1996, while plaintiffs compared the overstatement to first and second quarter income. The court's confusion caused it to disregard the plaintiffs' argument that the misstatement materially overstated quarterly income.

Although we cannot be sure how the district court would have ruled if it had not been operating under this misconception, the court did adopt the defendants' argument that it could rely solely on a percentage benchmark to find the alleged overstatement immaterial. It stated: "Courts, and economic analysts, have often used a ratio of the omitted fact to that disclosed by looking to the overall percentages of the financial information available." Quoting from a November 3, 1998 article in the Wall Street Journal, the court said: "Most auditors -- and their corporate clients -- define materiality as any event or news that might affect a

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4/ (...continued)
revenues to Citizens' net after-tax revenues and has nothing to do with the issue we address here. As noted (supra, n.3), plaintiffs' allegation that Citizens should have used principles of equity accounting was not related to their allegation that Citizens improperly inflated its income for the first two quarters of 1996.

company's earnings, positively or negatively, by 3% to 10%. * * * [it] has become standard practice in corporate America." 5/ The court concluded that "the amount in issue here -- 1.7% of Citizens revenues for the relevant time period, pursuant to GAAP -- is immaterial as a matter of law."

The court did not compare the overstatement to any item other than revenue. Because the overstatement was only 1%-2% of Citizen's annual revenue, the court concluded that it was immaterial as a matter of law. The court disregarded plaintiffs' allegations that the overstated income recognized in 1996 was actually income received in 1995, which was improperly held over until 1996 for the purpose, and with the effect, of showing an increase in earnings from 1995 to 1996 and of meeting analysts' earnings projections for 1996. Presumably, the court considered these allegations to be irrelevant under its minimum percentage test. 6/

5/ This Wall Street Journal article, in a part not mentioned by the district court, quotes the Chairman of the Commission as stating: "[M]ateriality is not a bright-line cutoff of 3% or 5%. It requires consideration of all relevant factors that could impact on an investor's decision."

6/ The court found it significant to its materiality analysis that on August 7, 1997, when the company disclosed the decrease in income from HTCC, "there was no movement in the Citizens stock following the announcement and within days thereafter, the price of the stock increased." Plaintiffs argued that the effect of Citizens' announcement on August 7, 1997 on its stock price was irrelevant because the sell-off in Citizens' stock had already (continued...)

Having concluded that the alleged overstatement was immaterial as a matter of law, the court decided that

> the Court need not examine the remaining elements of plaintiffs' securities fraud action. Nevertheless, the Court has thoroughly examined those elements and plaintiffs' supporting authority, and holds that such would not change the outcome of this case.

The court dismissed the complaint, and plaintiffs appeal from the entry of judgment for the defendants.

SUMMARY OF ARGUMENT

The district court erroneously used a percentage benchmark to determine whether a misstated item in a financial statement is material without considering other relevant factors. The materiality of an item in a financial statement does not turn exclusively on numerical or percentage benchmarks because even a small misstatement may be material to investors depending on the facts and circumstances. Although the percentage impact of a misstated item in a financial statement may be considered in determining the materiality of the misstatement, it cannot substitute for an analysis of all relevant factors.

The court also erred in ignoring the impact of the overstatement on income.

6/ (...continued)
occurred in May after Citizens announced lower than expected earnings.

The decision could be read as holding that a significant overstatement of income is immaterial unless there is a material overstatement of revenue. Because the complaint alleged that Citizens overstated income, the court should not have disregarded the impact on income in determining whether the misstatement was material, particularly since income and earnings are among the most important information relied on by investors in deciding whether to buy or sell stock.

Finally, the court erred in looking only to the impact of the overstatement on Citizens' annual financial results without considering its impact on quarterly results. If a misstatement appears in both quarterly and annual financial statements, the court should analyze the misstatement's impact on both.

ARGUMENT

A. Exclusive Reliance on a Numerical Analysis to Determine Materiality Without Considering All Relevant Factors Is Not Appropriate.

The use of a minimum percentage threshold may provide a basis for a preliminary assumption that a deviation of less than this threshold is not likely to be material. But exclusive reliance on any percentage or numerical threshold to determine materiality of a misstatement, without also considering the context in which the misstatement was made, has no basis in the accounting literature or the law.

A fact is material if there is "a substantial likelihood that the * * * fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). The accounting literature uses a similar analytic framework for assessing materiality. In its Statement of Financial Accounting Concepts No. 2 (1980) at ¶ 132, the Financial Accounting Standards Board (FASB) states that

> [t]he omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

The American Institute of Certified Public Accountants ("AICPA"), Codification of Statements on Auditing Standards ("AU") § 312 specifically instructs auditors to consider materiality when auditing financial statements, and states that " * * * materiality judgments are made in light of surrounding circumstances." See AU § 312.10 (1984).

Accordingly, materiality depends on the "total mix" of available information or the "surrounding circumstances." Whether a misstatement is material cannot be determined by a statistical formula. As the Supreme Court has cautioned,

> Although * * * ideally it would be desirable to have absolute certainty in the application of the materiality concept * * * such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula.

Basic Inc. v. Levinson, 485 U.S. 224, 236 n.14 (1988) (quoting House Committee on Interstate and Foreign Commerce, Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 95th Cong., 1st Sess., 327 (Comm. Print 1977). See also In re Kidder Peabody Securities Litig., 10 F. Supp. 2d 398, 410 (S.D.N.Y. 1998) (rejecting defendants' argument that misstatements of profits amounting to 1% - 2.5% of total earnings were immaterial as a matter of law, stating that "the Court declines to adopt a statistical bright line rule to determine what a reasonable investor would consider significant.").

While the "total mix" includes the size in numerical or percentage terms of a misstatement in a financial statement, it also includes the factual context in which the user of financial statements would view the financial statement item. In re Kidder Peabody Securities Litig., 10 F. Supp. 2d at 410 ("The Court must view the misstatements in the context of what a reasonable investor would have considered important at the time.") As the FASB indicates, "magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment." FASB

Statement of Financial Accounting Concepts No. 2 (1980) at ¶ 125. In 1980, the FASB specifically rejected promulgating quantitative materiality guides, which it called a "minority view," stating, "The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment." Statement of Financial Accounting Concepts No. 2 (1980) at ¶ 131. The AICPA similarly instructs auditors that "misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements." AU § 312.11 (1984). 7/

There are various circumstances in which a misstatement below a particular minimum percentage of a financial statement item could nonetheless be material to investors. For example, a small misstatement could mask a significant change in earnings or other trends, or hide a failure to meet analysts' consensus earnings expectations. 8/ We also note that, while the intent of a company's management

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7/ Consistent with the foregoing discussion, the Commission's staff, in Staff Accounting Bulletin No. 99 (SAB 99)(Aug. 12, 1999), recently discussed its agreement with the accounting literature and the courts that materiality does not depend exclusively on any numerical benchmark.

8/ Neither SAB 99 nor this brief address the separate question of whether information may be qualitatively material for non-financial reasons – e.g., as (continued...)

does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to manage reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the company's financial statements. 9/

The Chairman of the Commission, Arthur Levitt, recently explained the problem of earnings management in his September 28, 1998 address entitled "The Numbers Game" at the NYU Center for Law and Business. See www.sec.gov/news/speeches/spch220.txt. The Chairman expressed concern that "[I]n the zeal to satisfy consensus earnings estimates and project a smooth earnings

8/ (...continued)
bearing on management's integrity -- in contrast to information that bears on the company's financial condition or the price of the company's stock. See SAB 99 at n.5.

9/ The Big Five Audit Materiality Task Force, which was convened in March 1998, made recommendations in August 1998 to the Auditing Standards Board in which it detailed several factors to be assessed in determining whether an item is material, including "the potential effect of the misstatement on trends -- especially trends in profitability," "the significance of earnings and earnings per share to public company investors," and the "intentional misstatement to 'manage' earnings and/or 'smooth' earnings trends." This "Status Report and Initial Recommendations" is available at www.aicpa.org.

path, wishful thinking may be winning the day over faithful representation." He further stated that the "game" of earnings management leads to "an erosion in the quality of earnings, and therefore, the quality of financial reporting." The federal regulatory scheme, the stock market and public investors depend on companies accurately reporting their financial results. Any attempt to distort the accuracy of this critical information, by managing earnings or otherwise, undermines the proper operation of the federal securities laws and runs counter to the very principles behind the stock market's strength and success.

The complaint in this case alleged that defendants' actions were intended to hide the company's failure to meet analysts' expectations and to mask a change in the company's 50-year earnings trend. It alleged that the overstatement, which was included in the first two quarters of 1996, accounted for all of the increase in income over the same six-month period for 1995. 10/ Plaintiffs alleged that

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10/ Plaintiffs alleged that the $10.1 million overstatement accounted for 100% and 70% of the increase in income for the first and second quarters of 1996 over the same period for 1995, and 50% of the annual increase in income over 1995. Defendants, on the other hand, did not calculate the impact of the overstatement on Citizens' increased income. But under defendants' method of analysis (as reflected in footnote 4 of their reply brief below), the overstatement would have accounted for 67% and 21.5% of the increase in income for the first two quarters of 1996 over the same period in 1995, and for 21% of the annual increase in income over 1995.

without the overstatement, Citizens would have failed to meet analysts' estimates and could not have claimed to have increased its earnings in those quarters over the prior year. Such allegations are relevant to an assessment of materiality. See Carley Capital Group v. Deloitte & Touche, LLP, 27 F. Supp. 2d 1324 (N.D. Ga. 1998).

B. Assessing the Materiality of the Overstatement Requires Considering Its Impact on All Overstated Items in Financial Statements for All Relevant Periods, Not Just Its Impact on Revenue and Its Impact on Results for the Entire Year.

In evaluating whether an overstatement in a financial statement is material, the court should consider the impact of the overstatement on all misstated items in the financial statement for all relevant periods. In this case, plaintiffs alleged that Citizens overstated income in the first two quarters of 1996. Accordingly, the overstatements' impact on Citizens' quarterly income, not just annual income or revenue, was relevant to assess the materiality of the overstatement.

1. The District Court Erred in Assessing the Impact of the Overstatement on Revenue Only and Disregarding the Alleged Impact on Income.

The district court considered the impact of the overstatement on revenue, and apparently disregarded its impact on income. The court's decision could be read to hold that an overstatement of income, even if important to investors, cannot be material unless there is a material overstatement of revenue. The impact of a misstatement on income, however, is particularly important because investors look carefully at income and earnings in determining whether to purchase or sell stock. "Indeed, earnings reports are among the pieces of data that investors find most relevant to their investment decisions." In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1420 n.9 (3d Cir. 1997). See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) ("[M]aterial facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.") (emphasis added); In re Kidder Peabody Securities Litig., 10 F. Supp. at 410 ("[F]inancial reports are relevant to investment decisions, with reports of current and past earnings likely to aid in predicting future earnings."); Carley Capital Group v. Deloitte & Touche, LLP, 27 F. Supp. 2d 1324 (N.D. Ga. 1998) ("Whether earnings are increasing or decreasing is highly material to investors.").

The cases cited by the district court are not to the contrary because they all *establish that a misstatement should be compared to whatever item is being* misstated. For example, Ferber v. Travelers Corp., 802 F. Supp. 698 (D. Conn.

1992), the principal case relied on by the district court, involved misrepresentations about the quality of one class of assets, which the court evaluated in relation to total assets.

> [T]hese second mortgages were part of a total mortgage-loan and real estate portfolio of $16.129 billion. Moreover, Travelers reported a total investment portfolio of $43.237 billion and a total asset portfolio of $55.356 billion. * * * Thus, Travelers' second mortgages constituted approximately one percent of its assets and three percent of its mortgage-loan and real estate portfolio. In view of the entirety of information disclosed by Travelers, the plaintiffs have failed to allege particularized facts from which the court can infer that the failure to disclose $585 million in second mortgages was a material omission.

In Parnes v. Gateway 2000, Inc., 122 F.3d 539, 547 (8th Cir. 1997), the court held that an alleged overstatement of assets that represented only 2% of Gateway's total assets was not material. Notably, the court stated that "there may certainly be many cases where this amount of money would be material and would dramatically affect the total mix of information relied on by a reasonable investor" but that "this simply is not the situation in this case." See also Glassman v. Computervision Corp., 90 F.3d 617 (1st Cir. 1996) (comparing overstatement of revenue items to revenue); Shuster v. Symmetricon, Inc., 1997 WL 269490 (N.D. Cal. Feb. 25, 1997) (comparing overstatement of revenue item to revenue in case involving no allegation that income was overstated). None of these cases supports the district court's decision that an overstatement of income should be evaluated exclusively in terms of its impact on revenue. 11/

2. The District Court Erred in Assessing the Overstatement's Alleged Impact on Annual Financial Results Only Without Also Assessing Its Impact on Financial Results for the First and Second Quarters.

The district court erred in analyzing the alleged impact of the overstatement on 1996 financial results as a whole without also looking at the impact on quarterly results. An overstatement may have only a minor impact on annual financial results and may still have a significant impact on financial results for a particular quarter. A materially misleading quarterly financial statement cannot be cured by a subsequent annual financial statement that is not materially misleading. Investors and financial analysts attach importance to quarterly financial statements in evaluating whether a company is performing according to expectations.

In this case the alleged overstatement was included in income for the first six

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11/ We note that the impact of the $10.1 million overstatement in this case on Citizens' revenue appears to be irrelevant. As we interpret Citizens' financial statements for the relevant periods, revenue for Citizens was gross receipts for providing utility services. Operating costs and depreciation were deducted from revenue to calculate "income from operations." The company then added "other income" to "income from operations" before calculating net income. Plaintiffs allege that the $10.1 million was included in "other income." Accordingly, the overstatement's impact on revenue, which did not even include the overstatement, does not seem relevant to assessing whether the overstatement was material.

months of 1996, and accordingly had its greatest impact on the first two quarters. Plaintiffs argued below that Citizens overstated its net income after taxes by 17.76 % and 6.9% for the first and second quarters respectively. Defendants urged the court to look at the impact on annual income, which under defendants' method of analysis was overstated by only 2.8%. Although defendants did not attempt to apply their methodology to calculate the impact on Citizens' quarterly financial results, we note that under their methodology, the overstatement in the first and second quarters amounted to 8.4% and 3.5% of income, respectively, and 5.8% of income for the first six months of 1996. 12/

12/ The parties do not agree on what is the appropriate measure of income for purposes of determining the impact of the overstatement. Defendants' argument that Citizens' annual income was overstated by 2.8% was based on comparing the overstatement Citizens' "income from operations," "other income" and "investment income" before "interest expense" has been subtracted. Plaintiffs' argument that Citizens' first quarter income was overstated by 17.78 % is based on comparing the overstatement to net income after taxes. We believe that the percentage impact of the overstatement on income probably lies somewhere between the parties' percentages after adjustments for taxes and interest expense, if appropriate, have been made.

CONCLUSION

For the foregoing reasons, the Commission urges this Court to hold (1) that the materiality of an item in a financial statement does not turn exclusively on numerical or percentage benchmarks, and (2) that the district court should have considered the effect of the alleged misstatements on annual and quarterly income and should not have restricted its inquiry to the effect on annual revenue.

Respectfully submitted,

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October 1999

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 99-7904

JOSEPH A. GANINO, et al.,

Plaintiffs-Appellants,

v.

CITIZENS UTILITIES COMPANY, et al.,

Defendants-Appellees.

On Appeal from the United States District Court
for the District of Connecticut

CERTIFICATE OF SERVICE

I, Hope Hall Augustini, hereby certify that on Friday, October 29, 1999, I served the Clerk for the Court of Appeals for the Second Circuit and the following parties with two copies of the brief of the Securities and Exchange Commission, amicus curiae, by federal express postage prepaid:

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CERTIFICATE OF COMPLIANCE

I, Hope Hall Augustini, hereby certify that the foregoing brief complies with the type volume limitation of Federal Rules of Appellate Procedure 32(a)(7), and contains 5208 words in 14 point Times New Roman.

Hope Hall Augustini

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state enforcement activities do not impair federal regulatory interests, *see Florida Lime & Avocado Growers, Inc. v. Paul,* 373 U.S. 132, 142, 83 S.Ct. 1210, 10 L.Ed.2d 248 (1963). *Cf. Gonzales v. City of Peoria,* 722 F.2d 468, 474 (9th Cir.1983) (holding that federal law does not preclude local enforcement of the criminal provisions of the Immigration and Naturalization Act), *overruled on other grounds by Hodgers-Durgin v. De La Vina,* 199 F.3d 1037 (9th Cir.1999). Thus, in the absence of federal preemption in the area of criminal firearm laws—of which there is no issue raised here—we look to state law to determine the authority of the state officers to arrest and seize evidence for violations of federal felonies in this arena.

[4] The Supreme Court of Vermont has conclusively established that its officers are authorized by state statute to arrest for violations of federal law. In *Vermont v. Towne,* 158 Vt. 607, 615 A.2d 484 (1992), the court upheld a defendant's arrest by state officers on the ground that they had probable cause to believe that Towne possessed a firearm in violation of federal law. *See id.,* 158 Vt. at 628, 615 A.2d at 495. The court found that Rule 3(a)(1) of the Vermont Rules of Criminal Procedure, which allows law enforcement personnel to arrest without a warrant "when the officer has probable cause to believe a person has committed or is committing a felony," applies with equal force to federal as well as state law felonies. *Id.,* 158 Vt. at 628, 615 A.2d at 496. The court "conclude[d] that [Rule 3(a)(1)] permits state officers to make an arrest without a warrant where they have probable cause to believe that a federal felony is being or has been committed." *Id.*

[5] Accordingly, under our precedents, which compel application of Vermont law to determine the validity of the arrest, the state officers in this case were clearly authorized to arrest Haskin; Haskin does not dispute that, the officers possessed probable cause to believe he was in violation of the federal law prohibiting a convicted felon from possessing a weapon. Furthermore, it is clear that the power to arrest for violations of federal law implies the power to seize evidence incident to that arrest. *See Viale,* 312 F.2d at 601 ("Accordingly we hold that these ... arrests, although made without warrants, were legal under [state law] and that the searches incidental to these arrests were legal."); *Marsh,* 29 F.2d at 175 (upholding the arrest by state officers for violation of federal law and "the seizure [of evidence], which went along with it, [which] was reasonable and lawful").

CONCLUSION

For the foregoing reasons, we uphold the District Court's denial of the motion to suppress and affirm the judgment of conviction.

Joseph A. GANINO, Robert E. Creighton, Louise A. Creighton, William J. Fray, The Estate of Norman Garand, The Garand Family Partnership, A. John Kalil, Reza Najafzadeh, Jeffrey T. Norton, Rebecca L. Norton, John Norton, Matthew Norton, Laura Norton, Alice M. Tobin and Brantley H. Tudor, individually and on behalf of a class of persons similarly situated, Plaintiffs-Appellants,

v.

CITIZENS UTILITIES COMPANY, Leonard Tow, Livingston E. Ross, and Robert J. Desantis, Defendants-Appellees.

Docket No. 99-7904

United States Court of Appeals, Second Circuit.

Argued April 10, 2000.

Decided Sept. 06, 2000.

As Amended Sept. 11, 2000.

Investors brought securities fraud suit alleging that corporation reported fees received in 1995 as 1996 income. The United States District Court for the District of Connecticut, Warren W. Eginton, J., 56 F.Supp.2d 222, dismissed suit, and investors appealed. The Court of Appeals, Katzmann, Circuit Judge, held that: (1) complaint alleged material misrepresentations, and (2) remand was required to determine whether complaint adequately pled scienter.

Vacated in part, reversed in part and remanded with instructions.

1. Securities Regulation ⟹60.10

Section 10(b) bars conduct involving manipulation or deception, manipulation being practices that are intended to mislead investors by artificially affecting market activity, and deception being misrepresentation, or nondisclosure intended to deceive. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

2. Securities Regulation ⟹60.15, 60.18

To state claim under § 10(b) and corresponding Rule 10b-5, plaintiff must plead that defendant, in connection with purchase or sale of securities, made materially false statement or omitted material fact, with scienter, and that plaintiff's reliance on defendant's action caused injury to plaintiff. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

3. Securities Regulation ⟹60.53, 60.54

At pleading stage, plaintiff satisfies materiality requirement of Rule 10b-5 by alleging statement or omission that reasonable investor would have considered significant in making investment decisions; it is not sufficient to allege that investor might have considered misrepresentation or omission important. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

4. Securities Regulation ⟹60.51

Investor alleging Rule 10b-5 claim need not assert that investor would have acted differently if accurate disclosure was made. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

5. Securities Regulation ⟹60.28(11)

Omitted fact may be immaterial, under Rule 10b-5, if information is trivial, or is so basic that any investor could be expected to know it. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

6. Securities Regulation ⟹60.46

There is no single numerical or percentage benchmark for determining whether misstatement of revenue is material for purposes of Rule 10b-5 claim. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

7. Securities Regulation ⟹3

Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) does not have force of law.

8. Securities Regulation ⟹3

Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) regarding factors that could cause misstatements of quantitatively small amounts to be material was persuasive guidance for evaluating materiality of alleged misrepresentation; SAB was thoroughly reasoned and consistent with existing law.

