

NOTE

**THE IMPLICATIONS OF IFRS ON THE FUNCTIONING OF
THE SECURITIES ANTIFRAUD REGIME
IN THE UNITED STATES**

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The United States is home to one of the most investor-friendly securities antifraud regimes in the world. Corporate misstatements that form the basis for a cause of action under one of the many antifraud provisions arise in a variety of contexts, an important one being as violations of U.S. generally accepted accounting principles (“GAAP”). For several years, the Securities and Exchange Commission has been considering changing the standardized accounting practice in the United States from GAAP to International Financial Reporting Standards (“IFRS”) to promote comparability between global investment opportunities. IFRS is a principles-based system of accounting, while GAAP is rules based. Because of the flexibility of financial reporting inherent in the principles-based approach of IFRS, investors and the Securities and Exchange Commission will face greater difficulty in relying on accounting violations to establish the elements of the securities antifraud causes of action if IFRS is adopted.

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INTRODUCTION

Public companies in the United States have not always been required to prepare financial statements in accordance with standardized accounting practices. In fact, public companies in the United States have not always been required to issue financial statements at all.¹ Of the billions of dollars in new securities purchased during the years leading up to the Great Depression, most of the investment decisions were made without adequate financial information.² To protect investors, Congress enacted the Securities Act of 1933³ and the Securities Exchange Act of 1934,⁴ which force companies to make certain disclosures and seek to discourage fraud.⁵

Concomitant to the promulgation of the securities laws, the desire for comparability between the financial positions of various firms and within the same firm across time inspired the movement for a uniform system of financial reporting.⁶ In 1933, the American Institute of Accountants⁷

1. Dan L. Goldwasser, *The Audit Process*, in ACCOUNTANTS' LIABILITY 1992, at 9, 12 (PLI Litig. & Admin. Practice, Course Handbook Series No. 440, 1992).

2. J. Arnold Pines, *The Securities and Exchange Commission and Accounting Principles*, 30 LAW & CONTEMP. PROBS. 727, 727 (1965).

3. 15 U.S.C. §§ 77a–77aa (2006).

4. *Id.* §§ 78a–78ll.

5. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 1 (2d ed. 2008). The Exchange Act established the Securities and Exchange Commission (“SEC”), and the Securities Act gave the SEC the power to prescribe accounting rules for use in statements filed with the SEC. The SEC has neglected to fully exercise this power, however, opting instead to allow the accounting profession and corporate officers to develop the governing rules. Thomas D. Flynn, *Uniformity in Financial Accounting: A Progress Report*, 30 LAW & CONTEMP. PROBS. 623, 625 (1965); see also Stephen A. Zeff, *The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards* (pt. 1), CPA J., Jan. 2005, at 19, 20 (noting that, in 1938, “[t]he SEC, by a narrow vote, support[ed] a reliance on the private sector to establish GAAP” and that the SEC “looks to the private sector for leadership”).

6. Flynn, *supra* note 5, at 623–24; Jay H. Price, Jr. et al., *Accounting Uniformity in the Regulated Industries*, 30 LAW & CONTEMP. PROBS. 824, 826 (1965) (“[T]he financial information about itself that a business discloses will be substantially useful only if that information provides a basis for comparing that business with others. Thus there is now a widely recognized need in the investing community not only for publication of financial information about businesses but also for the publication of reports that disclose essential factual differences and are therefore ‘comparable’ in some degree.”).

7. The American Institute of Accountants is now called the American Institute of Certified Public Accountants. Flynn, *supra* note 5, at 623.