9. Securities Regulation ⟹60.46

Misstatements of income can be material, under Rule 10b-5, because earnings reports are among the pieces of data that investors find most relevant to their investment decisions. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

10. Securities Regulation ⟹60.46

Materiality of misstatement, for purposes of Rule 10b-5 claim, is determined in light of circumstances existing at time alleged misstatement occurred. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

11. Securities Regulation ⇐60.27(6)

In determining whether corporation's alleged failure to report fees in quarter received was misstatement under Rule 10b-5, it was appropriate to compare fees to not only annual, but also quarterly financial results. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

12. Securities Regulation ⇐60.46

Alleged misrepresentation of $10.1 million of fees received in 1995 as 1996 income was material, as required to plead Rule 10b-5 claim; the $6.9 million of 1995 fees booked during first quarter of 1996 equaled 17.7% of reported after-tax net income and 11.7% of pre-tax net income for that quarter, and the $10.1 million reflected in 1996 Second Quarter Form 10-Q amounted to 11.9% of after-tax net income and 8% of pre-tax net income for first six months of 1996. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

13. Evidence ⇐18

Federal Civil Procedure ⇐1832, 2533.1

District court may take judicial notice of well-publicized stock prices without converting motion to dismiss into motion for summary judgment.

14. Federal Civil Procedure ⇐1829

On motion to dismiss Rule 10b-5 suit for failure to state claim, district court should have inferred, from allegation that corporation's earnings and earnings per share fell in particular month, that price per share dropped correspondingly. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

15. Securities Regulation ⇐60.46

Under "truth on the market" corollary to "fraud on the market" theory, misrepresentation is immaterial if information is already known to market because misrepresentation cannot then defraud the market; defendant may rebut presumption that its misrepresentations have affected market price of its stock by showing that truth of matter was already known, but corrective information must be conveyed to public with degree of intensity and credibility sufficient to counter-balance effectively any misleading information created by alleged misstatements. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

16. Federal Civil Procedure ⇐1831

Truth-on-the-market defense is intensely fact-specific and is rarely appropriate basis for dismissing § 10(b) complaint for failure to plead materiality. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

17. Federal Civil Procedure ⇐1831

Whether corporation's disclosures before class period had already transmitted all relevant information about fee deal to market, rendering alleged inflation of 1996 income using 1995 fees immaterial, was fact-specific inquiry and inappropriate basis for dismissing § 10(b) complaint for failure to state claim. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

18. Federal Civil Procedure ⇐636

Complaint alleging securities fraud must plead fraud with particularity. Fed. Rules Civ.Proc.Rule 9(b), 28 U.S.C.A.

19. Securities Regulation ⇐60.45(1)

Intent to deceive, manipulate or defraud, required to support Rule 10b-5 claim, can be established either by alleging facts to show that defendants had both motive and opportunity to commit fraud, or by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

20. Securities Regulation ⇐60.51

Although speculation and conclusory allegations will not suffice to plead intent requirement of Rule 10b-5 claim, great specificity is not required, provided plaintiff alleges enough facts to support strong inference of fraudulent intent. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5; Fed. Rules Civ.Proc.Rule 9(b), 28 U.S.C.A.

21. Securities Regulation ⟹60.51

Private Securities Litigation Reform Act (PSLRA) did not eliminate option of pleading scienter by alleging that defendant had motive and opportunity to commit fraud. Private Securities Litigation Reform Act of 1995, § 1 et seq., 15 U.S.C.A. § 78a note.

22. Securities Regulation ⟹60.53, 60.54

Motive to commit fraud, for purposes of pleading rule 10b-5 claim, entails concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged; general allegations that defendants acted in their economic self-interest are not enough. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

23. Securities Regulation ⟹60.40

To make out prima facie case of control person liability under Securities Exchange Act, plaintiff must show primary violation by controlled person and control of primary violator by targeted defendant, and show that controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by controlled person. Securities Exchange Act of 1934, § 20(a), 15 U.S.C.A. § 78t(a).

Andrew M. Schatz (Jeffrey S. Nobel, Andrew S. Turret, on the brief), Schatz & Nobel, PC, Hartford, CT, for Appellants.

George A. Zimmerman (W.H. Ramsay Lewis, Shoshanah V. Asnis, on the brief), Skadden, Arps, Slate, Meagher & Flom, LLP, New York, New York, for Appellee.

Before: NEWMAN, KEARSE, and KATZMANN, Circuit Judges.

KATZMANN, Circuit Judge:

The plaintiffs-appellants appeal from a final judgment of the United States District Court for the District of Connecticut (Warren W. Eginton, *Senior Judge*), granting the defendants-appellees' motion to dismiss the Second Amended Complaint (the "Complaint") for failure to state a claim under Sections 10(b)[1] and 20(a)[2] of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§ 78j(b) & 78t(a), and Rule 10b-5[3] promulgated thereunder, 17 C.F.R. § 240.10b-5. The district court held: (1) the misrepresentations regarding certain payments amount-

1. Section 10 of the Exchange Act provides, in relevant part:

   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

   ...

   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

   15 U.S.C. § 78j(b).

2. Section 20(a) of the Exchange Act provides, in relevant part:

   Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

   15 U.S.C. § 78t(a).

3. Rule 10b-5, entitled "Employment of manipulative or deceptive device," makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."

   17 C.F.R. § 240.10b-5.

ing to 1.7% of total annual revenue were immaterial as a matter of law; (2) the lack of share price movement following the release of corrective information was evidence of immateriality; and (3) the Complaint was defective as to one or more of the other elements of a Rule 10b-5 suit. For the reasons that follow, we reverse in part, vacate in part, and remand with instructions.

I. BACKGROUND

A. *Factual Background*

The plaintiffs in this action purchased or acquired the common stock of Citizens Utilities Company ("Citizens" or the "Company"), the corporate defendant, between May 7, 1996 and August 7, 1997 (the "Class Period"). Alleging that Citizens' share price was fraudulently inflated during the Class Period, the plaintiffs seek to represent the class of all purchasers of Citizens common stock during the Class Period in this action against Citizens and three of its senior officers. The following allegations are drawn from their Complaint, which we accept as true for purposes of this appeal.

Citizens is a publicly traded communications and public services company. As of 1995, Citizens had reported over fifty consecutive years of increased revenue, earnings, and earnings per share, a fact which it emphasized in its public comments. In 1995, however, Citizens would not receive approximately $88 million in revenue from Pacific Bell. In order to continue to report increased earnings, the Company had to find another source of revenue.

That replacement source was Hungarian Telephone & Cable Corporation ("HTCC"), a U.S. company which provides telephone services in Hungary under telecommunications concessions from the Hungarian government. The concession contracts require HTCC to meet certain construction milestones. Failure to do so would subject HTCC to fines, reduction of its exclusivity period, or abrogation of the contracts. Unprofitable since its inception, HTCC by 1995 lacked the necessary funds to satisfy its contractual requirements and began looking for a source of financing. Beginning in May 1995, HTCC and Citizens (through a wholly owned subsidiary of Citizens) entered into a series of agreements under which Citizens agreed in 1995 to make and/or guarantee loans to HTCC. In consideration for these loans and guarantees, Citizens received substantial fees (the "Financial Support Fees" or the "Fees"), consisting primarily of HTCC stock and options. In addition, Citizens also provided management consulting services to HTCC.

1. *Allegations of Material Misrepresentations*

Although Citizens earned and received approximately $10.1 million in Financial Support Fees from HTCC in 1995, Citizens, according to the Complaint, fraudulently recognized this sum as 1996 first and second quarter income without proper disclosure. Because Citizens' 1995 annual financial statement ("1995 Form 10-K") filed with the Securities and Exchange Commission (the "SEC") stated that Citizens "ha[d] been compensated for ... guarantees and financial support [to HTCC]," investors were allegedly misled into believing that the $10.1 million booked in 1996 was new income, unrelated to the 1995 HTCC loan and guarantee transactions. *See* 15 U.S.C. § 78m(a)(2) (requiring quarterly and annual financial reports to be filed with the SEC); 17 C.F.R. § 240.13a-13(a).

a. *May 7, 1996 Announcement of 1996 First Quarter Financial Results and First Quarter Form 10-Q*

On May 7, 1996, Citizens publicly announced an after-tax net income of $38.9 million for the first quarter of 1996, up 15% from the corresponding period in 1995. These results were reflected in its 1996 first quarter financial statement ("First Quarter Form 10-Q"). The defendants did not disclose that "as much as $6.9 million of the $38.9 million ... was HTCC related income which was deceptively 'stored' by Citizens" until the first quarter of 1996. According to the Complaint, the defendants also concealed the fact that this $6.9 million made up most if not all of the reported 15% increase during the first quarter of 1996.

b. *August 15, 1996 Press Release and 1996 Second Quarter Form 10–Q*

On August 15, 1996, Citizens issued another press release announcing "record ... profits for the three— and six-month periods ended June 30, 1996," with the second quarter's net income of $46.3 million representing a 10% increase over the comparable period in the preceding year. Citizens attributed this growth to "continuous above-average growth in volume and profitability in each of its sectors, particularly telecommunications." These results were reflected in its 1996 second quarter financial report ("Second Quarter Form 10-Q"). The Complaint charges that the August 15, 1996 press release and the 1996 Second Quarter Form 10–Q both failed to disclose that "approximately $10 million of the $85.1 million of reported income for the six months ended June 30, 1996 was HTCC related income" which should have been recognized in 1995. The Complaint states that the defendants also concealed the fact that this approximately $10 million accounted for the full 10% increase in income for the first six months of 1996 over the comparable period in 1995.

c. *Subsequent Financial Statements and Press Releases*

The $10.1 million of Financial Support Fees were also reported as part of the year-to-date earnings in Citizens' 1996 Third Quarter Form 10–Q, 1996 Form 10-K, and accompanying press releases. An additional $11.2 million of Fees were booked in the last quarter of 1996 and reflected in the 1996 year-end statement ("1996 Form 10–K"). In total, the Fees at issue added up to approximately $22 million, or 1.7% of Citizens' total revenue for 1996. As with the Form 10–Qs for the first two quarters of 1996, the defendants did not disclose in the Third Quarter Form 10–Q, 1996 Form 10–K, and accompanying press releases that the reported income included HTCC Fees earned and received in 1995.

On April 30, 1997, Citizens issued a press release announcing lower than expected earnings for the first quarter of 1997. These results were reflected in the Company's 1997 First Quarter Form 10–Q. Neither document attributed the drop in income to the decrease in HTCC Fees. Instead, according to the Complaint, the press release misleadingly focused on rising expenses. Beginning in or about May 1997, industry analysts began to report weaknesses in Citizens' earnings position. Their predictions were confirmed by Citizens in August 1997 with the filing of its 1997 Second Quarter Form 10–Q, which also disclosed that the reported income for the first two quarters of 1996 included material income from HTCC.

d. *Other Misrepresentations*

The defendants allegedly made other material misrepresentations. According to the Complaint, the defendants failed to disclose that the Fees were non-recurring income, in violation of a Generally Accepted Accounting Principle ("GAAP")[4] that

4. Generally Accepted Accounting Principles ("GAAP") are the official standards adopted by the American Institute of Certified Public Accountants (the "AICPA"), a private professional association, through three successor groups it established: the Committee on Accounting Procedure, the Accounting Principles Board (the "APB"), and the Financial Accounting Standards Board (the "FASB"). *See PNC Bancorp, Inc. v. Commissioner of Internal Revenue*, 212 F.3d 822, 825 n. 1 (3d Cir.2000); *Amerada Hess Pipeline Corp. v. Federal Energy Regulatory Comm'n*, 117 F.3d 596, 601 (D.C.Cir.1997); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1421 n. 10 (3d Cir.1997); *Providence Hosp. of Top-*

companies report "extraordinary, unusual or infrequently occurring events and transactions." *See generally* Accounting Principles Board ("APB") Opinion No. 30, ¶¶ 19–24 (1973) (explaining "Criteria for Extraordinary Items"). The defendants also allegedly concealed Citizens' control over HTCC and in fact, by employing "cost accounting," which under GAAP is appropriately used only to reflect a registrant's investment in a company the registrant does not dominate, Citizens falsely represented that it exercised no such control over HTCC. *See generally* APB Opinion No. 18, ¶¶ 5–17 (1971). According to the Complaint, Citizens' secret domination of HTCC was all the more significant because the Fees were paid in the form of HTCC stock and options, the price of which Citizens could manipulate using its influence over HTCC.

2. *Scienter Allegations*

The Complaint alleges that the defendants made the purported misrepresentations knowingly or recklessly. That is, defendants Leonard Tow and Robert DeSantis, senior officers of Citizens, believed throughout most of 1995 that a new source of income was needed to replace revenue from Pacific Bell that ceased in 1994. However, by the end of 1995, after the HTCC Fees were already paid in, Citizens found that it was able to meet earnings projections even without the Fees. Not only were the HTCC Fees not needed in 1995 to replace lost revenue from Pacific Bell, but if Citizens had recognized the HTCC Fees in 1995, the Fees would have so increased Citizens' 1995 earnings that the Company would have difficulty meeting expectations for increased earnings in 1996. *See id.* Thus, according to the Complaint, the defendants manipulated the recognition of the Fees in order to manage the income trend.

The defendants allegedly had other corporate and personal motives to maintain an artificial earnings growth trend, thus propping up Citizens' share price. In 1996, Citizens engaged in a stock-for-stock acquisition of another company and placed a debenture offering to finance its telecommunications expansion. Both of these transactions, the Complaint states, were well-served by an inflated stock price. As to the individual defendants, Livingston Ross (also a senior Citizens officer) and DeSantis purportedly engaged in insider trading during the Class Period, and all three individual defendants benefitted by securing their executive privileges.

B. *Procedural History*

In 1998 the plaintiffs filed this action, asserting violations of § 10(b) of the Exchange Act and the corresponding Rule 10b–5 against all defendants, and violation of § 20(a) of the Exchange Act against the individual defendants as persons controlling Citizens. The plaintiffs also sought to certify this action as a class action under Rule 23 of the Federal Rules of Civil Procedure. The defendants moved to dismiss the Complaint in its entirety, arguing that: (1) the nondisclosures at issue were immaterial because the information was already publicly available; (2) the plaintiffs failed to plead scienter with particularity; (3) the amount of Fees they allegedly "deceptively stored" was immaterial as a matter of law since it comprised a *de minimis* 1.7% of Citizens' total pre-tax revenues during the class period; (4) the plaintiffs' allegations of GAAP violations, without corresponding fraudulent intent, failed to state a claim; and (5) the Complaint failed to state a § 20(a) claim because the underlying § 10(b)/Rule 10b–5 charges are not viable.

The district court granted the defendants' motion to dismiss. *See Ganino v.*

penish v. Shalala, 52 F.3d 213, 219 n. 7 (9th Cir.1995). GAAP does not prescribe a fixed set of rules, but rather represent "the range of reasonable alternatives that management can use." *In re Burlington Coat Factory*, 114 F.3d at 1421 n. 10 (citing *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 544, 99 S.Ct. 773, 58 L.Ed.2d 785 (1979)). The SEC treats the FASB's standards as authoritative. *See PNC Bancorp*, 212 F.3d at 825 n. 1.

Citizens Utilities Co., 56 F.Supp.2d 222 (D.Conn.1999). Focusing on the issue of materiality, the court quoted a newspaper article which observed that "'[m]ost auditors—and their corporate clients—define materiality as any event or news that might affect a company's earnings, positively or negatively, by 3% to 10% .... [it] has become standard practice in corporate America. Thus, if a particular charge or event doesn't meet the 3% to 10% level, companies feel they don't have to disclose it.'" *Id.* at 226 (alteration in original) (quoting Elizabeth MacDonald, *SEC Readies New Rules for Companies About What is "Material" for Disclosure*, WALL ST. J., Nov. 3, 1998, at A2). Applying this 3% to 10% range, the court held that "the amount in issue here—1.7% of Citizens' revenues for the relevant time period, pursuant to GAAP—is immaterial as a matter of law." *Id.* at 227. In addition, the court found that the lack of change in Citizens' stock price following the filing of the 1997 Second Quarter Form 10–Q on August 7, 1997, to be evidence of immateriality. *See id.*

Because the alleged misrepresentations were held to be legally immaterial, the court found it unnecessary to discuss the other grounds for dismissal urged by the defendants. It stated summarily that "[n]evertheless, the Court has thoroughly examined [the other] elements [of a Rule 10b–5 claim] and plaintiffs' supporting authority, and holds that such would not change the outcome of this case." *Id.* This appeal followed.

II. *DISCUSSION*

We review *de novo* a district court's dismissal of a complaint pursuant to Rule 12(b)(6), accepting all factual allegations in the complaint as true and drawing all reasonable inferences in the plaintiffs' favor. *See Friedl v. City of New York*, 210 F.3d 79, 83 (2d Cir.2000); *Koppel v. 4987 Corp.*, 167 F.3d 125, 130 (2d Cir.1999) (internal quotation omitted). We uphold a dismissal only if "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Id.* (internal quotation marks and citations omitted).

A. *The § 10(b)/Rule 10b–5 Claims*

1. *Prima Facie Case*

[1, 2] Section 10(b) of the Exchange Act bars conduct "involving manipulation or deception, manipulation being practices ... that are intended to mislead investors by artificially affecting market activity, and deception being misrepresentation, or nondisclosure intended to deceive." *Field v. Trump*, 850 F.2d 938, 946–47 (2d Cir. 1988) (internal quotation marks and citation omitted); *see Press v. Chemical Inv. Serv. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999). To state a claim under § 10(b) and the corresponding Rule 10b–5, a plaintiff must plead that the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that the plaintiff's reliance on the defendant's action caused injury to the plaintiff. *See In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153, 155–56 (2d Cir.1998); *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 808 (2d Cir.1996); *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir.1995).

The plaintiffs' principal contentions on appeal are that the district court erred in deciding that the Complaint failed to allege material misrepresentations and scienter. Neither they nor the defendants interpret the district court's dismissal of the Rule 10b–5 claims as having any other basis. Accordingly, we consider only the elements of materiality and scienter.

2. *Materiality*

[3–5] At the pleading stage, a plaintiff satisfies the materiality requirement of Rule 10b–5 by alleging a statement or omission that a reasonable investor would have considered significant in making investment decisions. *See Basic Inc. v. Lev-*

inson, 485 U.S. 224, 231, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988) (adopting the standard in *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976), for § 10(b) and Rule 10b-5 actions); *Glazer v. Formica Corp.*, 964 F.2d 149, 154-55 (2d Cir.1992). "[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'" *Basic*, 485 U.S. at 231-32, 108 S.Ct. 978 (quoting *TSC Indus.*, 426 U.S. at 449, 96 S.Ct. 2126). It is not sufficient to allege that the investor might have considered the misrepresentation or omission important. On the other hand, it is not necessary to assert that the investor would have acted differently if an accurate disclosure was made. *Cf. Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1533-34 (2d Cir. 1991) (holding that jury charge which may have misled jury to believe that information is material only if it is outcome-determinative was error). An omitted fact may be immaterial if the information is trivial, *see Basic*, 485 U.S. at 231, 108 S.Ct. 978 (citation omitted), or is "so basic that any investor could be expected to know it," *Levitin v. PaineWebber, Inc.*, 159 F.3d 698, 702 (2d Cir.1998) (internal quotation marks omitted), *cert. denied*, 525 U.S. 1144, 119 S.Ct. 1039, 143 L.Ed.2d 47 (1999). Therefore, whether an alleged misrepresentation or omission is material necessarily depends on all relevant circumstances of the particular case.

Materiality is a mixed question of law and fact. *See TSC Indus.*, 426 U.S. at 450, 96 S.Ct. 2126. We have held that, when presented with a Rule 12(b)(6) motion, "a complaint may not properly be dismissed ... on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir.1985); *see Azrielli v. Cohen Law Offices*, 21 F.3d 512, 518 (2d Cir.1994).

a. *Numerical Benchmark*

[6] The district court held that the alleged misrepresentations of the HTCC Fees as having been received in 1996 were immaterial as a matter of law because the Fees amounted to only 1.7% of Citizens' 1996 total revenue. The plaintiffs and the SEC, as amicus curiae, contend that the court's exclusive reliance on a single numerical or percentage benchmark to determine materiality was error. Their position is supported by ample authority. In *Basic*, the Supreme Court expressly rejected the use of a numerical formula:

> A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress' policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.

Basic, 485 U.S. at 236 & n. 14, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988) (citing House Committee on Interstate and Foreign Commerce, Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 95th Cong., 1st Sess., at 327 (Comm. Print 1977)); *see also* FASB, Statement of Financial Accounting Concepts No. 2, ¶ 125 (1980) ("[M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.").

Following *Basic*, we have consistently rejected a formulaic approach to assessing the materiality of an alleged misrepresentation. For example, in *Press*, we considered when failure to disclose the specifics of a securities markup[5] would be material. *See Press*, 166 F.3d at 534–37. Under § 10(b) of the Exchange Act, a seller has a duty to disclose the details of a markup if the markup is "excessive." *See id.* at 534. We declined in that case to establish a specific range beyond which a markup would be deemed "excessive," holding instead that courts must assess a broad range of factors. *See id.* at 535. In *Glazer*, we rejected the notion that merger talks are not material as a matter of law unless the discussions had ripened into an agreement-in-principle on price and structure. *Glazer*, 964 F.2d at 156. We held that the materiality of merger negotiations depends on the specific facts of each case. *See id.* *See also In re Home Health Corp. of America, Inc. Sec. Litig.*, No. Civ. A. 98-834, 1999 WL 79057, at *6–7 (E.D.Pa. Jan. 29, 1999) (declining to hold immaterial as a matter of law failure to report loss of a *de minimis* percentage of total revenue where qualitative factor rendered the loss significant); *In re Kidder Peabody Sec. Litig.*, 10 F.Supp.2d 398, 410 (S.D.N.Y. 1998) (relying on *Basic* and declining to hold as a matter of law that misstatements affecting profits by no more than 2.54% were immaterial).

[7, 8] With respect to financial statements, the SEC has commented that various "[q]ualitative factors may cause misstatements of quantitatively small amounts to be material." SEC Staff Accounting Bulletin ("SAB") No. 99, 64 Fed.Reg. 45150, 45152 (1999) (to be codified at 17 C.F.R. pt. 211, subpt. B) (representing interpretations and practices followed by the SEC's Division of Corporation Finance and the Office of the Chief Accountant in administering disclosure requirements of federal securities law).[6] Of particular relevance to this action are the following:

- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise[.]

Id. Unlike, for example, a rule promulgated by the SEC pursuant to its rulemaking authority, *see* 15 U.S.C. § 78w(a), SAB No. 99 does not carry with it the force of law. *See, e.g., Christensen v. Harris County*, — U.S. —, 120 S.Ct. 1655, 1662–63, 146 L.Ed.2d 621 (2000) (explaining that interpretations contained in opinion letters, like those in policy statements, agency manuals, and enforcement guidelines, which are not, for example, the result of a formal adjudication or notice-and-comment process, lack the force of law); *General Elec. Co. v. Gilbert*, 429 U.S. 125, 141, 97 S.Ct. 401, 50 L.Ed.2d 343 (1976) (stating that courts may give less weight to guidelines than to administrative regulations which Congress has declared shall have the force of law or to regulations which, under the enabling statute, may themselves supply the basis for imposition of liability) (superseded by statute on other grounds). Nonetheless, because SEC staff accounting bulletins "constitute a body of experience and informed judgment," *Skidmore v. Swift & Co.*, 323 U.S. 134, 140, 65 S.Ct. 161, 89 L.Ed. 124 (1944), and SAB No. 99 is thoroughly reasoned and consistent with existing law—its non-exhaustive list of factors is simply an application of the well-established *Basic* analysis to misrepresentations of financial results—we find it persuasive guidance for evaluating the materiality of an alleged misrepresentation. *See Christensen*, — U.S. —, 120 S.Ct. at 1663 (quoting *Skidmore*, 323 U.S. at 140,

5. "A markup is the difference between the price charged to a customer for a security and the prevailing market price for the security." *Press*, 166 F.3d at 533 n. 2.

6. The defendants argue that we should not apply SAB No. 99 to this case because it was promulgated after the events at issue here and "is not intended to change current law or guidance in the accounting or auditing literature." SAB No. 99, 64 Fed.Reg. 45150, 45152. However, the fact that SAB No. 99 did not alter the existing law or guidance is a reason to consider it in this case, not to refrain from doing so.

65 S.Ct. 161); *Gilbert*, 429 U.S. at 125, 97 S.Ct. 401.

The two Court of Appeals cases cited by the district court support the approach we take here. In *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir.1997), the Eighth Circuit held that the alleged misrepresentations, which amounted to 2% of total assets, were immaterial as a matter of law "*[t]aken in context*." *Id.* at 547 (emphasis added). The court did not rely on the single numerical benchmark, but also took into consideration the fact that the case involved a high-risk/high-yield investment, and that the risk factors had been prominently disclosed in a prospectus. *Id.* at 542–43, 547. Similarly, in *Glassman v. Computervision Corp.*, 90 F.3d 617 (1st Cir.1996), the First Circuit Court of Appeals considered whether a 3% to 9% drop in quarterly revenue was immaterial as a matter of law. It stated, in dicta, that "[w]here a variable, *although material*, is of only minor predictive value, disclosure of a rough estimate of that variable's value can obviate the need for more specific disclosure." *Id.* at 633 (emphasis added). The clear implication of this statement is that a 3% to 9% drop may be material depending on the circumstances. To the extent that the two district court decisions also cited in the opinion below adopted a bright-line test for materiality, we disagree with their approach. *See Shuster v. Symmetricon, Inc.*, No. 94-20024, 1997 WL 269490, at *8 (N.D.Cal. Feb. 25, 1997); *Ferber v. Travelers Corp.*, 802 F.Supp. 698, 708 (D.Conn.1992).

b. *Relevant Line Item*

[9] The plaintiffs argue that the district court erred by comparing the Fees to Citizens' total revenue instead of total income. In so holding, the district court mistakenly believed that the plaintiffs' argument rested on an invalid accounting principle:

> Although defendants assert that the amount of plaintiffs' alleged nondisclosure amounts to $6.9 million, or approximately 2% of Citizens' revenues, plaintiffs[ ] allege that this statement was inaccurate by 15.78% *because Citizens used GAAP principles, rather than Equity Accounting.*[7]

Ganino, 56 F.Supp.2d at 224 (emphasis added). In fact, however, the plaintiffs' contentions with respect to the booking of the 1995 Fees as 1996 income depended not so much on the use of equity accounting as on the characterization of the Fees as income rather than revenue. Misstatements of income could be material because "earnings reports are among the pieces of data that investors find most relevant to their investment decisions." *In re Burlington Coat Factory*, 114 F.3d at 1420 n. 9; *see In re Kidder Peabody*, 10 F.Supp.2d at 410. The Complaint alleged that the Fees were "pre-tax income (revenue for which there was no corresponding expense)" and repeatedly compared the Fees

7. In a footnote, the court explained:

> Equity Accounting compares HTCC's gross pre-tax revenues to Citizens' net after-tax revenues. Each of the percentages set forth by plaintiffs use this accounting principle. The Court finds, however, that this approach is economically unsound and fails to take into account generally accepted accounting principles. As defendants have noted, such reasoning is to compare apples with oranges.

Id. at n. 1. We have a different understanding of the accounting concepts. Equity accounting is itself a GAAP principle and is a form of accounting that is most appropriately used "by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee." Accounting Principles Board Opinion No. 18, ¶ 18.17 (1972); *see also* Abraham J. Briloff, *Unaccountable Accounting* 48–49, 243 (1972) (discussing APB Opinion No. 18). Ownership "of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over the investee." *Id.* In that circumstance, the investing company is required to report its percentage share of the investee's income or loss on its own financial statement. *See generally id.* ¶ 18.19. Equity accounting does not compare a company's gross pre-tax revenues to its net after-tax revenues.

to the "Net Income" line item on the Form 10-Qs. Whether the plaintiffs will be able to prove that the Fees had no offsetting expenses—and therefore can be properly recorded as income—is an issue of fact that cannot be decided at this stage of the litigation. On a motion to dismiss, the allegations in the Complaint must be accepted as true. Accordingly, the Fees should be treated as and compared to Citizens' pre-tax income.

The defendants do not dispute that the items in issue should be compared to like items on the corporate financial statement. On the contrary, they themselves point to numerous cases that did exactly that. *See, e.g. Parnes,* 122 F.3d at 546 (comparing reserves for dubious accounts receivable to total assets); *In re Westinghouse Sec. Litig.,* 90 F.3d 696, 715 & n. 15 (3d Cir.1996) (comparing loss reserves, which for accounting purposes "most immediately" affects income, to total income for relevant period); *Glassman,* 90 F.3d at 633 (comparing dollar amount of backlog orders, a revenue item, to total revenues); *Ferber,* 802 F.Supp. at 707 (comparing real estate investments to total "invested assets"); *In re First Chicago Corp. Sec. Litig.,* 769 F.Supp. 1444, 1454 (N.D.Ill.1991) (comparing allegedly risky real estate loan to total real estate loan portfolio for year). Rather, the defendants challenge the assertion that the Fees went directly to Citizens' bottom line as income, a factual dispute that cannot be resolved without further development of the record.

c. *Relevant Timeframe*

We next consider the relevant timeframe. The plaintiffs, joined by the SEC, maintain that the court should have considered the impact of the alleged misrepresentations on all misstated items in the financial statement for all relevant periods, not only for the year as a whole. In this case, the Complaint alleged that substantial portions of the income reported during the first two quarters of 1996 were in fact the 1995 Fees. Accordingly, the plaintiffs and the SEC contend that the court should have assessed the impact of the Fees on Citizens' quarterly income. The defendants argue that the court correctly compared the Fees to annual results only, because the plaintiffs theorized that the defendants deferred recognition of the Fees in order to maintain Citizens' annual growth trend.

[10] We reject the defendants' contention. Materiality is determined in light of the circumstances existing at the time the alleged misstatement occurred. *See Pommer v. Medtest Corp.,* 961 F.2d 620, 625 (7th Cir.1992); *City Nat'l Bank of Fort Smith v. Vanderboom,* 422 F.2d 221, 230 (8th Cir.1970); *Spielman v. General Host Corp.,* 402 F.Supp. 190, 194 (S.D.N.Y.1975) ("The determination of materiality is to be made upon all the facts as of the time of the transaction and not upon a 20-20 hindsight view long after the event." (footnote omitted)), *aff'd,* 538 F.2d 39 (2d Cir.1976). Thus, we held in *Kaiser-Frazer Corp. v. Otis & Co.,* 195 F.2d 838, 843 (2d Cir.1952), that an overstatement of fourth quarter earnings was not rendered immaterial simply because profits for the year as a whole were not affected by the misrepresentation because "the prospective purchaser was entitled to a full disclosure of all the facts that were known to the Corporation at the time the [financial statement] was issued." *See also Glassman,* 90 F.3d at 633 (comparing quarterly results); *SEC v. Keller Indus., Inc.,* 342 F.Supp. 654, 657 n. 5 (S.D.N.Y.1972) (recognizing that a publicly filed interim quarterly report can be actionable under Rule 10b-5 if it contains material misstatements).

[11] Citizens' own press releases implicitly acknowledge the significance of quarterly financial statements. For example, its May 7, 1996 press release touted first quarter results as a predictor of annual performance, stating that the Company was "well on its way toward its 52nd consecutive year of increased revenues, net income and earnings per share." *See also* 5B Arnold S. Jacobs, *Litigation and Prac-*

tion under Rule 10b-5 § 81.02[c], at 3-198 (West 1999) (noting that a company's decision to issue press release may show that company thought the data significant). Therefore, we think it appropriate to compare the Fees to not only annual, but also quarterly financial results.

d. *This Complaint*

[12] Applying the foregoing principles to this action, we conclude that the Complaint alleged material misrepresentations in the 1996 First and Second Quarter Form 10-Qs and corresponding press releases, namely, the alleged misrepresentation of $10.1 million of Fees received in 1995 as 1996 income. The $6.9 million of 1995 Fees booked during the first quarter of 1996 equaled 17.7% of Citizens' reported after-tax net income ($38.9 million), and 11.7% of its pre-tax net income ($58.78 million) for that quarter. The $10.1 million reflected in the 1996 Second Quarter Form 10-Q amounted to 11.9% of after-tax net income ($85.15 million), and 8% of pre-tax net income ($126.62 million) for the first six months of 1996. We believe it is inappropriate to determine at this stage of the litigation that these substantial amounts, both in absolute terms and as percentages of total net income for the respective quarters, were immaterial as a matter of law.

Aside from the magnitude of the overstatements, the Complaint alleged that the defendants deceptively stored the Fees until 1996 in order to manage the Company's 1995 and 1996 income, and that they did so in order to conceal Citizens' failure to meet analysts' expectations and to sustain its 51-year earnings trend. The Complaint asserted that the $6.9 million of Fees reported in the First Quarter Form 10-Q accounted for "a substantial portion, if not all, of the increase in income for the first quarter 1996 compared to the first quarter of 1995[.]" Moreover, according to the Complaint, analysts' projections of Citizens' "income for the first six (6) months of 1996 were met and exceeded only as a result of th[e] additional HTCC-related income, and the increase in income for the first six months of 1996 compared to the first six months of 1995 was due *entirely* to the income recognized from HTCC." Viewed in this context, it cannot be said that no reasonable investor would have considered the misreporting of 1995 Fees as 1996 income to be significant or to have altered the total mix of information affecting their investment decisions. We therefore conclude that the Complaint alleged material misrepresentations. We need not and do not decide whether the purported misstatements regarding Citizens' control of HTCC and the non-recurring nature of the Fees are also material.

e. *Market Response*

[13] The defendants urge us to affirm the district court's decision based on the lack of movement in Citizens' stock price after it filed its 1997 Second Quarter Form 10-Q on August 7, 1997, which the court held was "significant evidence" that none of the alleged misstatements of income were material to the investing public.[5] *Ganino*, 56 F.Supp.2d at 227. According to the Complaint, on that date Citizens first publicly acknowledged that the reported income for the first and second quarters of 1996 included substantial payments from HTCC. The plaintiffs chal-

5. The New York Stock Exchange data mentioned in the opinion below were not attached to the Complaint as an exhibit or incorporated by reference into the Complaint. Nevertheless, the district court may take judicial notice of well-publicized stock prices without converting the motion to dismiss into a motion for summary judgment. *See Fant v. Perelman*, Nos. 97 Civ. 8435, 97 Civ. 8436, 1999 WL 199078, at *5 (S.D.N.Y. Apr. 9, 1999); *Comas v. Merrill Lynch & Co.*, No. 92 Civ. 6560, 1993 WL 300778, at *4 n. 2 (S.D.N.Y. July 2, 1993); *cf. Cerasani v. Sony Corp.*, 991 F.Supp. 343, 354 n. 3 (S.D.N.Y.1998) (taking judicial notice of widespread press coverage of a criminal trial). Moreover, the movement of Citizens' stock price is integral to the plaintiffs' fraud-on-the-market theory. *See Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 47 (2d Cir.1991).

lenge this evidence, noting that Citizens' stock price did experience a "precipitous drop" in *May* 1997, when reports of Citizens' poor earnings outlook first emerged.

[14] The Complaint alleges only that earnings and earnings per share fell in May 1997, not price per share. However, drawing all reasonable inferences in favor of the non-moving party, as we must, we infer that Citizens' price per share dropped correspondingly in May 1997. In granting the defendants' motion to dismiss, the court did not draw this inference and did not appropriately resolve the disputed factual issue of whether the alleged misrepresentations adversely affected Citizens' share price during the Class Period. *Cf. Silver v. H & R Block, Inc.*, 105 F.3d 394, 397 (8th Cir.1997) (declining, on a summary judgment motion, to infer that allegedly material statements were false "from the movement of stock price alone ... given the abundance of market variables"). We therefore vacate the district court's decision to the extent it held that the steadiness of Citizens' stock price after August 7, 1997 proved that the misreporting of 1995 Fees as 1996 income was immaterial.

2. "Truth on the Market" Doctrine

[15] Because of the factual dispute over Citizens' share price, we also reject the defendants' attempt to rely on the so-called "truth on the market" corollary to "fraud on the market" as a basis for affirming the district court's decision. Under this corollary, a misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market. *See Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir.1996); *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 213–14 (7th Cir.1993); *cf. Rodman v. Grant Found.*, 608 F.2d 64, 70 (2d Cir.1979) ("In determining whether [proxy statement] constituted full and adequate disclosure, the district court properly took into account information already in the public domain and facts known or reasonably available to the shareholders."). A defendant may rebut the presumption that its misrepresentations have affected the market price of its stock by showing that the truth of the matter was already known. *See Provenz*, 102 F.3d at 1492 & n. 4; *Associated Randall Bank*, 3 F.3d at 213–14; *cf. Basic*, 485 U.S. at 248, 108 S.Ct. 978 (presumption of reliance in a fraud-on-the-market case may be rebutted by proving that "the 'market makers' were privy to the truth"). However, the corrective information must be conveyed to the public "with a degree of intensity and credibility sufficient to counter-balance effectively any misleading information created by" the alleged misstatements. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116 (9th Cir.1989).

[16] The truth-on-the-market defense is intensely fact-specific and is rarely an appropriate basis for dismissing a § 10(b) complaint for failure to plead materiality. *Cf. Provenz*, 102 F.3d at 1493 (noting that summary judgment based on the "truth on the market" doctrine is appropriate only if defendants show that "no rational jury could find that the market was misled" (internal quotation marks omitted)). The two cases cited by the defendants do not hold otherwise, as both were decided at later stages of litigation after the parties had presented substantial evidence. *See In re Convergent Tech. Sec. Litig.*, 721 F.Supp. 1133, 1138–39 (N.D.Cal.1988) (deciding motion for summary judgment); *Beissinger v. Rockwood Computer Corp.*, 529 F.Supp. 770, 781–82 (E.D.Pa.1981) (deciding post-trial motion for involuntary dismissal).

[17] Here, the defendants argue that the alleged inflation of 1996 income using the 1995 Fees was immaterial because Citizens' disclosures before Class Period had already transmitted all relevant information about the HTCC deal to the market. But as explained above, the evidence on

which they rely—the lack of movement in the Citizens share price after August 1997—is in dispute. Moreover, on the present record, it cannot be said that no reasonable investor could have been misled by Citizens' statement in its 1995 Form 10-Q that it "ha[d] been compensated" for its loans and guarantees to HTCC, into believing that Citizens' 1996 First and Second Quarter Form 10-Qs included no HTCC Fees.

The defendants also argue that HTCC's SEC filings during the Class Period contained sufficient accurate information to neutralize any misleading impressions created by Citizens' financial reports. They note that as early as April 1996, one month before the Class Period, HTCC had correctly disclosed when it paid the Fees to Citizens—$6.9 million in options in 1995 and $3.2 million in stock in February 1996. Their argument is untenable for two reasons. First, whatever dubious merit this argument may have, the defendants themselves have undermined it. They appear to have conceded, in the section of their brief discussing scienter, that the Fees were in fact recognized as 1996 income following a GAAP rule governing loan guarantee fees. *See* FASB, Emerging Issues Task Force Abstract No. 85-20 ("the guarantor should recognize fee income over the guarantee period"). Given that the Complaint alleges that at least a portion of the financial support that Citizens provided to HTCC took the form of direct loans, not loan guarantees, and that the Fees should have been reported as 1995 income, the plaintiffs have satisfied their burden of pleading a material misrepresentation. Second, even assuming that HTCC's disclosures were factually accurate, we cannot decide on the present record whether those disclosures were conveyed with sufficient "intensity and credibility" as to dispel the false impression created by Citizens' alleged misrepresentations. Therefore, we decline to affirm the district court's opinion based on the "truth on the market" doctrine.[9]

B. *Scienter*

Next, the plaintiffs appeal to the extent the court ruled that they failed to plead scienter. Because we cannot discern from the opinion below whether the district court found the scienter allegations defective, we remand with the following comments on the proper pleading standard. *See, e.g., Cosgrove v. Sears, Roebuck, & Co.*, 191 F.3d 98, 102 (2d Cir.1999) (remanding for explanation of district court's basis for awarding costs); *Etuk v. Slattery*, 936 F.2d 1433, 1446-47 (2d Cir.1991) (remanding for further consideration or clarification). The district court should review the Complaint to determine whether it meets our Circuit's pleading requirements for scienter as to each of the defendants.

1. *Pleading Requirements*

[18-20] It is well-settled in this Circuit that a complaint alleging securities fraud must satisfy the pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure. *See Chill v. General Elec. Co.*, 101 F.3d 263, 267 (2d Cir.1996); *Acito*, 47 F.3d at 52; *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129-30 (2d Cir.1994); *Goldman*, 754 F.2d at 1069-70. Rule 9(b) provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally." *Chill*, 101 F.3d at 267; *Goldman*, 754 F.2d at 1070. The requisite state of mind in a Rule 10b-5 action is "an intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). Such intent can be established "either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by

9. Each of the parties have submitted and have asked that judicial notice be taken of various HTCC financial statements filed with the SEC. We need not decide the propriety of taking judicial notice of such materials because they would not affect the outcome of this case and, therefore, we do not rely on them.

alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Shields*, 25 F.3d at 1128; *see Acito*, 47 F.3d at 52; *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268–69 (2d Cir.1993). Although speculation and conclusory allegations will not suffice, neither do we require "great specificity" provided the plaintiff alleges enough facts to support "a strong inference of fraudulent intent." *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 84 (2d Cir. 1999); *see Chill*, 101 F.3d at 267 (internal quotation marks omitted); *Acito*, 47 F.3d at 53; *Shields*, 25 F.3d at 1128–29; *In re Time Warner*, 9 F.3d at 268; *cf. Press*, 166 F.3d at 538 (affirming denial of a motion to dismiss where plaintiff "barely alleged" scienter).

[21] The defendants contend that the Private Securities Litigation Reform Act ("PSLRA"), P.L. 104–67, 109 Stat. 737 (1995), eliminated the option of pleading scienter by alleging that a defendant had motive and opportunity to commit fraud. We disagree.

The PSLRA tracks the first portion of our test requiring facts that support a strong inference of intent to promote a fraud:

> In any private action arising under this title ... the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u–4(b)(2). However, the PSLRA did not expressly adopt our two distinct ways for pleading the requisite intent. On the contrary, the managers of H.R. 1058 (the PSLRA bill) stated that "[b]ecause the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard." H.R.Rep. No. 104–369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. The legislative record, however, does not end there.