(“AIA”) adopted six broad principles that formed the basis for what later came to be known as generally accepted accounting principles, or GAAP—a term first used by the AIA in 1936.⁸ Authoritative rulings from various official accounting standard-setting bodies⁹ combined with other statements approved by a significant segment of the accounting profession comprise the current body of U.S. GAAP.¹⁰

The advantages of having comparable financial data among various firms have garnered recurring relevance amidst the globalization of securities markets. Technological innovation has greatly facilitated cross-border capital flows.¹¹ The benefits of financial globalization have been widespread. Two thousand and five marked the first year in which over half of all global saving was invested abroad.¹²

Though technological advancements have eliminated some barriers to cross-border securities transactions, other barriers remain. For example, variations in standardized accounting practices create one of the biggest impediments to worldwide capital-market integration by hindering the ability of investors to compare financial data and by forcing companies to compile financial statements that comply with the reporting requirements of every country in which they wish to enlist.¹³

Every country with an established securities market now requires companies to comply with a standardized accounting practice,¹⁴ but not all standardized accounting practices are alike. Some countries, including the United States, employ a “homegrown” system developed by a wholly internal

8. Zeff, *supra* note 5, at 20.

9. After the AIA adopted the original six GAAP rules, it created the Committee on Accounting Procedure (“CAP”) to oversee the development of accounting standards. In 1959, the AIA replaced the CAP with the Accounting Principles Board (“APB”). In 1972, the AIA replaced the APB with the Financial Accounting Standards Board (“FASB”), which is the current official accounting standard-setting body in the United States. Zeff, *supra* note 5, at 22–23, 27.

10. *E.g.*, BARRY J. EPSTEIN ET AL., WILEY GAAP CODIFICATION ENHANCED 1–5 (2009).

11. Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, Securities Act Release No. 8982, Exchange Act Release No. 58,960, 94 SEC Docket 1703 (Nov. 14, 2008) [hereinafter IFRS Roadmap].

12. HALL S. SCOTT, INTERNATIONAL FINANCE 18 (2d ed. 2008).

13. See Frederick D. S. Choi & Richard M. Levich, *Introduction and Overview*, in INTERNATIONAL CAPITAL MARKETS IN A WORLD OF ACCOUNTING DIFFERENCES 1, 3 (Frederick D. S. Choi & Richard M. Levich eds., 1994) (“[O]ne half of [the institutional investors, corporate issuers, investment underwriters and market regulators in major financial centers in Germany, Japan, Switzerland, the United Kingdom and the United States] interviewed reported being bothered by national accounting differences.”); SCOTT, *supra* note 12, at 97 (“[T]he need to reconcile financial statements with U.S. generally accepted accounting principles (GAAP) has been a major obstacle to foreign companies listing on US exchanges.”); Kun Young Chang, *Reforming U.S. Disclosure Rules in Global Securities Markets*, 22 ANN. REV. BANKING & FIN. L. 237, 241 (2003) (“[M]any commentators have pointed out that the primary obstacle to a foreign company entering the U.S. market is the increased disclosure costs that accompany the need to reconcile their financial statements to U.S. generally accepted accounting principles . . .”).

14. See generally INTERNATIONAL CAPITAL MARKETS IN A WORLD OF ACCOUNTING DIFFERENCES, *supra* note 13.

body and often unique in substance, known as a local GAAP system.¹⁵ Many other countries have adopted the International Financial Reporting Standards (“IFRS”) as the official domestic accounting practice. IFRS is a system of financial reporting developed by the International Accounting Standards Board (“IASB”),¹⁶ a private and independent international standard-setting body comprised of representatives from several different countries.¹⁷

Since its origination in 1973, IFRS has spread with considerable popularity. In 2005 the European Union adopted it with a few minor variations,¹⁸ marking a major milestone in the move toward global uniform accounting standards. Other major securities markets including Hong Kong, Australia, New Zealand, Singapore, and the Philippines have since followed suit,¹⁹ and there are currently over 100 IFRS-based countries.²⁰

The future of IFRS in the United States is still uncertain. The SEC currently permits foreign countries to compile financial reports in accordance with IFRS without reconciling them to U.S. GAAP.²¹ The question is whether the SEC will either permit or require U.S. companies to use IFRS in lieu of U.S. GAAP.²²

In 2008, the SEC published its Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers,²³ a proposed time line for U.S. conversion from GAAP to IFRS. The report contemplates conversion by 2014, with a select category of companies eligible for IFRS by 2010.²⁴ Though the proposed roadmap for conversion is not binding, many commentators inside

15. Canada, Japan, and China also use local GAAP systems. See Ian Hague, *International Financial Reporting Standards*, J. BUS. VALUATION, Feb. 2009, at 1, 2.