In part because of the quoted language in the Conference Report, the President vetoed H.R. 1058. *See* 141 Cong. Rec. S8194 (1995).[10] During the subsequent Congressional debate to override the veto, major supporters of the bill, including its original sponsors, refuted the Conference Report, explaining that H.R. 1058 in fact *codified* the Second Circuit standard. *See, e.g.*, 141 Cong. Rec. S8823 (1995) (statement of Sen. Domenici) ("[I]t is the Second Circuit's pleading standard."); 141 Cong. Rec. S8228 (1995) (statement of Sen. Dodd) ("We have met the second circuit's standard here"); 141 Cong. Rec. S7802 (1995) (statement of Rep. Lofgren) ("The President says he supports the second circuit standard for pleading.... That is what is included in this bill."). Their understanding was later explicitly and prominently endorsed in the Joint Explanatory Statement of the Committee of Conference in connection with passage of the Securities Litigation Uniform Standards Act (the "Uniform Standards Act"), P.L. 105–353, 112 Stat. 3227 (1998):

> [I]t was the intent of Congress, as was expressly stated during the legislative debate on the [PSLRA], and particularly during the debate on overriding the President's veto, that the [PSLRA] establish a heightened uniform Federal standard on pleading requirements *based upon the pleading standard applied by the Second Circuit Court of Appeals.*

10. The conferees' reading of the PSLRA also conflicted with the understanding held by some of the bill supporters at the time. *See, e.g.*, 141 Cong. Rec. S5238 (1995) (statement of Sen. D'Amato) ("The legislation creates a uniform standard for complaints that allege securities fraud. This standard is already the law in New York."); 141 Cong. Rec. S5300 (1995) (statement of Sen. Gramm) (expressing particular support for various provisions of H.R. 1058, including "[c]odification of the pleading standard adopted by the second circuit court of appeals").

H. Rep. No. 105-803, at 15 (1998) (emphasis added) This legislative history leaves no doubt that the PSLRA "heightened the requirement for pleading scienter to the level used by the Second Circuit." *Press*, 166 F.3d at 537-38; *see also Stevelman*, 174 F.3d at 84.[11]

2. *This Complaint*

Although the Complaint need only plead scienter by alleging either motive and opportunity, or conscious or reckless misbehavior, the plaintiffs contend that the Complaint does both. The Complaint alleges that the defendants consciously or recklessly failed to disclose the following material facts: (1) the Fees recognized in 1996 were earned and received in 1995; (2) a material portion of Citizens' 1996 first and second quarter income consisted of the non-recurring Fees; (3) Citizens and HTCC were related parties; (4) Citizens' 1996 income was inflated by unearned management fees; and (5) Citizens improperly used equity accounting with respect to its transactions with HTCC. On remand, the district court should consider whether any of these allegations, if true, would give rise to a strong inference of the defendants' intent to commit fraud.

[22] As to motive and opportunity, opportunity is not disputed. However, the defendants challenge the sufficiency of the motive allegations. Motive "entail[s] concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged." *Shields*, 25 F.3d at 1130. General allegations that the defendants acted in their economic self-interest are not enough. *See, e.g., id.* at 1130 (defendants' alleged motive of prolonging executive benefits does not support a strong inference of fraudulent intent); *Chill*, 101 F.3d at 268 (allegation that defendant desired to justify substantial investment by creating appearance of investment profit fails to plead scienter). The Complaint asserts that the defendants had three motives: to maintain its 51-year trend of increased earnings; to maintain an artificially high stock price to ensure a favorable stock-for-stock acquisition of another company; and to facilitate its debenture offering. In addition, the Complaint alleges that two of the three individual defendants engaged in insider trading during the Class Period and secured their executive benefits. Whether any of these allegations plead a cognizable motive under Rule 10b-5 should be determined by the district court in the first instance. Of course, if the court decides on remand that the Complaint successfully pleaded the defendants engaged in conscious or reckless misbehavior, it need not also consider the motive and opportunity prong of scienter.

3. *The § 20(a) Claim*

[23] To make out a prima facie case under § 20(a) of the Exchange Act, a plaintiff "must show a primary violation [here, the alleged Rule 10b-5 violations] by the controlled person [here, Citizens] and control of the primary violator by the targeted defendant [here, the individual defendants], and show that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person." *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir.1996).

In this case, the district court dismissed the § 20(a) claim against the individual defendants upon ruling that the Complaint failed to plead the primary Rule 10b-5 violations. Because we remand the Rule 10b-5 claims, we also vacate the dismissal of the § 20(a) cause of action and remand

11. The legislative record of the Uniform Standards Act also disclaimed footnote 23 of the Conference Report of the PSLRA, which rejected "in the pleading standard certain language relating to motive, opportunity, or recklessness" based on Second Circuit case law. H.R.Rep. No. 104-369, at 48 n. 23, *reprinted in* 1995 U.S.C.C.A.N. 730, 747 n. 23. That footnote was "inserted at the last minute [by a committee staffer] without [the committee's] knowledge." 141 Cong. Rec. H10782 (daily ed. Oct. 13, 1998) (statement of Rep. Markey); *see* 141 Cong. Rec. E2246 (daily ed. Oct. 20, 1998) (statement of Rep. Dingell).

to the district court for further consideration.

CONCLUSION

For the reasons explained above, the judgment of the district court dismissing the Complaint for failure to state a claim is hereby vacated. We reverse the district court's holding with respect to materiality, and remand for further consideration of the scienter allegations and the § 20(a) claim.

Felix SUTHERLAND, Petitioner,

v.

Janet RENO, Attorney General of the United States, Respondent.

No. 99-4145.

United States Court of Appeals, Second Circuit.

Submitted July 12, 2000.

Decided Sept. 15, 2000.

Amended Sept. 20, 2000.

Alien petitioned for review of decision of Board of Immigration Appeals (BIA) determining he was eligible for removal as alien convicted of crime of domestic violence based upon his Massachusetts conviction for indecent assault and battery on person over age of 14. The Court of Appeals, Sotomayor, Circuit Judge, held that: (1) BIA's interpretation of Massachusetts statute was subject to de novo review; (2) Massachusetts conviction involved substantial risk that physical force might be used, as required for such offense to be a "crime of violence" supporting alien's removal; and (3) alien's 19-year-old stepdaughter, who was victim of his Massachusetts crime, was protected person, as required for alien to be removable

Affirmed.

1. Statutes ⇐219(1)

When reviewing an agency determination, federal courts must accord substantial deference to an agency's interpretation of the statutes it is charged with administering.

2. Statutes ⇐219(2)

Where a statutory provision is silent or ambiguous, a court may not substitute its own construction of the provision for a reasonable interpretation made by the administrator of an agency charged with administering the statute.

3. Statutes ⇐219(1)

In contrast to situations where a federal agency is interpreting a statute it is charged with administering, courts owe no deference to an agency's interpretations of state or federal criminal laws, because the agency is not charged with the administration of such laws.

4. Aliens ⇐54.3(4)

Statutes ⇐219(9.1)

Interpretation by Board of Immigration Appeals (BIA) of state criminal statute, in determining whether alien was eligible for removal as alien convicted of crime of domestic violence, was subject to de novo review, and was not entitled to deferance, inasmuch as BIA was not charged with administering such statute. Immigration and Nationality Act, § 237(a)(2)(E)(i), as amended, 8 U.S.C.A. § 1227(a)(2)(E)(i).

5. Aliens ⇐53.2(3)

A determination of whether an alien's crime constitutes a "crime of domestic violence" making the alien eligible for removal involves a two-pronged analysis: (1) whether the alien's crime was a "crime of violence" according to the statute defining that phrase, and (2) whether the alien's

Attachment B

February 13, 2008

Mr. Robert C. Pozen
Chairman
SEC Advisory Committee on
Improvements to Financial Reporting
c/o Nancy M. Morris
Federal Advisory Committee Management Officer
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

File: 265-24

Dear Chairman Pozen:

Attached please find a paper prepared for the purpose of providing the SEC Advisory Committee on Improvements to Financial Reporting (the Advisory Committee) with a perspective on certain matters relating to the subject of materiality. The paper was prepared by an *ad hoc* task force comprised of the individuals listed below and was furnished to the Advisory Committee's *Subcommittee III: Audit Process and Compliance* during December 2007. We are providing a copy of the paper to you so the full Advisory Committee will have the opportunity to review the paper in connection with its on-going deliberations.

If you or any member of the Advisory Committee has any questions, please feel free to contact any of the task force members.

Sincerely,

The Members of the *Ad Hoc* Materiality Task Force,

Diann D. Gross
John J. Huber
Teresa E. Iannaconi
Gregory J. Jonas
Phillip R. Jones
H. Stephen Meisel
Guy W. Moore
Lawrence J. Salva
Scott A. Taub

Frequently Asked Questions Regarding Materiality

December 2007

Materiality Task Force:

Diann D. Gross
John J. Huber
Teresa E. Iannaconi
Gregory J. Jonas
Phillip R. Jones
H. Stephen Meisel
Guy W. Moore
Lawrence J. Salva
Scott A. Taub

<u>Question 1</u>: Staff Accounting Bulletin No. 99, "Materiality" (SAB 99) sets forth the view that a misstatement that is small (in magnitude) may, nonetheless, be material based on a complete analysis of all the surrounding facts and circumstances. Can surrounding facts and circumstances also lead to a conclusion that a large misstatement is immaterial?

<u>Response</u>: Yes. A misstatement is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision[1] in light of all the surrounding facts and circumstances. Quantitative characteristics are an important element to consider, however, the analysis of whether a particular misstatement is material does not rest solely on quantitative factors. This is true whether the misstatement is small or large.

SAB 99 is limited in its focus to the analysis of surrounding facts and circumstances (sometimes referred to as qualitative factors) that may indicate that a small misstatement is material. However, the converse is also true: a misstatement that is large in magnitude might, nonetheless, be properly viewed as immaterial based on a full analysis of the surrounding facts and circumstances.

SAB 99 lists examples of some of the qualitative factors that may be relevant when considering whether a small misstatement is material. The list, however, is not exhaustive and there can be other surrounding circumstances to consider.

The absence of the qualitative factors outlined in SAB 99 does not necessarily mean that a large misstatement is immaterial. Rather, each misstatement must be analyzed in light of <u>all</u> the surrounding facts and circumstances--weighted as appropriate. The nature of the misstatement (e.g., classification-only vs. impacting earnings), the nature of the affected financial statements (interim vs. annual), the effects on trends relating to key financial metrics and other characteristics are important factors to consider. The following are examples[2] of qualitative factors that could be considered when evaluating whether a large misstatement is, nonetheless, immaterial:

- The misstatement only impacts metrics that do not drive a reasonable investor's conclusions or are not important to a reasonable investor's valuation models.

- Misstatements that reasonable investors view as affecting a single period rather than affecting an ongoing trend.

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[1] All references in this document to "materiality" and "importance" are intended to be viewed from the perspective of a reasonable investor making an investment decision considering all the surrounding facts and circumstances. Similarly, all references to an "investor" are intended to mean a reasonable investor in making an investment decision.

[2] These factors are included for illustrative purposes only and are not intended to represent an exhaustive listing of the qualitative factors that might be considered when evaluating whether a large misstatement is, nonetheless, immaterial. Similarly, these examples should not be used as a "checklist" whereby the presence of any one of the qualitative factors would automatically lead to a conclusion that a large misstatement is immaterial.

- The misstatement does not significantly impact a reasonable investor's impressions of important trends.

- The misstatement does not impact a business segment or other portion of the registrant's business that a reasonable investor sees as driving valuation or risks. That is, the misstatement does not significantly impact a reasonable investor's assessment of the entity's financial condition or performance considering the segments or other portion of the registrant's business within the context of the whole business.

- Misstatements that relate to financial statement items whose measurement are inherently highly imprecise.

Materiality is a highly subjective matter that requires well-reasoned professional judgment to determine whether a particular misstatement (whether large or small) is material to a reasonable investor making an investment decision. When appropriate, materiality analyses should consider items beyond traditional financial statement metrics to evaluate how a misstatement impacts the fundamental value drivers of the business.

Issuers may consider investment or credit analysis models and other available information that would be informative in assessing materiality from a reasonable investor's perspective. Two errors of equal quantitative magnitude may have different effects on a reasonable investor's behavior. For instance, the failure to identify and disclose the impairment of a key intangible asset relating to a developing technology or product may have greater consequences from a reasonable investor's perspective than an error with the same historical financial statement impact relating to a technical misapplication of derivative instrument accounting standards.

Question 2: Should a misstatement relating to previously issued interim financial statements be evaluated for materiality differently than a misstatement in previously issued annual financial statements?

Response: The materiality analysis does not change simply because the misstatement relates to interim financial statements rather than annual financial statements. Accordingly, a materiality analysis with respect to a misstatement in previously issued interim financial statements should follow the same general framework that would be used to evaluate the materiality of a misstatement in previously issued annual financial statements. That is, the analysis should consider the misstatement in light of all the surrounding circumstances to determine whether the error affects the total mix of information and whether there is a substantial likelihood that the misstatement is important to a reasonable investor making an investment decision.

When performing a materiality analysis with respect to a misstatement in previously issued interim financial statements, issuers should consider the qualitative differences between interim and annual financial statements. Frequently, interim financial statements derive their usefulness from their relationship to the annual financial statements and in depicting trends. Accordingly, a materiality analysis with respect to interim financial statements should generally focus more on the relationship of the misstatement to the annual period and on trends than on the discrete interim period. This means that an error of a given relative magnitude (e.g., percentage of pre-tax income) in an interim period might properly be considered immaterial with respect to that interim period even if a misstatement of the same relative magnitude/percentage in the annual financial statements would be considered material. That is not to suggest that interim financial statements are unimportant. Rather, it is an acknowledgement that certain factors are evaluated differently in the materiality analysis relating to interim financial statements. Investors frequently use interim financial statements differently than they use annual financial statements and these differences should be recognized when considering the materiality of a particular misstatement. This notion is also supported by the concept of integrated disclosure in which interim reports are intended to build upon information previously disclosed in the annual report[3].

The materiality analysis with respect to a misstatement in previously issued interim financial statements should generally consider the misstatement from two different perspectives: as an originating error and as an out-of-period correction.

If the <u>annual</u> financial statements in which an error <u>originated</u> are materially misstated, then those financial statements should be restated promptly. The restatement would usually be accomplished by amending prior reports but is sometimes effected by restating the financial statements being presented for comparative purposes in a current filing if that filing is imminent.

If annual financial statements in which an error <u>originated</u> are not materially misstated but the interim financial statements include an error which, after considering the qualitative factors described above, is determined to be material, then the interim and annual financial statements should be revised[4] no later than the next time they are filed. Depending on the facts and circumstances, the issuer may determine, on its own consideration or upon the advice of counsel, that it should revise its previously issued financial information before the next interim period filing that requires the comparative interim period financial statements that contained the misstatement. The previously issued misstated annual financial statements would be revised no

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3 Specifically, integrated disclosure presumes investors have information from the latest annual report and does not require certain repetition in the interim reports. Therefore, interim information can be presumed to be evaluated by investors who already have knowledge of the registrant's annual performance and trends as set forth in the latest annual report. Said another way, interim misstatements need not be evaluated on a stand alone basis but should be evaluated on the assumption that the investor or other user would view the misstatement in the context of the annual periods set forth in the latest annual report.

4 In the context of this document, the word "revise" means to correct the previously filed financial statements the next time the financial data of a prior period is presented (e.g., for comparative purposes). Issuers should also consider whether disclosure of the pending revision should be made prior to the time the revised financial statements are filed. Revising financial statements is contrasted with "amending" prior reports.

later than the next time they are presented in a filing. Disclosure around the revision should be transparent. [5]

If an error in previously issued financial statements is immaterial to both the interim and annual periods in which the error originated, then the error can be corrected as an out-of-period adjustment in a subsequent interim period unless the out-of-period adjustment is expected to introduce a material error into the financial statements for the year in which the error would be corrected (see below). If an out-of-period adjustment is material to the interim financial statements in which it is effected, then those interim financial statements should contain transparent disclosure of the nature and effect of the out-of-period adjustment.

If the out-of-period adjustment would introduce a material error into the financial statements for the year of correction, then the error should be corrected by revising the previously issued interim and annual financial statements in which the error originated the next time they are filed. Depending on the facts and circumstances, the issuer may determine, on its own consideration or upon the advice of counsel, that it should revise its financial information before the next interim or annual period filing. Disclosure relating to the revision should be transparent.

Question 3: Should the materiality of a misstatement that does not affect net earnings (or another key performance metric) be evaluated differently from a misstatement that does affect net earnings (or another key performance metric)?

Response: The basic framework for evaluating the materiality of a misstatement should be consistent regardless of the nature of the misstatement. Specifically, the evaluation should consider the impact of the misstatement on the totality of financial information based on the financial statements taken as a whole. It should not be based on a consideration of any element of the financial statements in isolation from other information within the financial statements. As with other misstatements, the materiality of a misstatement that does not affect net earnings (or another key performance metric) should be evaluated in light of all the surrounding facts and circumstances to determine whether there is a substantial likelihood that the misstatement would be important to a reasonable investor in making an investment decision. However, the nature of the misstatement (e.g., disclosure/classification-only vs. impacting net earnings) is an important factor to be considered when evaluating all the surrounding facts and circumstances.

A misstatement that only impacts the classification between or among line items (including subtotals) within a particular financial statement might properly be viewed as immaterial even if the misclassification is large in magnitude. That is not to say that classification and subtotals are

[5] Although the appropriate level of disclosure will depend on facts and circumstances, investors should generally be provided sufficient information to be able to understand the nature of the misstatement and the impact on key elements of the affected financial statements. This disclosure should be included in the financial statements. Additionally, issuers might need to supplement the financial statement disclosure with similar disclosure in its MD&A.

unimportant. Rather, it is a recognition that the materiality evaluation must be made in the context of what a reasonable investor would consider important in making an investment decision and should consider the financial statements taken as a whole and not necessarily the impact on a single financial statement line item.

For instance, a relatively large misclassification between financing and investing cash flows might properly be viewed as immaterial if a reasonable investor would consider the misclassification unimportant. This might be the case when reasonable investors are focused less on the investing and financing designations/subtotals that are prescribed by the accounting literature and more on the transparency around the types and amounts of cash flows that a company generates/expends. Misclassifications that affect operating cash flows might require further analysis if the net operating cash flows subtotal is an important metric. When correcting a large, but immaterial, misclassification, issuers should provide transparent disclosure so investors understand what has changed.

Conversely, a relatively small misclassification between cost of goods sold and general/administrative expense might properly be viewed as material if reasonable investors consider gross profit percentage to be an important metric and the misclassification has an important impact on gross profit percentage.

A misstatement that only impacts note disclosure might properly be determined to be immaterial even if the misstatement is large in magnitude or the note disclosure is omitted altogether. That is not to say that note disclosures are unimportant. Rather, just as with classification matters, it is a recognition that the materiality evaluation must be made in the context of what a reasonable investor would consider important in light of all the surrounding facts and circumstances. Likewise a misstatement in terms of identification of segments or information within the segment disclosure (even a segment that is viewed as important to the registrant's current performance and prospects for growth) must be made in the context of what a reasonable investor would consider important in light of all the surrounding facts and circumstances.

Question 4: How should offsetting misstatements be considered when evaluating materiality?

Response: When a particular accounting period is impacted by more than one misstatement, issuers should consider the misstatements individually and in the aggregate as one component of the materiality analysis. As with all materiality analyses, the evaluation should be oriented toward determining whether there is a substantial likelihood that the misstatements would be important to a reasonable investor in light of all the surrounding facts and circumstances.

In this context, the surrounding circumstances could include the fact that the effect of one misstatement is mitigated by the effect of another misstatement.

The evaluation should not be directed solely at determining whether any one of the misstatements would be material in isolation. Rather, it should be focused on whether a reasonable investor would consider the financial statements (taken as a whole) to be misstated in an important way.

The existence of two equal but offsetting errors might raise valid questions about whether a material weakness in the company's internal control over financial reporting exists. However, it might not necessarily indicate the financial statements contain a material misstatement.

For instance, two misstatements of equal but opposite magnitude might properly be determined to be immaterial if they both relate to the same financial statement line item and would not require any changes in disclosures (e.g., two equal but opposite revenue cut-off errors at period end in the same business unit). Although there may be valid questions relating to internal control over financial reporting, in this example the financial statements do not contain any material misstatement. Conversely, two misstatements of equal but opposite magnitude which affect multiple financial statement line items might be properly viewed as material because of their individual impact on the particular line items[6].

<u>Question 5</u>: How should materiality be evaluated in periods of significant earnings change?

Response: A misstatement relating to the financial statements for a period of significant earnings change is material if there is a substantial likelihood that a reasonable investor would consider it important in light of all the surrounding facts and circumstances.

The key drivers leading to the significant earnings change will generally be important factors to consider when evaluating the surrounding facts. For instance if a company with a stable earnings history experiences a significant change in earnings because of a large impairment, restructuring charge or gain that is not expected to recur, then the materiality of a particular misstatement might be properly evaluated against results excluding the non-recurring item. If the key driver of the significant earnings change results from an item which is expected to recur (e.g., a change in capital structure from the issuance of a substantial amount of long-term debt) then materiality would likely be considered based on the actual results.

[6] As indicated in the Response to Question 3, the materiality evaluation must be made in the context of what a reasonable investor would consider important in making an investment decision and should consider the financial statements taken as a whole and not necessarily the impact on a single line item.

Attachment C

RULES OF THE ROAD FOR RESTATEMENTS

JOHN J. HUBER

LATHAM & WATKINS LLP

RULES OF THE ROAD FOR RESTATEMENTS

2006 demonstrates that restatements are here to stay – they are a fact of corporate life. 1,244 U.S. public[1] companies and 112 foreign private issuers filed a total of 1,538 restatements in 2006. The number of U.S. companies restating in 2006 compares to 1,159 in 2005, 589 in 2004 and 480 in 2003. Since the Sarbanes-Oxley Act ("SOX") became law in July 2002, we have gone from approximately 4% of public companies restating in 2003 to approximately 10% restating in 2006.

Multiple reasons have been offered for the increase:

- SOX, particularly Section 404, has caused companies to design and implement new systems and develop and standardize practices, procedures and programs for internal control over financial reporting that have uncovered errors in historical as well as current financial statements, because of what many viewed as historical neglect of corporate infrastructure and what others termed a historic shift in requiring more than was necessary for internal control over financial reporting.[2]

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1 Unless otherwise noted, all statistics on restatements are from Glass Lewis & Co. "The Error of Their Ways" published on February 27, 2007 (hereinafter "Glass Lewis"). Audit Analytics publishes similar surveys and has different numbers with 1,591 companies filing 1,876 restatements in 2006. Under either system, 2006 was a record. The disparity between the number of companies and the number of restatements results from the fact that 116 companies filed multiple restatements in 2006. Large numbers of companies restating a restatement is a new phenomenon. In 2005, only seven did so. Glass Lewis at 5.

2 As stated by Mark Olson, Chairman of the Public Company Accounting Oversight Board (the "PCAOB"), "In June, 'AS2' will go away and we'll have a new standard that will go to the SEC for approval."… "It will describe how you can identify the controls that really matter." Neal St. Anthony, "Chief overseer aims to ease Sarbanes-Oxley: A former Minnesota banker heads the agency that supervises accounting firms. He favors some relaxation of the antifraud law," Star Tribune, Business Insider Section (April 9, 2007).

- The demise of Arthur Andersen LLP has resulted in some auditors adopting a "take no risk" policy; many chief financial officers believe that engagement partners are in search of the perfect audit, one where any error can be viewed as grounds for restatement.[3]
- GAAP has become so complex that no one can get it right all the time and for certain issues there is no clearly right answer.[4] Very few companies have the resources to have a specialist in every aspect of GAAP.
- Transactions have become even more complex which can result in lessening the ability of accountants to ferret out every accounting issue even when they are shown the contracts before they are signed by the business people.
- FAS 154, Accounting Changes and Error Corrections, adopted by the Financial Accounting Standards Board which took effect in mid-2005 to hasten convergence with international accounting standards has confused investors who cannot differentiate a restatement resulting from an error from one resulting from a change to a more preferable accounting standard[5] and has limited the alternatives to a restatement by eliminating the ability of in-house accounting staff to take a cumulative catch-up under old APB 20, Accounting Changes.
- Public companies did not historically devote adequate time, effort or expense to the accounting function or internal audit function are now playing catch-up under far stricter regulatory scrutiny from the courts and the Department of Justice in addition to the SEC.

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3 The Public Company Accounting Oversight Board has an enforcement capability that is directed at the outside auditor, rather than the company.

4 At the SEC Speaks in February 2007, Conrad Hewitt, the Chief Accountant of the Securities and Exchange Commission (the "SEC"), stated that he would begin to formulate a framework in the next two months to "do something about the complexity of our standards." Speech by Conrad Hewitt, Remarks to the Practising Law Institute's SEC Speaks Series (http://www.sec.gov/news/speech/2007/spch020907cwh.htm) February, 9, 2007.

5 In April 2007, the Public Company Accounting Oversight Board published for comment a proposed standard, Evaluating Consistency of Financial Statement, to respond to FAS 154 and help investors discern why a change in the financial statements occurred.

- Practices that were acceptable in the past, such as sloppy procedures for granting options, are now the subject of close scrutiny by auditors and regulators.[6]
- Since the scandals of Enron and WorldCom, the Department of Justice and state attorneys general have brought a criminal focus to what previously had been almost exclusively the domain of civil liability and the SEC which has resulted in a propensity to err on the side of a restatement, rather than to take a chance of being second-guessed down the road.
- SAB 99 has 'dumbed down' the definition of materiality from a standard of "what a reasonable investor would consider important"[7] in making an investment decision to "what she might want to know" or "what he ought to know in making an investment decision." Some people think that since the standard for what's important is so low under SAB 99, it doesn't take very much to have an error result in a restatement.

While no single reason or combination of reasons has emerged as "the" cause for the surge in restatements, one thing is clear: restatements have not decreased in the five years since SOX became law.[8]

Given that almost one in ten public companies restated its financial statements in 2006, the ongoing wave of options backdating, the focus on non-options accounting issues, such as FIN 48, EITF 00-19 and cash flow statements, as well as the expected application of Section 404 to smaller public companies, 2007 looks like another year for a high volume of restatements by public companies.

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[6] As one CFO remarked on a panel, "What keeps me up at night is what I am doing now that is perfectly acceptable today, but will be illegal five years from now."

[7] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (U.S. 1976).

[8] Significantly, the type of company restating financial statements may be changing. Restatements by public companies with a market capitalization of at least $750 million decreased from 238 in 2005 to 209 in 2006, while restatements by companies with a market capitalization of less than $75 million increased from 633 in 2005 to 884 in 2006. While the smaller companies haven't had to comply with Section 404 of SOX yet, perhaps the increase for smaller companies is a harbinger of what will happen when the SEC requires them to do so.

Here are my Rules of the Road for Restatements:

1. Once an issue comes to your attention, you should consider the following at the beginning of the process, before any decision to restate has been made:

- Identify the issues, recognizing that the issues you start out with may change during the process. Be sure to follow all the flags, especially red ones.
- Implement procedures to retain documents, especially e-mail.
- For each issue, find out all of the facts including:
  - What is the issue?
  - Is it still happening or did it only happen in the past?
  - Could it happen again?
  - When and where did it happen?
  - Why did it happen?
  - What are the collateral issues that relate to it?
  - Who was or is involved?
  - How did it happen and how does it affect your financial statements?
- With the facts in hand, determine whether the issues complied with GAAP and GAAS and if not, identify how, where and when they did not comply and how it should be classified under SFAS 154, e.g., an error, change in estimate or change in accounting principle.
- If there were errors within the meaning of paragraph 2.h of SFAS 154, were they material under SAB 99? Be prepared to conduct a detailed SAB 99 materiality analysis and to provide a SAB 99 memo to the audit committee of the board of directors. If the errors are identified as the result of a review by the Staff of the

SEC's Division of Corporation Finance (the "Staff"), be prepared to provide the SAB 99 memo to the Staff.

- How can the errors be corrected? Conduct an analysis under paragraph 25 of SFAS 154 to determine whether a restatement is required. Also consider whether paragraph 29 of APB 28, "Interim Financing Reporting" or Staff Accounting Bulletin No. 108[9] is applicable, and, if so, how it can be implemented.
- If there were errors, were they caused by one or more people who knew or should have known what they were doing? Did they have a reckless disregard for what they did or failed to do? Were they aware of the consequences of their actions? Did they benefit from their conduct and, if so, how? Consider whether and how Section 304 of SOX could apply.
- If a restatement is required, what periods and what filings are involved? Are you able to estimate the time and resources necessary to prepare and audit restated financial statements? In terms of personnel devoted to the process, don't be penny wise and pound foolish. While the working group should be kept as small as possible and totally committed to resolving the issue, it must be big enough to get the job done. If you don't have sufficient staffing to complete the process, retain additional permanent or temporary employees or another accounting firm as soon as possible so that the management does not become a bottleneck in the restatement process.
- If a restatement is required, it is important to understand that the company may not be able to conduct business as usual, especially given the diversion of management's attention.

9 Staff Accounting Bulletin No. 108 ("SAB 108") is attached as Appendix 1.

- Get the support of senior management, especially the chief executive officer, and the audit committee to get the job done, fully and completely the first time to avoid a restatement of a restatement. The commitment should be to get it done right as quickly as possible, not to get it done as quickly as possible.
- Did the company (or any insiders) sell securities during any of the periods at issue?
- Review your D&O insurance policy and indemnification provisions with this fact pattern in mind.
- How will the facts affect internal control over financial reporting, Section 404 compliance, disclosure controls and procedures or certifications under Sections 302 and 906 of SOX? Is your documentation adequate and are your systems sufficient to retrieve dependable information in a timely, efficient and reliable manner?
- Although practice varies, the audit committee should reach the conclusion that previously issued financial statements cannot be relied upon for purposes of Item 4.02(a) of Form 8-K and that a restatement is required.
- What disclosure should be made? Paragraph 26 of SFAS 154 may only be the starting point. When and how? *See* Rule 2 below.
- Expect the Item 4.02 of Form 8-K you file to be reviewed promptly after filing (typically within two business days of filing) by the Staff and expect to receive a comment letter. Experienced counsel can help minimize or pre-empt Staff comments.

2. Remember the *Goldilocks Rule of Disclosure*: not to early, not too late – time your disclosure just right. What this means is to go through an analysis before putting out the first press release. While you don't have to disclose until it's ripe to do so, time is of the essence, so don't delay disclosure unless it is necessary. For example, once you become

aware of the possibility of a restatement, don't say you are going to restate unless a decision has been made that you are going to restate. You don't have to restate unless your financial statements are wrong and wrong to a material extent. So, examine all aspects of materiality. SAB 99 memos have become commonplace in conducting this analysis. Look at the accounting alternatives to a restatement, like paragraph 29 of APB 28, "Interim Financial Reporting," and SAB 108. Be sure that your people understand the "reasons behind the rules and how they were violated"[10] especially if you are going to hold an analyst conference call to discuss the restatement. In addition, try to get your arms around "the why" as well as "the what." Is the restatement due to an innocent error or financial fraud or something else. Remember to close the trading window, shut down your shelfs, and inform your commercial bank lender and rating agencies before the press release is issued. Be careful in doing so, because a leak may result in you having to make disclosure before you are ready to do so. Given the close relationship between a restatement and a SEC Enforcement inquiry, consider calling the Division of Enforcement and providing them with the press release you are publishing, not to get their comments but rather to show them that you are following the right process.

When you do issue your press release, make sure it has full, fair and complete disclosure and that it anticipates, to the extent possible, questions you may be asked by the market. Since the market hates uncertainty, try to anticipate questions about the restatement and include the answers in the press release. While people will press you to say what the restated numbers will be, don't disclose the numbers or ranges of numbers on a restated

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[10] Lessons from Fannie – Bob Blakely's Tips on Restatements, in CFO.com at http://www.cfo.com/article.cfm/8885662/c_8910395?f=magazine_featured. (hereinafter "Blakely's Tips").

basis unless you (and your auditors) have a high degree of confidence that they represent the best current estimate of what the restatement will look like. Don't guess what the restated numbers will be. When in doubt, leave it out. If the question is important enough to answer, consider putting it into the press release.

If you are going to have a conference call, make sure your preparation anticipates the questions you will answer and those which you have to defer because the restatement process is in its early stages. Think about how you are going to answer tough questions that may not answered in your press release because they currently have unfavorable answers, such as "Is there fraud?" "Is anyone being terminated?" "Is there a disagreement with your auditor?" "Is the SEC conducting an investigation?" If you are going to use Q&A's for employees, make sure the Q&A's don't have material facts that aren't in the press release.

Although the Staff comment letter on your Item 4.02 Form 8-K and the SROs may want you to disclose the date when you will issue restated numbers, try not to do so. Don't promise anything in your press release about the restatement, especially the time when it will be completed. Think about the effect of a restatement on your guidance. Don't provide or reaffirm guidance in your press release unless you are confident it can be met. Regardless of whether you publish guidance, remember to include a customized safe harbor statement to get the benefit of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

In making public disclosure, understand your different audiences, such as investors, customers, suppliers, employees, joint venture partners and regulators from the SEC through the SROs. Balance all these interests with Regulation FD, Rule 10b-5, Regulation G and Item 10 of Regulation S-K, SAB 99 and the duty to update. In making disclosure, understand the tension between a "self-fulfilling prophecy" and full and fair disclosure.

If your press release also relates to the late filing of a periodic report, coordinate your disclosure with Form 8-K and Form 12b-25. Understand that your Form 12b-25 disclosure will form the core of your press release and bear in mind that Form 12b-25 is a disclosure document, not simply a notice. Don't forget Spiegel.[11]

If the restatement process is taking an extended period of time to complete, determine what your disclosure policy is going to be until you do file your restatement. Are you going to go radio silent after the initial press release or file press releases with each detailed Form 12b-25 as the restatement process progresses. Recognize the pros and cons of each approach such as: if the facts are not ripe, they can change and new issues can arise, resulting in an interim press release subsequently being viewed as misleading. Moreover, interim press releases may exacerbate updating issues.

How are you going to handle analysts? Major shareholders and institutional investors? Are you going to have analyst calls at the initial announcement only or with the filing of each Form 12b-25? Have you typically held them in the past? Understand that the Form 8-K rules still apply to you even though you haven't filed one or more periodic reports.

3. Talk to the SEC, your SRO and your rating agencies before or at the time you issue your press release. Expect the SEC's Division of Enforcement to open an investigation, if your press release says you are going to restate. Cooperate with the SEC. Expect

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[11] Independent Examiner's Report Concerning Spiegel, Inc. at pages 27-28 included in <u>SEC v. Spiegel, Inc.</u>, 2003 WL 22178223 (N.D. Ill).

litigation, especially if your stock price drops when the press release is issued.[12] Given the prospect of a SEC investigation and private litigation, it is prudent to involve litigators from the beginning.

Remember your listing requirements, especially if you are going to file or be late in filing periodic reports. While the restatement process may seem too slow and never ending, the SRO delisting process can be too fast and result in adverse decisions before you are able to finish the restatement process. If you file a Form 12b-25 and state that you do not expect to file by the extension date, expect to have your SRO, particularly The NASDAQ Stock Market, begin a delisting proceeding promptly after your initial announcement. The SRO notification letter can result in further disclosure and a SRO hearing process, which can happen as soon as a month after your initial press release. While NASDAQ's process is triggered by a missed Form 10-Q,[13] the New York Stock Exchange process focuses on a missed Form 10-K[14] and in the past has been a more flexible process. Recent events have caused NASDAQ to change its traditional delisting process for companies with options dating issues.

4. Identify and analyze the collateral effects that an accounting, late filing or control deficiency can have on:

- Your company's business – for example, if royalty payments to a third party are based on revenue or net income from a product and the amounts are being restated,

[12] In 2006, the median stock return on companies that restated financial statements was a negative 6%. Glass Lewis at 1.

[13] NASDAQ's Marketplace Rule 4310(c)(14) relating to timely filing with NASDAQ, Rule 4380, Termination Procedure, Rule 4805, Request for a Hearing, Rule 4806, The Listing Qualification Panel and Rule 4807, Review by the NASDAQ Listing and Hearing Review Council.

[14] Rule 802.01E, SEC Annual Report Timely Filing Criteria, and Section 804 of the NYSE Listed Company Manual.

are subject to change or are not being published because periodic reports are not being filed, anticipate the issues with the third party, rather than run the risk of a breach of contract. Understand what the effects can be.

- Bond rating downgrades – as an example, Fitch Ratings downgraded American International Group, Inc.'s debt because the annual report was delayed and Standard & Poor's downgraded the debt because of internal control over financial reporting not because a $1.7 billion restatement was material. A downgrade in the credit rating can result in higher cost of capital because investors will demand to be paid higher interest rates, which in turn increases expenses and the cost of doing business which can make the company's products less competitive.
- Indenture default – The court in The Bank of New York v. Bearing Point, Inc., Index No. 600169/06 (Sup. Ct. N.Y. Sept. 18, 2006) (hereinafter "Bearing Point")[15] held that Bearing Point's failure to file annual and quarterly reports with Bank of New
- York, the indenture trustee, in accordance with an indenture provision,[16] breached the indenture and constituted a default which obligated Bearing Point to accelerate principle and accrued interest. While the emerging consensus is that this case is wrongly decided, it has caused at least one other company to file a declaratory judgment action[17] and still other companies to arrange bridge financing when they fail

[15] The opinion is attached as Appendix 2.

[16] Section 5.02 of the Bearing Point indenture, titled "SEC and Other Reports," stated:

> [T]he Company shall file with the Trustee, within 15 days after it files such annual and quarterly reports, information, documents and other reports with the SEC, copies of its annual report and of the information, documents and other reports (or copies of such portions of any of the foregoing the SEC may by rules and regulations prescribe) which the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. The Company shall comply with the other provisions of TIA Section 31.4(a)

Bearing Point at 5.

[17] Complaint filed in Affiliated Computer Services, Inc. v. The Bank of New York Trust Company, N.A., 306-CV-1770D, (N.D. Tex. Filed Sept. 26, 2006).

to file a periodic report with the SEC and an indenture trustee in situations where the indenture has similar language to that in Bearing Point.

- Bank credit agreement – securing a waiver from lenders in a credit agreement may be easier to do than convincing a trustee that no default has occurred in an indenture with a provision similar to that in Bearing Point, especially if hedge funds hold or are purchasing the debt.
- Form S-8 availability – the Staff's position is that the failure to file one or more Form 10-Qs does not necessarily mean that your Form S-8 can no longer be used, if counsel determines that the disclosure is still useable which means that the company still has a valid prospectus under Section 10(a) of the Securities Act of 1933 and that the company is able to determine that it has no concerns under Section 12(a)(2) of the Securities Act or under the antifraud provisions of the federal securities laws. Failure to file a Form 10-K can lead to a different result if the sixteen month period of Section 10(a)(3) under the Securities Act of 1933 has elapsed. So, the failure to file a Form 10-K after the required due date does not, in itself, mean that the Form S-8 is no longer useable, so long as the company concludes it still has a valid prospectus under Section 10(a) of the Securities Act and has no concerns under Section 12(a)(2) of the Securities Act or the antifraud provisions of the federal securities laws. However, the use of the Form S-8 would be suspended if the Form 10-K is not filed by the end of that sixteen month period. For a company with a calendar year fiscal period, this means the Form 10-K has to be filed by April 30th, otherwise the Form S-8 is not useable thereafter. If, however, the Form 10-K is filed on May 15, the Form S-8

would again be useable without further action by the company.[18] The filing of an Item 4.02 Form 8-K can lead to the conclusion that the company no longer has a valid prospectus under Section 10(a) of the Securities Act. The biggest fallout from an inability to use Form S-8 is that employee benefit plans have to shut down resulting in employee morale issues.

- Form S-3 availability – Assuming that the company is able to conclude that it has no concerns under Section 12(a)(2) of the Securities Act or under the antifraud provisions of the federal securities laws, you will be able to continue using Form S-3 until at least your next update under Section 10(a)(3) of the Securities Act of 1933, after which date your Form S-3 will have to be converted to a Form S-1. Although Form S-3 availability has traditionally focused on timely filing of Form 10-K to refresh the registration statement under Item 512 of Regulation S-K, the Staff's position on Form S-8 with respect to the sixteen month period under Section 10(a)(3) of the Securities Act is applicable to Form S-3. Unlike Form S-8 which has a current reporting requirement as the trigger for eligibility, Form S-3's requirement for timely reporting during the prior twelve months will cause the company to have to file a post-effective amendment to the Form S-3 to convert it to a Form S-1. Like the Form S-8 analysis, the filing of an Item 4.02 Form 8-K can mean that the company no longer has a valid prospectus under Section 10(a) of the Securities Act.
- Loss of WKSI status – If you did not file your Form 10-K on a timely basis or you did not meet the requirements of Section 10(a)(3) of the Securities Act with respect to

[18] This assumes that the Form 10-K constitutes a valid prospectus under Section 10(a) of the Securities Act because of incorporation by reference.

the prospectus, you will have lost your status as a Well Known Seasoned Issuer and can only use Form S-1.

- Rule 144 under the Securities Act of 1933 is not available for sales of restricted securities or control securities because the current information requirement of Rule 144(c) is not being complied with.
- Section 211 of the Delaware General Corporation Law ("DGCL") requires a company to hold an annual meeting even though it is unable to distribute an annual report to shareholders pursuant to Rule 14a-3 of the Securities Exchange Act of 1934 when shareholders use in Delaware Chancery Court to compel the company to hold a meeting.[19] The rub for the company is that while it has to hold the annual meeting under Section 211, it can't solicit proxies from shareholders for management's slate of directors under the SEC's proxy rules. Other corporate codes, such as Ohio, state provisions that have not been the subject of litigation. This can cause issues when hedge funds or others have bought the stock and are asking for a change of management and/or the sale of the company because of management's performance as exemplified by the restatement and how long its taking to complete the process.
- It is not business as usual – since a restatement means that historical financial statements are no longer reliable, a company's ability to secure financing, either public or private, to make acquisitions, using its own securities as currency and to conduct normal business operations is adversely affected.
- Hedge funds – acquiring the debt and following a Bearing Point approach or acquiring the common stock and running a proxy contest under Section 211 of the

[19] Vesta Insurance Group, Inc. v. Newcastle Partners, L.P., No. 562, 2005 (Del. Nov. 16, 2005)

DGCL can cause a change of control and also can cause, or facilitate, a sale of the company to a third party.