16. Until 2001, the IASB was known as the International Accounting Standards Committee (“IASC”). See Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Securities Act Release No. 8818, Exchange Act Release No. 55,998, 90 SEC Docket 2694 (July 2, 2007).

17. According to the IASB Constitution, “The governance of the [IASB] shall rest with the [Board of] Trustees . . .” INT’L ACCOUNTING STANDARDS COMM. FOUND. CONST. pt. A, cl. 3 (rev. 2009). There must be six trustees appointed from the Asia/Oceania region, six trustees appointed from Europe, six trustees appointed from North America, and four trustees appointed from any area, subject to the requirement of overall geographic balance. *Id.* at pt. A, cl. 6.

18. Richard Fleck & Kathryn Cearn, *Developments in International Accounting Standards*, 42 INT’L LAW. 501, 502 & n.10 (2008).

19. Stuart H. Deming, *International Accounting Standards*, 40 INT’L LAW. 363, 365 (2006).

20. Robert N. Rapp & Eric S. Zell, *On the Road to IFRS in the United States*, BANKING & FIN. SERVICES POL’Y REP., Feb. 2009, at 1, 1. Several countries still using local GAAP systems have implemented plans to convert to IFRS in the near future. Canada, Japan, and China, for example, all expect to operate under IFRS by 2011. *Id.*

21. See SCOTT, *supra* note 12, at 98–99.

22. See *id.* at 99–100.

23. IFRS Roadmap, *supra* note 11.

24. See *id.* at 4.

and outside of the accounting profession nevertheless believe that conversion is a matter of when and not if.²⁵

Numerous countervailing considerations inform the debate surrounding the prudence of conversion. IFRS advocates continue to rely on the age-old comparability justification for support.²⁶ IFRS opponents, on the other hand, identify several potential problems. They argue:

[M]andatory [implementation of IFRS by U.S. issuers] will result in a high risk that users of financial information will be confused and thus lack confidence in the information; companies will not have the expertise to implement an entirely new set of rules; auditors will struggle to accept conflicting policies that companies within the same industry may adopt; and finally, and most importantly, companies will incur significant costs in implementing the rules with little or no tangible benefit at a time when the economy is very weak.²⁷

IFRS opponents also cite the difficulty of reorganizing accounting-education curriculum²⁸ and the susceptibility of the IASB to political pressure.²⁹

What the pundits of conversion have not considered is the impact that the substantive differences between GAAP and IFRS will have on the functioning of the securities antifraud regime in the United States. Given that former SEC Commissioner Christopher Cox has emphasized that the interests of investors will drive the decision to adopt IFRS in the United States,³⁰ and that the securities antifraud regime is perhaps the most potent investor-protection vehicle in the United States, it is surprising that the implications of IFRS on the domestic securities antifraud regime have largely been overlooked.³¹ The various aspects of U.S. securities regulation are inextricably interrelated. A change in the rules governing financial

25. *E.g.*, Rapp & Zell, *supra* note 20, at 1 (“[T]he move to IFRS has been widely described as inevitable . . .”); Am. Inst. of Certified Pub. Accountants, International Financial Reporting Standards Frequently Asked Questions, http://www.ifrs.com/ifrs_faqs.html#q4 (last visited Aug. 25, 2009) (“Many people believe that acceptance of IFRS in the United States by the SEC for public companies are [sic] inevitable.”).

26. *See, e.g.*, IFRS Roadmap, *supra* note 11 (“With a single set of accounting standards, investors can more easily compare information and will be in a better position to make informed investment decisions.”).