- Employee morale – as demonstrated by the options dating situations, employees, especially in technology companies, depend on non-cash compensation and a restatement, especially one that takes a prolonged period to complete, can result in a decline in employee morale, as well as turnover, when employees leave to take jobs at companies that are current in their SEC filing obligations.
- Material contracts – anticipate deadlines and the requirements in your material contracts.
- Litigation – especially in situations where there has been a drop in the per share price of the stock or where the investigation with audit committee oversight conducted by independent counsel has found intentional wrongdoing by senior management over a sustained period of time. *See* Rule 7 below.
- Bankruptcy – although it seldom happens, a bankruptcy can result from a restatement that is not completed prior to the filing in bankruptcy court.

5. Be aware of the potentially divergent interests that can arise in a post-SOX world. These include the special responsibilities of members of the audit committee, certifications by the CEO and the CFO under Sections 302 and 906 of SOX, external auditor responsibilities, such as Section 10A of the Securities Exchange Act of 1934, and your external auditor's aversion to risk as well as part 205 for attorneys. These interests run the gamut from macro-issues, such as duties under SOX and SRO listing, to micro-issues, such as the disclosure in a Form 12b-25 and whether you file a Form 8-K pursuant to Item 4.02(a) or 4.02(b). Understand that a micro issue can become a macro issue.

6. From a procedural standpoint, restatements fall into two categories: those that require a review or investigation possibly conducted by independent counsel with oversight by the audit committee of the board of directors; and those that don't, such as a restatement as a result of discontinued operations. Don't just look at what caused the original issue to arise. Follow the flags wherever they lead and be prepared to initiate an investigation or expand the scope of your investigation, if one has been undertaken. The goal is to restate once and not to restate a restatement. The market can lose faith in you, your venders and banks can become frightened resulting in an adverse cascading effect, if you have to restate a restatement.

7. Restatements are a process. You have a choice: you can manage the process or it can manage you. Approach it like any other project with a beginning, a middle and an end. "A classic project management process is very helpful to keep track of schedules and progress as well as facilitating the prompt identification of issues that need to be resolved."[20] The bigger the restatement, the more project managers you will need to keep track of the myriad of details, schedules and issues.

8. The audit committee has oversight responsibility, whether or not an investigation or review is being conducted. Therefore, coordination and transparency among and between management, the audit committee and the internal and outside auditors is critical. Anticipate issues by making sure your disclosure controls and procedures work now so that they will operate when put under the stress of a restatement. Involve the national office of your accounting firm especially if the restatement involves any judgment calls in applying GAAP. Have your outside law firm retain forensic

[20] Bob Blakely, Chief Financial Officer of Federal National Mortgage Association (hereinafter "Bob Blakely").

accountants so that SAB 99 memos can be prepared and reviewed before being furnished to the outside auditor.

9. Although the steps to analyze whether to restate are similar, every restatement is different. Expect the unexpected. Expect the restatement process to take longer than anyone thought it would and prepare core constituencies accordingly. Factors to consider in terms of timing include: the type and number of accounting issues; the number of periods involved; and how the restatement implicates internal control over financial reporting and prior certifications under Sections 302 and 906 of SOX. Even if internal control over financial reporting is not an issue at the beginning of the restatement process, it will become an issue before the process is completed. With increasing frequency, control deficiencies, particularly material weaknesses as defined in Public Company Accounting Oversight Board Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," represent the "canary in the mineshaft" of financial reporting. A material weakness can foreshadow a restatement. If internal control over financial reporting becomes an issue during the restatement process, such as where systems are unable to provide reliable data, or personnel are no longer available to assist in preparing restated financial statements, or provide to management representatives, the outside auditor, the restatement process may take an extended period of time and you may not be able to estimate a completion date with any accuracy. While restatements may not always constitute a material weakness under the PCAOB's proposed Audit Standard No. 5, which will replace AS 2, AS 5 has not yet been adopted.

10. Keep in mind that finalizing the restatement does not mean the job is finished. Among other things, there is the analysis of internal control over financial reporting, amendments to SEC periodic reports to be drafted, reviewed by all interested parties and filed. In multiple prior periodic reports will have to be amended as a result of the restatement, submit a waiver request to the Office of Chief Accountant of the Staff.[21] Moreover, the SEC investigation will continue after the time the company has finished the restatement and regained its status as a current reporter at the SEC.

11. Restatements are expensive. An ounce of prevention is worth a pound of cure. Devoting the time, effort and expense now to have the right tone at the top, a fully staffed, talented and trained accounting staff and internal audit function, effective disclosure controls as well as internal controls and procedures can minimize the likelihood of a restatement.[22] Otherwise, you will just be paying for the restatement and then incurring the same time, effort and expense to avoid the next one.

12. Remember that the biggest issue in restatements is not a legal, accounting, auditing or even a business issue – its psychological. A restatement is like a death in the family. A company is prone to going through the same stages of denial, blaming of others, self doubt and depression before coming to the realization that life has to go on and it's important for everyone to get on with life. How fast a company goes through these stages and how quickly you recognize where you are in the process and how to cope with

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[21] The Dear CFO letter issued by the Division's Office of Chief Accountant with respect to options dating restatements is attached as Appendix 3 to this paper.

[22] Studies have shown that companies with good internal controls and thorough and effective IT audits have higher return on assets than those with material weaknesses. Terrence Belford "Information Technology Audits Catching on Fast" Globe & Mail BIO (April 16, 2007). Moreover, IT audits for internal control purposes can be broadened to include enterprise risk management and other business issues in addition to internal control over financial reporting. Id.

it and instill a culture of "can do" to replace a feeling of self-doubt is critical to completing the restatement process. Thus, the right attitude or the proper corporate culture can go a long way to getting the restatement completed correctly and quickly, rather than taking a long time and risking a restatement of a restatement.[23]

13. Once the restatement is completed, conduct a post mortem, but be careful not to overreact by replacing your external auditor. If you do change accountants, the new accounting firm can challenge past practices and policies that your former external auditor agreed to, which, in turn, may result in a further restatement. Thus the grass is not necessarily greener. This, is especially the case where you have not retained sufficient documentation to explain past decisions, such as judgment calls on the application of GAAP, or the personnel who made the decisions are no longer with the company. Unless the new auditor is provided with documentation, there is a risk that the new auditor won't sign off on the current period where the same accounting policy is being applied because the new auditor could be concerned that the new client will be selected for review by the PCAOB inspector reviewing the audit firm and the lack of sufficient documentation will be a black mark against the new auditor. So adequate documentation can be useful both for purposes of accounting and internal control over financial reporting.

14. In appropriate circumstances, consider using Public Company Accounting Oversight Board Auditing Standard No. 4, "Reporting on Whether a Previously Reported Material

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[23] Coping mechanisms, include overcoming the negatives by sharing the positives, like celebrating milestones in the restatement process. "Staffs often become both extremely conservative and shell shocked when a restatement is required. Part of the psychology that must be reinforced is surfacing issues promptly so they can be resolved. Bad news doesn't age well. Also, don't be critical of mistakes or false starts. The issues are typically complex and if management is not 100% supportive, guess what? The issue doesn't get promptly raised the next time." Bob Blakely.

Weakness Continues to Exist," to have your outside auditor conduct an audit of material weaknesses disclosed in the Form 10-K with restated financial statements. Audit Standard No. 4 can help put the adverse effects of a restatement behind management before the next Section 404 audit by the outside auditor.

APPENDIX 1 to Rules of the Road for Restatements

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 211

[Release No. SAB 108]

Staff Accounting Bulletin No. 108

AGENCY: Securities and Exchange Commission.

ACTION: Publication of Staff Accounting Bulletin.

SUMMARY: The interpretations in this Staff Accounting Bulletin express the staff's views regarding the process of quantifying financial statement misstatements. The staff is aware of diversity in practice. For example, certain registrants do not consider the effects of prior year errors on current year financial statements, thereby allowing improper assets or liabilities to remain unadjusted. While these errors may not be material if considered only in relation to the balance sheet, correcting the errors could be material to the current year income statement. Certain registrants have proposed to the staff that allowing these errors to remain on the balance sheet as assets or liabilities in perpetuity is an appropriate application of generally accepted accounting principles. The staff believes that approach is not in the best interest of the users of financial statements. The interpretations in this Staff Accounting Bulletin are being issued to address diversity in practice in quantifying financial statement misstatements and the potential under current practice for the build up of improper amounts on the balance sheet.

DATE: September 13, 2006.

FOR FURTHER INFORMATION CONTACT: Mark S. Mahar, Office of the Chief Accountant (202) 551-5300, Todd E. Hardiman, Division of Corporation Finance (202) 551-3400, or Toai P. Cheng (202) 551-6918, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance, the Division of Investment Management and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Nancy M. Morris
Secretary

Date: September 13, 2006

Part 211 – [AMEND]

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 108 to the table found in Subpart B.

A. STAFF ACCOUNTING BULLETIN NO. 108

The staff hereby adds Section N to Topic 1, Financial Statements, of the Staff Accounting Bulletin Series. Section N provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment.

Note: The text of SAB 108 will not appear in the Code of Federal Regulations.

1. Topic 1: Financial Statements

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2. N. Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of an improper expense accrual (*e.g.*, overstated liability) in the amount of $100, which has built up over 5 years, at $20 per year.[1] The registrant previously evaluated the misstatement as being immaterial to each of the prior year financial statements (*i.e.*, years 1-4). For the purpose of evaluating materiality in the current year (*i.e.*, year 5), the registrant quantifies the error as a $20 overstatement of expenses.

Question 1: Has the registrant appropriately quantified the amount of this error for the purpose of evaluating materiality for the current year?

Interpretive Response: No. In this example, the registrant has only quantified the effects of the identified unadjusted error that arose in the current year income statement. The staff believes a registrant's materiality evaluation of an identified unadjusted error should quantify the effects of the identified unadjusted error on each financial statement and related financial statement disclosure.

Topic 1M notes that a materiality evaluation must be based on all relevant quantitative and qualitative factors.[2] This analysis generally begins with quantifying potential misstatements to be evaluated. There has been diversity in practice with respect to this initial step of a materiality analysis.

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[1] For purposes of these facts, assume the registrant properly determined that the overstatement of the liability resulted from an error rather than a change in accounting estimate. *See* FASB Statement 154, *Accounting Changes and Error Corrections*, paragraph 2, for the distinction between an error and a change in accounting estimate.

[2] Topic 1N addresses certain of these quantitative issues, but does not alter the analysis required by Topic 1M.

The diversity in approaches for quantifying the amount of misstatements primarily stems from the effects of misstatements that were not corrected at the end of the prior year ("prior year misstatements"). These prior year misstatements should be considered in quantifying misstatements in current year financial statements.

The techniques most commonly used in practice to accumulate and quantify misstatements are generally referred to as the "rollover" and "iron curtain" approaches.

The rollover approach, which is the approach used by the registrant in this example, quantifies a misstatement based on the amount of the error originating in the current year income statement. Thus, this approach ignores the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years (*i.e.*, it ignores the "carryover effects" of prior year misstatements).

The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement's year(s) of origination. Had the registrant in this fact pattern applied the iron curtain approach, the misstatement would have been quantified as a $100 misstatement based on the end of year balance sheet misstatement. Thus, the adjustment needed to correct the financial statements for the end of year error would be to reduce the liability by $100 with a corresponding decrease in current year expense.

As demonstrated in this example, the primary weakness of the rollover approach is that it can result in the accumulation of significant misstatements on the balance sheet that are deemed immaterial in part because the amount that originates in each year is quantitatively small. The staff is aware of situations in which a registrant, relying on the rollover approach, has allowed an erroneous item to accumulate on the balance sheet to the point where eliminating the improper asset or liability would itself result in a material error in the income statement if adjusted in the current year. Such registrants have sometimes concluded that the improper asset or liability should remain on the balance sheet into perpetuity.

In contrast, the primary weakness of the iron curtain approach is that it does not consider the correction of prior year misstatements in the current year (*i.e.*, the reversal of the carryover effects) to be errors. Therefore, in this example, if the misstatement was corrected during the current year such that no error existed in the balance sheet at the end of the current year, the reversal of the $80 prior year misstatement would not be considered an error in the current year financial statements under the iron curtain approach. Implicitly, the iron curtain approach assumes that because the prior year financial statements were not materially misstated, correcting any immaterial errors that existed in those statements in the current year is the "correct" accounting, and is therefore not considered an error in the current year. Thus, utilization of the iron curtain approach can result in a misstatement in the current year income statement not being evaluated as an error at all.

The staff does not believe the exclusive reliance on either the rollover or iron curtain approach appropriately quantifies all misstatements that could be material to users of financial statements.

In describing the concept of materiality, FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, indicates that materiality determinations are based on whether "it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced *by the inclusion or correction of the item*" (emphasis added).[3] The staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying an error under both the rollover and iron curtain approaches as described above and by evaluating the error measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.

As a reminder, a change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.[4]

The staff believes that the registrant should quantify the current year misstatement in this example using both the iron curtain approach (*i.e.*, $100) and the rollover approach (*i.e.*, $20). Therefore, if the $100 misstatement is considered material to the financial statements, after all of the relevant quantitative and qualitative factors are considered, the registrant's financial statements would need to be adjusted.

It is possible that correcting an error in the current year could materially misstate the current year's income statement. For example, correcting the $100 misstatement in the current year will:

- Correct the $20 error originating in the current year;
- Correct the $80 balance sheet carryover error that originated in Years 1 through 4; but also
- Misstate the current year income statement by $80.

If the $80 understatement of current year expense is material to the current year, after all of the relevant quantitative and qualitative factors are considered, the prior year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

The following example further illustrates the staff's views on quantifying misstatements, including the consideration of the effects of prior year misstatements:

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of a sales cut-off error in which $50 of revenue from the following year was recorded in the current year, thereby overstating accounts receivable by $50 at the end of the current year. In addition, a similar sales cut-off error existed at the end of the prior year in which $110 of revenue from the current year was recorded in the prior year. As a result of the combination of the current year and prior year cut-off errors, revenues in the current year are understated by $60

[3] Concepts Statement 2, paragraph 132. *See* also Concepts Statement 2, Glossary of Terms - Materiality.

[4] Statement 154, paragraph 2h.

($110 understatement of revenues at the beginning of the current year partially offset by a $50 overstatement of revenues at the end of the current year). The prior year error was evaluated in the prior year as being immaterial to those financial statements.

Question 2: How should the registrant quantify the misstatement in the current year financial statements?

Interpretive Response: The staff believes the registrant should quantify the current year misstatement in this example using both the iron curtain approach (*i.e.*, $50) and the rollover approach (*i.e.*, $60). Therefore, assuming a $60 misstatement is considered material to the financial statements, after all relevant quantitative and qualitative factors are considered, the registrant's financial statements would need to be adjusted.

Further, in this example, recording an adjustment in the current year could alter the amount of the error affecting the current year financial statements. For instance:

- If only the $60 understatement of revenues were to be corrected in the current year, then the overstatement of current year end accounts receivable would increase to $110; or,

- If only the $50 overstatement of accounts receivable were to be corrected in the current year, then the understatement of current year revenues would increase to $110.

If the misstatement that exists after recording the adjustment in the current year financial statements is material (considering all relevant quantitative and qualitative factors), the prior year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

If the cut-off error that existed in the prior year was not discovered until the current year, a separate analysis of the financial statements of the prior year (and any other prior year in which previously undiscovered errors existed) would need to be performed to determine whether such prior year financial statements were materially misstated. If that analysis indicates that the prior year financial statements are materially misstated, they would need to be restated in accordance with Statement 154.[5]

Facts: When preparing its financial statements for years ending on or before November 15, 2006, a registrant quantified errors by using either the iron curtain approach or the rollover approach, but not both. Based on consideration of the guidance in this Staff Accounting Bulletin, the registrant concludes that errors existing in previously issued financial statements are material.

Question 3: Will the staff expect the registrant to restate prior period financial statements when first applying this guidance?

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[5] Statement 154, paragraph 25.

Interpretive Response: The staff will not object if a registrant[6] does not restate financial statements for fiscal years ending on or before November 15, 2006, if management properly applied its previous approach, either iron curtain or rollover, so long as all relevant qualitative factors were considered.

To provide full disclosure, registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in Topic 1N in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year, and the offsetting adjustment should be made to the opening balance of retained earnings for that year. Registrants should disclose the nature and amount of each individual error being corrected in the cumulative adjustment. The disclosure should also include when and how each error being corrected arose and the fact that the errors had previously been considered immaterial.

Early application of the guidance in Topic 1N is encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, filed after the publication of this Staff Accounting Bulletin. In the event that the cumulative effect of application of the guidance in Topic 1N is first reported in an interim period other than the first interim period of the first fiscal year ending after November 15, 2006, previously filed interim reports need not be amended. However, comparative information presented in reports for interim periods of the first year subsequent to initial application should be adjusted to reflect the cumulative effect adjustment as of the beginning of the year of initial application. In addition, the disclosures of selected quarterly information required by Item 302 of Regulation S-K should reflect the adjusted results.

http://www.sec.gov/interp/account/sab108.htm

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6 If a registrant's initial registration statement is not effective on or before November 15, 2006, and the registrant's prior year(s) financial statements are materially misstated based on consideration of the guidance in this Staff Accounting Bulletin, the prior year financial statements should be restated in accordance with Statement 154, paragraph 25. If a registrant's initial registration statement is effective on or before November 15, 2006, the guidance in the interpretive response to Question 3 is applicable.

APPENDIX 2 to Rules of the Road for Restatements

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 60
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THE BANK OF NEW YORK, not in its individual capacity but solely in its capacity as Indenture Trustee on behalf of all Holders of 2.75% Series B Convertible Subordinated Debentures Due December 15, 2024 of BearingPoint, Inc.,

Plaintiff, Index No. 600169/06

-against-

BEARINGPOINT, INC.,

Defendant.

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APPEARANCES:

For Plaintiff:

Kleinberg, Kaplan, Wolff & Cohen, P.C. LLP
551 Avenue of the Americas
New York, New York 10176
(David Parker, Edward P. Grosz, Esqs.)

Anthony, Ostlund & Baer, P.A.
90 S. 7th Street, Ste. 3600
Minneapolis, MN 55402
(Jeffrey I. Ross, Esq.)

For Defendant:

Fried, Frank, Harris, Shriver & Jacobson
One New York Plaza
New York, New York 10004-1980
(Matthew Gluck, Esq.)

FRIED, J.:

Plaintiff The Bank of New York, not in its individual capacity but solely in its capacity as Indenture Trustee on behalf of all Holders of 2.75% Series B Convertible Subordinated Debentures Due December 15, 2024 of BearingPoint, Inc., moves, pursuant to CPLR 3212, for an order granting summary judgment as to the first cause of action asserted in the complaint.

Defendant BearingPoint, Inc. cross-moves, pursuant to CPLR 3212, for summary judgment, dismissing the complaint.

Plaintiff The Bank of New York is a New York banking corporation with its principal place of business in New York, New York. The Bank of New York is the indenture Trustee (Indenture Trustee) under an indenture, dated as of December 22, 2004 (Indenture), between BearingPoint, Inc. (Bearingpoint) and itself as Trustee. Pursuant to the terms of the Indenture, BearingPoint issued $225 million principal amount of its 2.50% Series A Convertible Subordinated Debentures and $175 million principal amount of its 2.75% Series B Convertible Subordinated Debentures due December 15, 2024. The registered Holder of the Notes is Cede & Co., the nominee of the Depository Trust Company (DTC). Defendant BearingPoint is a publicly held global management and technology consulting firm that trades on the New York Stock Exchange. BearingPoint is incorporated under the laws of the State of Delaware, with its corporate headquarters in McLean, Virginia.

BearingPoint failed to file its required Annual Report on form 10-K for the December 31, 2004 year end, either with the SEC, with which it was due on or about March 16, 2005, or with the Indenture Trustee, with which it was due on or about April 1, 2005. BearingPoint also failed to file its required form 10-Q for the quarter ending March 31, 2005, either with the SEC, with which it was due on or about May 15, 2005, or with the Indenture Trustee, with which it was due on or about May 30, 2005. Furthermore, BearingPoint failed to file its required form 10-Q for the quarter ending June 30, 2005 either with the SEC, with which it was due on or about August 14, 2005, or with the Indenture Trustee, with which it was due on or about August 29, 2005.

The complaint alleges that BearingPoint's failure to file with the Trustee copies of its annual and quarterly reports breached § 5.02 of the Indenture. In addition, plaintiff alleges that by failing to make the required filings with the SEC, BearingPoint was responsible for the failure of a condition precedent to filing such annual and quarterly reports with the Indenture Trustee, as required by § 5.02 of the Indenture.

The complaint alleges that on or about September 8, 2005, BearingPoint was provided with a Notice of Default by Holders of the Series B Debentures, notifying BearingPoint of its failure to comply with § 5.02 of the Indenture, and that an Event of Default would occur if this failure continued for 60 days. More specifically, the letter stated:

> As set forth in our letter dated August 26, 2006 (copy attached), we represent entities, which in the aggregate, own in excess of 25% of the Debentures issued by the Company pursuant to that certain Indenture dated, December 22, 2004 (the "Indenture"), by and between the Company and The Bank Of New York, as trustee. Insofar as BearingPoint, Inc. has failed to file with the SEC its form 10-K or Form 10-Q for the most recent reporting periods and has failed to provide the Trustee for this issue of securities with substantially the same information required to be contained in such filing, by this letter you are notified of a default under Sections 5.02 and 7.01 (g) of the Indenture. Pursuant to Section 7.01 of the Indenture, we hereby demand that the Company cure such default within sixty (60) days from the receipt of this Notice of Default.
>
> This letter shall serve as a "Notice of Default" pursuant to Section 7.01 of the Indenture

(Notice of Cross Motion, exhibit 6).

On or about November 17, 2005, in accordance with § 7.02 of the Indenture, BearingPoint was notified by holders of the Series B debentures that an Event of Default had occurred and was continuing and that, as a result, the principal amount of the Series B Debentures, the accrued and unpaid Interest, and any accrued and unpaid Liquidated Damages were due and payable immediately (the Notice of Acceleration). BearingPoint made no such payment to the holder of the Series B Debentures. Plaintiff alleges that as of the date of the filing of this complaint, BearingPoint still had not filed its 2004 10-K, or its first quarter and second quarter 2005 10-Qs with the SEC or with the Indenture Trustee and had not complied with the Notice of Acceleration.

In its first cause of action, plaintiff sues for breach of contract, alleging that, as the Indenture Trustee, it is entitled to relief since BearingPoint breached the Indenture. Plaintiff alleges that Holders of the Series B Debenture are entitled to the remedy of acceleration or, in the alternative, damages pursuant to § 7.03 of the Indenture, as well as all other appropriate relief, including an award of attorneys' fees to the Indenture Trustee in accordance with the terms of the Indenture. In its second cause of action, plaintiff alleges that, to the extent that BearingPoint did not breach an express obligation set forth under § 5.02 of the Indenture, it breached an implied obligation, i.e., the covenant of good faith and fair dealing in the Indenture, and that Holders of the Series B Debentures are entitled to the remedy of acceleration or, in the alternative, damages pursuant to § 7.03 of the Indenture, as well as all other appropriate relief, including an award of attorneys' fees to the Indenture Trustee in accordance with the terms of the Indenture.

BearingPoint cross-moves for summary judgment, pursuant to CPLR 3212, to dismiss the complaint. BearingPoint alleges that the notice of default sent by plaintiff's law firm was deficient to provide notice of default to BearingPoint, pursuant to the notification procedures enunciated in the Indenture. BearingPoint further alleges that it did not violate any duties or obligations imposed by the Indenture and that, consequently, there was no defaulting event.

Section 5.02 of the Indenture, denominated "SEC and Other Reports," provides, in pertinent part:

> [T]he Company shall file with the Trustee, within 15 days after it files such annual and quarterly reports, information, documents and other reports with the SEC, copies of its annual report and of the information, documents and other reports (or copies of such portions of any of the foregoing the SEC may by rules and regulations prescribe) which the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. The Company shall comply with the other provisions of TIA Section 314(a)

(Complaint, exhibit 3, at 46-47).

Thus, by reference, § 5.02 incorporates Section 13 of the Securities Exchange Act of 1934, which expressly provides that publicly held companies must file annual and quarterly reports with the SEC "as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security" (15 USC § 78m [a]). Furthermore, the requirement to provide the annual and quarterly reports to the Trustee is mandated by Section 314(a) of the Trust Indenture Act of 1939 (the TIA) (15 USC Ch 2A Subch III) which is expressly referenced in the above-quoted language. Indeed, § 5.02 of the Indenture essentially adopts the exact language of Section 314(a)(1) of the TIA, which obligates an issuer of bonds or notes to provide the Indenture Trustee with its quarterly and annual SEC reports (15 USC § 77nnn).

The Indenture defines a default as follows:

> Section 7.01. Events and Defaults. So long as any Securities are outstanding, each of the following shall be, with respect to each series of Securities, an "Event of Default"
>
> ***
>
> (g) The Company fails to comply with any of the terms, agreements or covenants of the Company in the Securities or this Indenture [...] and such failure continues for 60 days after receipt by the Company of a Notice of Default

(Complaint, exhibit 3, at 49-50).

The Indenture's acceleration clause states:

> Section 7.02. Acceleration. If an Event of Default with respect to a series of Securities [...] occurs and is continuing (the default not having been cured or waived), the Trustee by notice to the Company, or the Holders of at least 25% in aggregate principal amount of the Securities of such series at the time outstanding by notice to the Company and the Trustee, may declare the principal amount of such series of Securities and any accrued and unpaid Interest and accrued and unpaid Liquidated Damages, if any, on all the Securities through the date of acceleration of such series to be immediately due and payable. Upon such a declaration such accelerated amount shall be due and payable immediately

(Complaint, exhibit 13, at 52).

It is axiomatic that the movant for summary judgment must tender sufficient evidence to eliminate any material issue of fact from the case (see JMD Holding Corp. v. Congress Fin. Corp., 4 NY3d 373 [2005]; Alvarez v. Prospect Hosp., 68 NY2d 320 [1986]). The failure to make such a showing requires denial of the motion, regardless of the sufficiency of the opposing papers (Winegrad v. New York Univ. Med., Ctr., 64 NY2d 851 [1985]). Once this showing has been made, however, the burden shifts to the party opposing the motion for summary judgment to produce evidentiary proof in admissible form sufficient to establish the existence of material issues of fact which require a trial of the action. Mere conclusions, expressions of hope, or unsubstantiated allegations or assertions are insufficient for this purpose (Zuckerman v. City of New York, 49 NY2d 557 [1980]).

In support of its motion for summary judgment, plaintiff argues that § 5.02 required BearingPoint to provide the Indenture Trustee with SEC filings, which BearingPoint failed to do, thereby breaching that section of the Indenture. BearingPoint, on the other hand, contends that its obligation to furnish the Indenture Trustee with annual and quarterly reports was dependent upon its filing those reports with the SEC. BearingPoint urges that since it did not file with the SEC, it had no obligation to provide copies of the filings with the Indenture Trustee.

In support of its cross motion, BearingPoint argues that as a threshold matter, the September 9, 2005 Notice of Default sent by the Holders' attorney was deficient for Tailing to comply with the Notice of Default provisions of the Indenture. In support of this contention, defendant relies upon the terms of the Indenture, which, according to BearingPoint, would designate Cede, as DTC's nominee, as the sole Holder of the Notes, since the Notes were issued as a single global security registered in Cede's name (Indenture § 2.01, at 14). Plaintiff argues that Cede's role, as registered Holder, is purely ministerial since Cede has no beneficial interest in the Notes and has no authority to act except on behalf its participants (see Offering Memorandum, at 62, affidavit of Marc R. Rosen, exhibit A). Plaintiff also contends that BearingPoint's argument that, notwithstanding Cede's purely administrative role, only Cede, rather than the beneficial Holders, was capable of proffering the Notice of Default, is contradicted by the provisions of the Offering Memorandum of the Indenture.

The Offering Memorandum describes the Indenture and Notes. It uses the term "Holder" to refer to the beneficial Holder, as distinct from the registered Holder, as follows:

> A holder may own its interest in the global Debentures directly through DTC if such holder is a participant in DTC, or indirectly through organizations which are direct DTC participants if such holder is not a participant in DTC .... Holders may also beneficially own interests in the global Debentures held by DTC through certain brokers, dealers, trust companies and other parties that clear through or maintain a custodial relationship with a direct DTC participant, either directly or indirectly

(Offering Memorandum, at 61, Affidavit of Marc R. Rosen, exhibit A).

In describing the various rights of the beneficial Holders, the Offering Memorandum states that "A holder that would like to convert Debenture into share...should contact its broker" (Offering Memorandum, at 48, Affidavit of Marc R. Rosen, exhibit A). Read in this context, beneficial Holders are then described as entitled to give the requisite Notice of Default.

The Notice of Default provisions of the Indenture reside in Section 7.01, which provides that a Notice of Default may be sent by the Trustee or by "the Holders of at least 25% in aggregate of the principal amount of the [Notes]" (Complaint, exhibit 3, at 51; affirmation of Matthew Gluck). The Indenture provides that notice can be given by an agent of a Holder in lieu of the Holder itself:

> Any request, demand, authorization, direction, notice, consent, waiver or other action provided for by this Indenture to be given or taken by Holders may be embodied in and evidenced by one or more instruments of substantially similar tenor signed by such Holders in person or by an agent duly appointed in writing;

> and [...] such action shall become effective when such instrument or instruments are delivered to the Trustee and [...], to the Company, as described in Section 13.02. Proof of execution of any such instrument or of a writing appointing any such agent shall be sufficient for any purpose of this Indenture and conclusive in favor of the Trustee and the company, if made in the manner provided in this Section
>
> (Indenture § 1.04 [a]).

Thus, an agent "duly appointed" by a Holder may provide notice under § 7.01 of the Indenture. Moreover, the above-quoted language states that the notice "becomes effective at the time of delivery" to the Trustee and to BearingPoint in accordance with § 13.02, i.e., the Indenture's general "Notice" section.

On September 9, 2005, the law firm of Andrews & Kurth LLP delivered a Notice of Default to BearingPoint on behalf of "entities which in the aggregate, own[ed] in excess of 25% of the [Notes]" (Affidavit of Richard Baumfield [Baumfield affidavit], exhibit 2; Complaint, exhibit 4). On that day, three groups of funds, Fore Research and Management LP, Linden Advisor LP and Whitebox Advisors LLC, had provided written authorization to Andrews & Kurth to send the Notice of Default (Baumfield affidavit, exhibits 3, 4 and 5; affidavit of Robert G. Lennon, exhibit 1; affidavit of Hareesh Paranjape, exhibit 1; affidavit of Dale Willenbring, exhibit 2). The three funds advised Andrews & Kurth of their individual holdings, which totaled $90,764 million, to wit: more than 25% of the Notes.

A few days later, on September 14, 2005, Andrews & Kurth communicated directly with BearingPoint by phone, offering to identify the Holders pursuant to a confidentiality agreement (Baumfield affidavit, ¶ 4). BearingPoint stated that it would get back to Andrew & Kurth regarding the issues discussed, but never did (Baumfield affidavit, ¶ 4).

Two months later, on November 17, 2005, the three Holders who authorized Andrews & Kurth to send the Notice of Default on their behalf, authorized different counsel to send a Notice of Acceleration (affirmation of Edward Grosz, exhibit 6). BearingPoint does not challenge the sufficiency of the acceleration notice.

After reviewing the documents produced by defendant, I find that as a threshold matter, the September 9, 2005 Notice of Default sent by Andrews & Kurth was sufficient as a matter of law. BearingPoint's argument that only the registered Holder of the Notes has authority to send a notice of default finds no support either in the Offering Memorandum, which provides that Beneficial Holders are themselves authorized to send the Notice of Default, or in the provisions in the Indenture itself Consistent with these provisions, after receiving the Notice of Default, BearingPoint's counsel sought to ascertain the identities of the Beneficial Holders in whose behalf the Notice of Default was sent.

Section 7.01 of the Indenture, requiring Notice by 25% of the Holders, must be read in conjunction with § 1.04 (a) of the Indenture, which provides for notice to be given by "an agent duly appointed in writing." Such notice became effective as of the date it was delivered to BearingPoint and to the Trustee (Section 1.04 [a]). The Holders appointed Andrews & Kurth as their agent in writing on September 9, and also informed Andrews & Kurth of their holdings (Baumfield affidavit ¶¶ 3-5, exhibits 3, 4, 5, 6, 7, 8). In opposition to BearingPoint's cross motion, plaintiff submits the affidavit of Richard Baumfield, who states that prior to sending the September 9, 2005 letter, his firm "requested and received from each Holder written communications confirming and representing to us their ownership of the Notes and authorizing Andrews Kurth LLP to send (the September 9, 2005 letter) on their behalf (Baumfield Affidavit, exhibits 3-8). In consideration of the documents submitted by plaintiffs, I find that there was full compliance with the Notice provisions in the Indenture.

Having communicated with Andrews & Kurth seeking identification of the beneficial Holders before discussing a possible settlement, BearingPoint should not be heard at this juncture to argue that the law firm was without authority to represent the Holders. Equitable estoppel arises when one party makes statements or engages in conduct which induces another to act to its detriment (Bender v. New York City Health and Hosps. Corp., 38 NY2d 662 [1976] [party equitably estopped from asserting improper notice defense when its counsel had been aware of allegedly defective notice before litigation but acted inconsistently with that knowledge]). Defendant never questioned whether the "entities" mentioned in the September 9, 2004 letter were the beneficial Holders of the Bonds. Neither did defendant ask to confirm the status of the Holders on whose behalf notice was given as registered Holders, which it knew could have been only DTC or its nominee, Cede & Co. On the contrary, defendant sought to confirm the identity and requisite percentage ownership of the beneficial Holders. BearingPoint is, therefore, estopped from now arguing that only Cede & Co. could give notice (see Friedman v. Airlift Intl., Inc., 44 AD2d 459, 461 [1st Dept 1974] [if beneficial ownership is indisputable, failure to proceed in name of nominee "is of no significance"). Notably, the filing by the beneficial Holders has now been retroactively ratified by the registered Holder (ratification letters by Cede & Co.; see Applestein v. The Province of Buenos Aires, 415 F3d 242 [2d Cir 2005]; Fontana v. Republic of Argentina, 415 F3d 238 [2d Cir 2005], where the Second Circuit held that an owner of a beneficial interest must receive authorization from the registered holder of the bond before it may sue, but that such authorization may be granted subsequent to the filing of a lawsuit]).

BearingPoint also contends that it did not breach the Indenture when it failed to provide the Indenture Trustee with timely SEC filings, alleging that it had no independent obligation under the Indenture to make any SEC filing, at all. This argument ignores the clear import of § 5.02 of the Indenture and the TIA. Under BearingPoint's interpretation of the relevant Indenture provision, BearingPoint's obligation to provide information to the Trustee was contingent on whether or not it chose to file with the SEC. Section 5.02, however, unambiguously obligates BearingPoint to make the required SEC filings and to provide copies of them to the Trustee. The provision, which is denominated "SEC and other Reports," provides: "[The Company **shall** file with the Trustee...copies of its annual report and of the information, documents and other reports...which the Company is **required** to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act" (emphasis provided). BearingPoint's tortured parsing of this provision to read the section as making SEC filings optional under the terms of the Indenture, vitiates the clear purpose of the Indenture to provide information to the investors so that they may protect their investment. This proposed construction would defy the clear intentions of the parties and does not comport with the straightforward and unambiguous intent of the provision.

BearingPoint's obligation to provide the Trustee with timely annual and quarterly reports is also expressly provided for by the second sentence of § 5.02 of the Indenture, which states: "The Company shall comply with the other provisions of TIA Section 314(a)." Section 314(a) of the TIA specifically obligates an issuer of bonds or notes, such as BearingPoint, to provide the Indenture Trustee with current SEC filings. Section 302(a)(4) of the TIA expressly provides that:

> [T]he national public interest and the interest of investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, which are offered to the public, are adversely affected ...
>
> (4) when the obligor is not obligated to furnish to the trustee under the indenture and to such investors adequate current information as to its financial condition, and as to the performance of its obligations with respect to the securities outstanding under such indenture ...

(15 USC § 77bbb [b]).

To implement Section 302, TIA § 314(a) expressly mandates that:

> Each person who ... is or is to be an obligor upon the indenture securities covered thereby shall --
>
> (1) file with the indenture trustee copies of the annual reports and of the information, documents and other reports...which such obligor is required to file with the Commission pursuant to section 78m or 780(d) of this title ...

(15 USC § 77nnn [a]).

Thus, § 5.02 requires BearingPoint to provide the Indenture Trustee with copies of required SEC filings, which BearingPoint failed to do. It is apparent that the underlying purpose of § 5.02 of the Indenture was to make BearingPoint's financial information available to the Series B Debenture Holders by providing such information to the Trustee. As a memorialization of apparent commercial realities, this section expressed that which is known to the investment community, i.e. that only by guarding against incomplete information, can investors make informed decisions about their investment and guard against the risks attendant to incomplete information.

Although BearingPoint cites the Offering Memorandum in support of its position that it had no obligation to file SEC reports pursuant to the terms of the Indenture, the referenced provisions of the Offering Memorandum, which, in any event would only be considered upon finding of ambiguity in the indenture (<u>Matter of Wallace v. 600 Partners Co.</u>, 86 NY2d 543, 548 [1995]) merely refer to the timing of the SEC filings and in no way obviate BearingPoint's obligation to file with the SEC. On the contrary, the offering plan provides that:

> [I]f we do not have audited financial statement available by March 31, 2005, we will be in default under our 2004 Credit Facility (unless the delay is solely as a result of continuing work by us and/or our independent registered public accounting firm to prepare opinions or statements required or permitted by Section 404 of Sarbanes-Oxley, in which case the requirement will be extended by 30 days) and possible other agreement. A default would permit the lender under the 2004 Credit Facility to terminate the 2004 Credit Facility, accelerate any outstanding loans and proceed against their collateral

(Cross-Motion, exhibit 4, at 12-13).

Thus, the clear and unambiguous import of the Indenture is merely underscored by the language in the Offering Memorandum.

In the absence of ambiguity which obscures the intentions of the parties to a contract, the interpretation of a contract and the obligations of the parties thereto are questions of law and not of fact (R/S Assoc. v. New York Job Dev. Auth., 98 NY2d 29, 32 [2002]; Bethlehem Steel Co. v. Turner Constr. Co., 2 NY2d 456 [1957]). "[W]hen parties set down their agreement in a clear, complete document, their writing should as a rule be enforced according to its terms" (W.W.W. Assoc. v. Giancontieri, 77 NY2d 157, 162 [1990]). It is well settled that "extrinsic and parol evidence is not admissible to create an ambiguity in a written agreement which is complete and clear and unambiguous upon its face" (Intercontinental Planning Ltd. v. Daystrom, Inc., 24 NY2d 372, 379 [1969]. Having found that the terms of § 5.02 are unambiguous, Bearingpoint's attempts to modify the terms of the provisions of the Indenture by referring to the Offering Memorandum are unavailing.

Since BearingPoint argues that there was no obligation to file reports with the SEC under the Indenture, they argue that the inexorable conclusion is that there was no Default Event. On the contrary, by not filing required SEC reports, BearingPoint repudiated its obligations under the Indenture, thereby frustrating the Trustee's rights under the Indenture. A party's repudiation of its future obligations under a contract may take the form of "'a voluntary affirmative act which renders the obligor unable or apparently unable to perform without such a breach'" (Norcon Power Partners v. Niagara Mohawk Power Corp., 92 NY2d 458, 463 [1998]). BearingPoint cannot take advantage of its failure to fulfill its obligation to file timely reports with the SEC by arguing that it has consequently not breached its obligation to provide the Trustee with copies of such reports (see In re Bankers Trust Co., 450 F3d 121 [2d Cir NY 2006]).

Consequently, the Notice of Default sent in the September letter was sufficient, and BearingPoint's cross-motion for summary judgment is unfounded in evidentiary proof sufficient to dismiss the complaint. Furthermore, plaintiff has established as a matter of law that BearingPoint defaulted under the provisions of § 5.02. Since the default mechanisms of the Indenture were fully satisfied by the September 9, 2005 Default letter and the November 17, 2005 Acceleration letter, BearingPoint was obligated to accelerate immediately all principal and accrued interest. Having failed to do so, BearingPoint breached § 7.02 of the Indenture (Complaint, exhibit 1, first cause of action, ¶ 21).

Accordingly, it is hereby

ORDERED that defendant's cross motion for summary judgment to dismiss the complaint is denied; and it is further

ORDERED that plaintiff's motion for summary judgment on its first cause of action is granted, and defendants found liable for breach of contract with the amount of damages to be determined at trial; and it is further

ORDERED that the remainder of the action shall continue.

Dated: 9/18/06

ENTER:

____

J.S.C.

BERNARD J. FRIED

J.S.C.

APPENDIX 3 to Rules of the Road for Restatements

SAMPLE LETTER SENT IN RESPONSE TO INQUIRIES RELATED TO FILING RESTATED FINANCIAL STATEMENTS FOR ERRORS IN ACCOUNTING FOR STOCK OPTION GRANTS

In December 2006, the Division of Corporation Finance responded to inquiries from several public companies requesting filing guidance as they prepare to restate previously issued financial statements for errors in accounting for stock option grants. The following illustrative letter provides information for registrants to consider as they prepare reports to be filed with the Commission to correct errors in accounting for stock option grants.

January 2007

Name
Chief Financial Officer
XYZ Corporation
Address

Dear Chief Financial Officer:

We understand that you plan to restate previously issued financial statements for errors in your accounting for grants of stock options to employees, members of the board of directors, and other service providers and that you have determined that your periodic filings for multiple periods contain materially inaccurate financial statements and related disclosures. In this letter, we are providing you with guidance as you consider how you will address these deficiencies in your periodic filings. You should not interpret this guidance to mean that we will not review your filings if you follow it. Furthermore, as with all staff guidance, the Commission has not approved this letter or the guidance we provide in it.

The Securities Exchange Act of 1934 requires you and your company to file reports with the Commission and to determine the accuracy and adequacy of the information you provide in them. Generally, previously filed reports containing financial statements determined to be materially misstated require amendment. However, since the restatement for errors in accounting for grants of stock options will affect a significant number of years, you have indicated that your company would be unduly burdened by amending all previously filed reports and that the filing of those numerous amendments could adversely impact the ability of a reader of your financial statements to easily and fully understand the impact of the restatement.