27. Letter from Carl T. Berquist, Executive Vice President of Marriott Int’l, Inc., to Florence E. Harmon, Acting Sec’y of the SEC, at 1 (Feb. 2, 2009), *available at* <http://www.sec.gov/comments/s7-27-08/s72708-36.pdf>.

28. *See id.*

29. *See* Letter from Sharon Sabba Fierstein, President of the N.Y. State Soc’y of Certified Pub. Accountants, to Elizabeth M. Murphy, Sec’y of the SEC, at 3 (March 5, 2009) *available at* <http://www.nyscpa.org/commentletter/sec09.pdf> (“Questions about IASB’s ability to weather political pressures raise serious doubts about its ability to issue high quality standards.”).

30. Rapp & Zell, *supra* note 20, at 2.

31. This Note does not take a position on whether the current level of investor protection, as reflected by the various antifraud securities laws, is appropriate. It merely takes the antifraud regime as Congress and the SEC have designed it, and argues that IFRS jeopardizes the status quo. Nor does this Note take a position on whether IFRS will either encourage or discourage fraudulent reporting by companies. *See infra* notes 159–162 and accompanying text.

disclosure cannot be considered in isolation of the effects it might have on the functioning of the antifraud provisions. This Note argues that the principles-based approach of IFRS, which provides companies with increased flexibility in financial reporting, will threaten the current level of success enjoyed by plaintiffs bringing claims under the various federal securities antifraud laws. Part I explains the role that GAAP violations have traditionally played in securities-fraud cases under U.S. law. Part II articulates some of the important differences between IFRS and GAAP and places special emphasis on the flexibility in financial reporting allowed under the former as compared to the latter. Part III argues that the flexibility of IFRS will diminish the ability of shareholders and the SEC to rely on accounting violations to establish the elements of securities-fraud claims, particularly the existence of a misstatement and scienter.

I. THE ROLE OF GAAP VIOLATIONS IN SECURITIES-FRAUD CASES

This Part explains the role that GAAP violations have traditionally played in securities-fraud cases. Section I.A provides a brief introduction to the antifraud framework in the United States. Section I.B shows that GAAP violations have frequently been used to prove the existence of a misstatement, one element required in securities-fraud cases, and scienter, another oft-required element.

A. *The U.S. Securities Antifraud Regime*

The U.S. securities-law framework is among the most comprehensive and investor friendly in the world.³² Investor protection has always been the primary motivation behind government regulation of securities transactions,³³ and Congress has passed many acts that seek to accomplish this goal in various ways.³⁴ But when it comes to protecting investors from corporate fraud and deception, the Securities Act of 1933³⁵ (“Securities Act”) and the Securities Exchange Act of 1934³⁶ (“Exchange Act”) do most of the heavy lifting. Four provisions in particular provide shareholders and the SEC with

32. See SCOTT, *supra* note 12, at 39 (“The prospect of incurring liability [for securities fraud] hangs over the U.S. capital market . . . [I]t deters foreign companies from issuing and listing securities in the United States, and . . . it has encouraged the expansion of private markets, with less liability than public markets.”).

33. CHOI & PRITCHARD, *supra* note 5, at 1.

34. Generally speaking, seven federal statutes govern the distribution of U.S. securities: the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Advisers Act of 1940, the Investment Company Act of 1940, and the Sarbanes-Oxley Act of 2002. SCOTT, *supra* note 12, at 26. These acts protect investors by discouraging fraud, forcing companies to keep accurate books and records, requiring companies to make certain disclosures, and prohibiting companies from prematurely hyping public securities distributions, among others.

35. 15 U.S.C. §§ 77a–77aa (2006).