The staff of the Division of Corporation Finance will not raise further comment regarding your company's need to amend prior Exchange Act filings to restate financial statements and related MD&A if your company amends its most recent Form 10-K and includes in that amendment the comprehensive disclosure outlined below. If your next Form 10-K is due to be filed within two weeks of the Form 10-K amendment that you would file in response to this guidance, we will not comment on your company's need to amend or file prior Exchange Act filings to restate financial statements and related MD&A if your company includes the comprehensive disclosure outlined below in that next Form 10-K, rather than including the comprehensive disclosure in an amendment to your most recent Form 10-K.

In taking this position, we understand that you will include the following disclosure in your Form 10-K amendment (or your next Form 10-K, as appropriate):

- An explanatory note at the beginning of the Form 10-K amendment that discusses the reason for the amendment.

- Selected Financial Data for the most recent five years as required by Item 301 of Regulation S-K, restated as necessary and with columns labeled "restated".

- Management's Discussion and Analysis as required by Item 303 of Regulation S-K, based on the restated annual and quarterly financial information, explaining the company's operating results, trends, and liquidity during each interim and annual period presented. Discussions relative to interim periods may be incorporated into the annual-period discussions or presented separately.

- Audited annual financial statements for the most recent three years, restated as necessary and with columns labeled "restated".

- If interim period information for the most recent two fiscal years as required by Item 302 of Regulation S-K is required to be restated, the information presented for the balance sheets and statements of income should be in a level of detail consistent with Regulation S-X Article 10-01 (a)(2) and (3), and appropriate portions of 10-01(b) and with columns labeled "restated". Note that there is no need to present cash flow information as it is not required by Item 302.

- Footnote disclosure reconciling previously filed annual and quarterly financial information to the restated financial information, on a line-by-line basis and for each material type of error separately, within and for the periods presented in the financial statements (audited), in selected financial data, and in the interim period information (see paragraph 26 of FASB Statement No. 154).

- The disclosure referred to in the Chief Accountant's September 19, 2006 letter that applies to your restatement (the letter can be found at http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm).

- Audited financial statement footnote disclosure of the nature and amount of each material type of error separately that is included in the cumulative adjustment to opening retained earnings.

- Audited financial statement footnote disclosure of the restated stock compensation cost in the following manner:

    - For the most recent three years: restated net income and compensation cost and pro forma disclosures, required by paragraph 45.c. of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as clarified and amended by FASB Statement No. 148, for each annual period presented in the financial statements for which the intrinsic value method of accounting in APB Opinion 25 was used, with columns labeled "restated" as appropriate.

    - For each annual period preceding the most recent three years: disclosure of the information required by paragraph 45.c.2. of FASB Statement No. 123, the restated stock compensation cost that should have been reported for each fiscal year. The total of the restated stock-based compensation cost should be reconciled to the disclosure of the cumulative adjustment to opening retained earnings. While the disclosure required by paragraph 45.c.2. is net of tax, material tax adjustments related to the accounting for stock-based compensation should also be disclosed by year. Registrants may also elect to voluntarily provide the full restated information previously disclosed pursuant to paragraph 45.c. of FASB Statement No. 123, for each period prior to the most recent three years, either in the audited financial statement footnotes or elsewhere in the filing.

    - For companies that adopted (1) FASB Statement No. 123 using the retroactive restatement method specified in FASB Statement No. 148 and/or (2) FASB Statement No. 123R, *Accounting for Share-Based Payment*, using the modified retrospective application method for all prior years for which FASB Statement No. 123 was effective: the disclosure outlined in the preceding two paragraphs should include the restated stock-based compensation pursuant to FASB Statement No. 123 and also the restated stock-based compensation cost that should have been reported under the accounting principle originally used for each period, presumably Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*.

- Appropriate revisions, if necessary, to previous disclosure under Items 9A and 9B:

    - As we discussed in "Staff Statement on Management's Report on Internal Control Over Financial Reporting" (May 16, 2005) (available at http://www.sec.gov/spotlight/soxcomp.htm), in disclosing any material weaknesses that were identified as a result of the restatement and/or investigation, you should consider including in your disclosures: the nature of the material weaknesses, the impact on the financial reporting and the control environment, and management's current plans, if any, for remediating the weakness. While there is no requirement for management to reassess or revise its original conclusion of the effectiveness of internal control over financial reporting, management should consider whether its original disclosures are still appropriate and should supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading.

- In light of the restatement and new facts discovered by management, including identification of any material weaknesses, disclose the certifying officers' conclusion regarding the effectiveness of the company's disclosure controls and procedures as of the end of the period covered by the amended filing. If the certifying officers' conclusion remains the same, that disclosure controls and procedures are effective, you should consider discussing the basis for that conclusion.

In advising you that the staff of the Division of Corporation Finance will not raise further comment regarding your company's need to amend prior Exchange Act filings to restate financial statements and related MD&A, it is important that we advise you that this guidance does not:

- mean the Division of Corporation Finance will not comment on or require changes in your Form 10-K amendment or Form 10-K that includes the comprehensive disclosure we outlined above;
- mean the Division of Corporation Finance has concluded that you or your company have complied with all applicable financial statement requirements;
- mean the Division of Corporation Finance has concluded that the company has satisfied all rule and form eligibility standards under the Securities Act and the Exchange Act;
- mean that the Division of Corporation Finance has concluded that the company is current in filing its Exchange Act reports;
- mean that the Division of Corporation Finance has concluded that the company has complied with the reporting requirements of the Exchange Act;
- foreclose any action recommended by the Division of Enforcement with respect to your disclosure, filings or failures to file under the Exchange Act; or
- foreclose any action recommended by the Division of Enforcement under Section 304 of the Sarbanes-Oxley Act, *Forfeiture of Certain Bonuses and Profits*, with respect to the periods that the company's financial statements require restatement, irrespective of whether the company amended the filings to include the restated financial statements.

As you know, the staff of the Office of the Chief Accountant is continuing to consider matters related to the accounting for stock options (we refer you again to Conrad Hewitt's September 19th letter at http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm). If you would like to discuss the particular facts and circumstances of your stock option grants and the accounting conclusions you have reached, we encourage you to contact Joe Ucuzoglu, Professional Accounting Fellow in the Office of the Chief Accountant at 202-551-5301 or Mark Barrysmith, Professional Accounting Fellow in the Office of the Chief Accountant 202-551-5304.

We have provided this guidance to you based on our understanding of your circumstances surrounding your decision to restate your financial statements to correct errors related to your accounting for stock options. Materially different circumstances, including filing delinquencies and restatements for other reasons, could result in our reaching a different conclusion.

Please direct any questions about the guidance we have provided to you in this letter to the staff of the Chief Accountant's Office in the Division of Corporation Finance (202-551-3400).

Sincerely,

Carol A. Stacey
Chief Accountant
Division of Corporation Finance

http://www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm

Attachment D

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April 11, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Roundtable on Implementation of Internal Control Reporting Provisions (File Number 4-497)

Dear Mr. Katz:

It is an honor to be invited to participate in the Commission's Roundtable on April 13, 2005. Given the topic of my panel *Reporting to the Public*, I will limit my remarks to disclosure.[1]

I was a young attorney in the Commission's Division of Corporation Finance when Congress passed the Foreign Corrupt Practices Act ("FCPA") which amended the Securities Exchange Act of 1934 to require companies filing periodic reports to "devise and maintain a system of internal accounting controls... ."[2] I watched with interest as the FCPA was implemented in the late 1970's without specific disclosure requirements pertaining to the adequacy of internal controls. It was not until SOX that disclosure controls and procedures and internal control over financial reporting became the subject of specific rules requiring disclosure.[3] While Item 9A of Annual Reports on Form 10-K and Item 4 in Quarterly Reports on Form 10-Q are of recent vintage, the disclosure has developed rapidly from short discussions

[1] For my other views on the Sarbanes-Oxley Act of 2002 ("SOX"), please see my outline co-authored with Julie K. Hoffman, "Sarbanes-Oxley Act of 2002 and SEC Rulemaking" which is printed in the ABA's The Practitioner's Guide to the Sarbanes-Oxley Act, Vol. 1, I-1, (2004), the editors of which are Stanley Keller, Vasiliki Tsaganos, Jonathan Wolfman and me.

[2] Section 13(b)(2)(B) of the Exchange Act.

[3] See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release Nos. 33-8238, 34-47986, 68 Fed. Reg. 36,635* (June 5, 2004) (available at http://www.sec.gov/rules/Final/33-8238.htm).

with oblique references to internal controls to specific disclosure[4] of material weaknesses[5] which also drill down into what management is doing to remediate the material weaknesses and when management estimates the process will be completed.[6]

This year, managements of accelerated filers are, for the first time, providing evaluations under Section 404(a) and outside auditors are providing attestations under Section 404(b) of SOX. As with the disclosure that has been provided in 2004, the presence or absence of a material weakness,[7] as defined in AS 2, drives the disclosure in Section 404 reports by management and audits by the outside auditor. The disclosure is part of the procedural requirements established by SOX, which are all interrelated and should be viewed as a whole, rather than individually. Put simply, it is one big procedural ball of wax.[8]

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[4] The Staff of the Division of Corporation Finance is to be commended for guiding the development of this disclosure through the comment process.

[5] Paragraph 10 of Public Company Accounting Oversight Board ("PCAOB") Audit Standard No. 2 ("AS 2").

[6] See my remarks set forth in the "SEC 'Hot Topics' Teleconference" sponsored by Glasser LegalWorks on July 27, 2004 ("Hot Topics"), "Impact of Internal Controls on M & A" sponsored by DealLawyers.com on January 19, 2005 and "Demystifying Internal Controls Disclosure" sponsored by The Corporate Counsel.net on February 2, 2005 ("Demystifying Teleconference"), the transcripts for which teleconferences were provided to the Commission on April 7, 2005.

[7] While some have advised that management should disclose significant deficiencies in periodic reports in addition to material weaknesses, I do not believe it is required. Moreover, such disclosure would not promote the disclosure policy that I believe these regulations are intended to promote, as discussed below.

[8] The linkage can be described as follows: Certification under Section 302 of SOX covers disclosure controls and procedures, which significantly overlaps with internal control over financial reporting. In my opinion, internal control over financial reporting is critical to enhancing the reliability of the financial statements. Internal control over financial reporting is one component of internal control under the FCPA and upon which the Report of the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Report"), first published in 1977 and republished in 1992, is based. In addition, the concept of disclosure controls and procedures is based – and indeed could be viewed as an extension of – internal control as defined in the COSO Report. Moreover, management's evaluation of internal control over financial reporting must be based on an established framework, and the Commission has designated the COSO Report as an acceptable evaluation framework for purposes of this evaluation and the disclosure requirements under Rule 13a-15(c) and Rule 15d-15(c) under the Exchange Act. No other framework prevalent in the United States has been so designated. Another way of explaining the interrelationship is to compare financial reporting to a house: the foundation is auditor independence; the infrastructure from the frame through the plumbing and electrical

Underpinning these procedures are the definitions of terms, one of which – material weakness – is critical to public disclosure. If a company has a material weakness, management cannot find that internal control over financial reporting is effective in its evaluation report. The auditor must disclaim an opinion in its 404 audit. Disclosure is required in periodic reports and can include a risk factor in the Form 10-K. Moreover, under the current system, the auditor cannot conclude that the material weakness has been remediated during interim periods unless it conducts a new audit.[9]

Given its importance, the issue I see is whether the definition of material weakness strikes the right balance from a disclosure policy point of view. The answer to the question includes consideration of the function it is intended to fulfill and how successful it has been in restoring investor confidence and protecting investors.

To me, the disclosure policy of material weakness is to act as the "canary in the mineshaft." Since the disclosure in periodic reports follows the requirements relating to disclosure controls and procedures and internal control over financial reporting, that disclosure is also focused on material weakness. Yet, I would respectfully submit that not all material weaknesses are created equal. A material weakness in revenue recognition is fundamentally different than a documentation failure for an overseas subsidiary or a one-time error made by a finance person in a complicated tax issue which is unlikely to reoccur. While material weaknesses are not the same, the current disclosure requirements do not differentiate between different types of material weaknesses. Therefore, the same quantity and quality of disclosure is required for every material weakness. Thus, it is understandable when investors become confused or get the wrong impression from the disclosure. The purpose for the disclosure requirement is not being achieved because the term material weakness is producing unnecessary disclosure to investors, disclosure which does not serve the function of the "canary in the mineshaft."

I believe the Commission and the PCAOB should consider whether the current definition sets the bar too low. If the threshold is set too low, the purpose is not being fulfilled[10] and the marketplace's reaction may well be to ignore or discount the significance of the disclosure because "everyone has one." And if "everyone has one," the marketplace will soon draw its own distinctions as to what is important and alternatively decide how to differentiate between

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systems is internal control over financial reporting; and the outside of the house, what you see when you look at it, are the financial statements

[9] The PCAOB recently proposed an Auditing Standard, Reporting on the Elimination of a Material Weakness which, if adopted, would permit an outside auditor to report on the elimination of a material weakness between annual audits under Section 404.

[10] Managements that have spent much time and expense in designing and maintaining this system are often concerned that the low threshold for identifying a material weakness, coupled with a conservative approach in applying the definition, is resulting in disclosure which is not indicative of what their situation really is.

material weaknesses that can affect the financial statements and those that the marketplace determines are unlikely to do so.

Rather than have the marketplace develop its own criteria, [11] I believe that the Commission and the PCAOB should consider revising the definition of material weakness. The alternatives available range from a major change – revising Staff Accounting Bulletin No. 99 which is part of the basis for the definition – to a more modest approach, such as amending the definition to recognize that a pervasive weakness that cannot be easily remediated in a short period of time is fundamentally different from a one-time error which is isolated and quickly fixed. Whichever approach is chosen depends, in part, on how well the Commission and the PCAOB believe the term material weakness is accomplishing its purpose as well as what is expected when the non-accelerated filers become subject to Section 404. I would respectfully submit that change is necessary to avoid the possibility of the definition losing its meaning and to promote, rather than undermine, investor confidence. Given our experience with the new system thus far, changes to the term material weakness would enhance investor understanding by eliminating unnecessary disclosure and could have the added beneficial effect of making the other elements of internal control over financial reporting more effective.

Regardless of the approach, I would recommend that the proposed change, as well as any changes to SAB 99, be the subject of notice and comment under the Administrative Procedure Act. These terms are too important not to be subject to public comment before being finalized.

Again, I commend the Commission for conducting the Roundtable and appreciate the opportunity to participate.

Respectfully submitted,

John J. Huber

John J. Huber
of LATHAM & WATKINS LLP

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[11] <u>See</u>, <u>e.g.</u> *Moodys Investor Services Special Comment, Section 404 Reports on Internal Control: Impact on Ratings will Depend on Nature of Material Weakness Reported* (October 2004) and *Institutional Shareholder Services, The Friday Report* (April 8, 2005).

Attachment E

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May 1, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Roundtable on Second-Year Experiences with Implementation of Sarbanes-Oxley Internal Control Reporting and Auditing Provisions (File Number 4-511)

Dear Ms. Morris:

It is an honor to be invited to participate in the Commission's Roundtable on May 10, 2006. Given the topic of my panel, I will limit my remarks to my view of the future of Section 404.[1]

While I believe that Section 404 is necessary for investor protection and the public interest, I also believe that changes should be made to make Section 404 workable. The situation concerning Section 404 should be contrasted to the three-year process which resulted in the final adoption in August 1983 of Rule 415, the shelf rule. As a staff member, I was involved in the rule being published for comment three times, participating as a hearing officer in the public hearings, as well as in the Commission's adoption of a temporary rule on an experimental basis and in its adoption as a permanent rule. Rule 415, one of the Commission's most successful rules, was thus given multiple opportunities to work before being finally adopted.[2] The explicit statutory time periods under Sarbanes-Oxley did not permit the Commission to follow the trial-and-error path that the Commission followed in adopting the shelf rule. However, I would suggest that the two-year period since Section 404 became effective for

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[1] For my other views on the Sarbanes-Oxley Act of 2002 ("SOX"), please see my outline co-authored with Julie K. Hoffman, "Sarbanes-Oxley Act of 2002 and SEC Rulemaking" which is printed in the ABA's The Practitioner's Guide to the Sarbanes-Oxley Act, Vol. 1, I-1, (2004) and my article co-authored with Joel H. Trotter, "Disclosure of Internal Control Over Financial Reporting", which is printed in Vol. III (2006), the editors of which are Stanley Keller, Vasiliki Tsaganos, Jonathan Wolfman and me.

[2] Even after being adopted on a permanent basis, the rule has been fine-tuned to keep up with the changing market conditions, most recently as part of the Securities Offering Reform proposals which became effective on December 1, 2005 (Release Nos. 33-8591; 34-5206, July 19, 2005).

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accelerated filers provides a database of experience to assess, review and revise the rules under Section 404 to make it more successful in the future.

Thus, I believe the time is ripe to revise the rules under Section 404 as well as Audit Standard No. 2, not to eliminate, but to improve, not to exempt, but to accommodate the needs of all registrants, not to give up, but to achieve its original purpose of enhancing investor confidence.[3] This effort would have four objectives:

- To achieve a better balance between the regulation, on the one hand, and the needs of the marketplace and the costs incurred by registrants, on the other. Not all registrants are in the same position to comply with Section 404. One size of Section 404 regulation does not fit all companies. When non-accelerated filers become subject to Section 404, they should not have to comply with the same requirements imposed on accelerated filers.

- Amend the rules to link the disclosure to the needs of the marketplace and investors, such as having the definition of a material weakness be something that when disclosure of it is made, the stock price is affected.[4] If that occurs, internal control over financial reporting will serve its purpose of acting as the "canary in the mineshaft" of the financial statements.

- Attempt to change the mindset of all the constituencies that affect the Section 404 process – registrants many of whom have only focused on costs and not benefits; auditors who are too concerned about being criticized by a PCAOB inspector; and regulators who are reluctant to defer to the judgment of registrants and their auditors.

- Consider foreign private issuers as part of a global marketplace and understand that US markets should continue to be gold standard of capital formation.

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[3] I urged the Commission and the Public Company Accounting Oversight Board (the "PCAOB") to revise the definition of material weakness in my written and oral remarks at the Roundtable in April 2005. Others have now joined me in the same conclusion since the May 2005 guidance was issued by the SEC and PCAOB. See, e.g., Harvey L. Pitt, "Make Sox Fit," Wall Street Journal, at A 12 (April 13, 2006); Alan L. Beller, Remarks at the Committee on Federal Securities Regulation of the Business Law Section of the American Bar Association in Tampa, Florida (April 8, 2006); and Robert C. Pozen, "Why Sweat the Small Stuff, "Wall Street Journal at A 20 (April 5, 2006).

[4] Under the current definition, the marketplace's reaction to disclosure of a material weakness is typically to ignore or discount the significance of such disclosure because "everyone has one."

With these objectives in mind, my specific suggestions are:

- Develop COSO guidance that meets the needs of smaller companies, so that non-accelerated filers do not believe that the regulatory structure of the Fortune 500 is being imposed on them.

- Co-ordinate with the European Union to develop an international standard of internal control over financial reporting so that foreign private issuers come to the United States to be listed, rather than pursue alternatives to de-list from US markets.[5]

- Revise Auditing Standard No. 2, not to change its overall structure, but to amend it to reflect the experience of the past two years, as well as to anticipate the issues that non-accelerated filers will confront.[6]

- Review the definitions of disclosure controls and procedures, on the one hand, and internal control and procedures, on the other hand, so that the ordinary American investor can understand what the relationship between disclosure controls is to internal controls.

- Create a pilot project for unaccelerated filers so that the Commission and public companies have the ability to learn from experience to establish a permanent framework for smaller public companies.[7]

- Make the zone of reasonableness, discussed in the May 2005 guidance, a meaningful concept that works in practice and promotes, rather than deters, the exercise of judgment by registrants and auditors alike.

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[5] See, e.g., William H. Lash III, "Reforming Deregistration, SEC Should Make Major Fix," The Washington Times at A 23 (April 26, 2006) and Bob Greifeld, "Its Time to Pull Up our SOX," Wall Street Journal (March 6, 2006).

[6] For example, the structure of the term material weakness – probability and magnitude – is appropriate, but the thresholds – more than remote likelihood based on FAS 5 and materiality based on SAB 99 – are too low. The PCAOB should raise the bar to "likely" rather than the current standard of "more than remote likelihood" and the Commission should revise SAB 99 to ensure that the definition truly reflects the standard of what as reasonable investor would need to know to make an informed investment decision. Another example would be to revise Auditing Standard No. 2 so that the top down, risk based guidance from May 2005 results in focusing on what is important and decreases the amount of time, effort and cost expended by registrants, consultants and auditors. Still another example is to have less documentation than what is required by Auditing Standard No. 3 for auditors.

[7] This is the suggestion made by Deloitte & Touche LLP in its April 3, 2006 comment letter to the Commission on the Exposure Draft of Final Report of the Advisory Committee on Smaller Public Companies, Release Nos. 33-8666 and 34-53385, File No. 265-33.

- Promote a regulatory system that trusts the judgments of registrants and auditors more than is currently the case. *This does not mean returning to the pre-SOX* system, but it would recognize that the overwhelming majority of registrants just want to know how to comply, what they have to do to comply and do not intend to evade or defraud. Establishing a workable standard of "trust, but verify"[8] would be a major component of revising Section 404.

In conclusion, I commend the Commission and the PCAOB for conducting the Roundtable and appreciate the opportunity to participate.

Respectfully submitted,

John J. Huber

John J. Huber
of LATHAM & WATKINS LLP

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[8] This phrase is borrowed by me from President Reagan.