36. *Id.* §§ 78a–78lll.

the weaponry needed to combat corporate fraud: Sections 11,³⁷ 12,³⁸ and 17³⁹ of the Securities Act and Section 10 of the Exchange Act⁴⁰ (and rule 10b-5 promulgated thereunder).⁴¹

Section 11 of the Securities Act creates a civil cause of action for misstatements and omissions in a registration statement filed with the SEC pursuant to a public offering.⁴² The information that a company is required to include in a registration statement depends in large part on the size of the company,⁴³ but in all cases companies are required to disclose a minimum amount of transaction-related information, information pertaining to exhibits and undertakings, and company information, including financial information.⁴⁴ According to Section 11, if, on the date the SEC declares the registration statement effective, it contains “an untrue statement of a material fact or omit[s] to state a material fact required . . . to make the statements therein not misleading, any person acquiring such security” is entitled to bring suit against any number of an enumerated list of statutory defendants.⁴⁵ To prevail on a Section 11 claim, a plaintiff must prove only that the registration statement contained a misstatement or omission, and that the misstatement or omission was material, meaning a reasonable investor would view it as significant given the “total mix” of information available.⁴⁶

37. *Id.* § 77k.

38. *Id.* § 77l.

39. *Id.* § 77q.

40. *Id.* § 78j(b).

41. See Kun Young Chang, *Multinational Enforcement of U.S. Securities Laws: The Need for the Clear and Restrained Scope of Extraterritorial Subject Matter Jurisdiction*, 9 FORDHAM J. CORP. & FIN. L. 89, 92–93 (2003); see also Gary M. Brown, *Exemptions from Registration Under the Securities Act of 1933*, in UNDERSTANDING THE SECURITIES LAWS 2007, at 193, 195 (PLI Corp. Law & Practice, Course Handbook Series No. B-1618, 2007); Mark D. Wood, *Liability for Securities Law Violations*, in UNDERSTANDING THE SECURITIES LAWS 2008, at 771, 773 (PLI Corp. Law & Practice, Course Handbook Series No. B-1690, 2008). Several other provisions seek to discourage fraud, either directly or indirectly. For example, Section 13(b)(2)(A) of the Securities Exchange Act requires that companies “make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.” 15 U.S.C. § 78m. Further, Section 302 of the Sarbanes-Oxley Act requires that the chief executive officer and chief financial officer personally certify that reports filed with the SEC, among other things, “fairly present in all material respects” the company’s results and financial position. *Id.* § 7241(a)(3). Provisions such as these, however, are supplemental to, and often overlap with, the core antifraud provisions. See CHOI & PRITCHARD, *supra* note 5, at 174. (“The specter of antifraud liability is bolstered by numerous other mechanisms that encourage accurate disclosures [such as Section 13(b)(2)(A)].”).

42. 15 U.S.C. § 77k.

43. See CHOI & PRITCHARD, *supra* note 5, at 426–27 (describing the two basic forms for the registration statement available to domestic companies engaged in a public offering).

44. *Id.*; see also 15 U.S.C. § 77g (describing information required in registration statements). Form S-3 issuers may incorporate company information by reference to past and future SEC filings. CHOI & PRITCHARD, *supra* note 5, at 427.

45. 15 U.S.C. § 77k.

46. CHOI & PRITCHARD, *supra* note 5, at 503. Section 11 defendants are entitled to assert a number of possible defenses, the most important of which is the due-diligence defense contained in Section 11(b)(3). *Id.* at 505–06.

Section 12(a)(2) creates a civil cause of action for misstatements and omissions contained in a prospectus.⁴⁷ In *Gustafson v. Alloyd Co.*,⁴⁸ the Supreme Court held that, as contemplated by Section 12(a)(2), the term prospectus refers to a document that “describes a public offering of securities by an issuer or controlling shareholder” and that is “held out to the public.”⁴⁹ Though the scope of the *Gustafson* definition of prospectus is not entirely clear, it undoubtedly encompasses the final statutory prospectus required by 10(a) of the Securities Act.⁵⁰ According to Section 10(a), the final statutory prospectus must contain substantially the same “information contained in the registration statement,” with a few acceptable omissions.⁵¹ Thus, a prospectus will also often include a minimum amount of transaction-related information, information pertaining to exhibits and undertakings, and company information, including financial information. Under 12(a)(2), “[a]ny person who . . . offers or sells a security . . . by means of a prospectus . . . which includes an untrue statement of a material fact . . . shall be liable . . . to the person purchasing such security from him.”⁵² A Section 12(a)(2) plaintiff must prove the existence of a misstatement or omission, that the misstatement or omission was material, and that there is some causal connection between the prospectus and the decision to buy the securities.⁵³

Section 17(a) of the Securities Act contains three general antifraud provisions. It authorizes suit against a seller of a security who has (1) employed a device, scheme, or artifice to defraud, (2) obtained money or property by means of material misstatements or omissions, or (3) engaged in a course of business that operated as fraud upon the purchaser.⁵⁴ Though the Supreme Court has never addressed the issue, most circuit courts agree that no private right of action exists under Section 17(a).⁵⁵ For this reason, it has been most valuable in civil actions brought by the SEC and in criminal actions brought by the Justice Department.⁵⁶ Regardless of whether the action is brought under 17(a)(1), (2), or (3), the SEC or the Justice Department needs to prove

47. 15 U.S.C. § 771.

48. 513 U.S. 561 (1995).

49. *Id.* at 584.

50. The final statutory prospectus is the prospectus that must accompany every sale of a security under Section 5(b)(2) of the Securities Act. 15 U.S.C. § 77e(b)(2).

51. *Id.* § 77j(a)(1).

52. *Id.* § 77l(a).

53. See CHOI & PRITCHARD, *supra* note 5, at 562. Courts have allowed plaintiffs to satisfy the final requirement by showing only that the prospectus was broadly disseminated to the public and that it likely influenced the market price. *E.g.*, *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225–27 (7th Cir. 1980).

54. 15 U.S.C. § 77q(a).

55. Paul Vizcarrondo, Jr. & Andrew C. Houston, *Liabilities Under Sections 11, 12, 15 and 17 of the Securities Act of 1933 and Sections 10, 18, and 20 of the Securities Exchange Act of 1934*, in UNDERSTANDING THE SECURITIES LAWS 2006, at 537, 575 (PLI Corp. Law & Practice, Course Handbook Series No. B-1556, 2006).

56. *Id.*

the existence of a misstatement,⁵⁷ and that the misstatement was material.⁵⁸ If the action is brought under 17(a)(1), the SEC or Justice Department needs to prove scienter,⁵⁹ but if the action is brought under 17(a)(2) or (3) a showing of simple negligence will suffice.⁶⁰

Rule 10b-5, promulgated under Section 10(b) of the Exchange Act, authorizes suit against a buyer or seller of a security who has (1) employed a device, scheme, or artifice to defraud, (2) made an untrue statement of material fact or omitted to state a material fact necessary to make the statements made not misleading, or (3) engaged in a course of business that operated as fraud upon any person.⁶¹ Rule 10b-5 is textually similar to Section 17(a) of the Securities Act in many respects. In fact, the SEC used Section 17(a) as guidance when it drafted Rule 10b-5.⁶² There are, however, important differences between the two. Notably, 10b-5 authorizes suit against the buyer of a security while Section 17 does not.⁶³ Further, while many circuits foreclose a private shareholder from bringing suit under Section 17, all courts agree that a violation of 10b-5 gives rise to a private right of action.⁶⁴ Finally, while a showing of scienter is required only in an action under Section 17(a)(1), it is required in all actions brought under Rule 10b-5.⁶⁵ In addition to scienter, all plaintiffs bringing a rule 10b-5 cause of action must prove the existence of a misstatement,⁶⁶ that the misstatement was material,⁶⁷ and that the fraud was perpetrated “in connection” with the

57. The term “misstatement” as contemplated here includes “devices” to defraud and “courses of business” to defraud. *See id.* at 578 (“[C]ourts have recognized that virtually any action against a seller that can be brought under . . . § 17(a)(1) can also be brought under § 17(a)(2) or (3), since virtually any ‘device . . . to defraud’ that violates the former provisions will ‘operate as a fraud’ in violation of § 17(a)(3) or involve obtaining money or property by means of misstatements or omissions in violation of § 17(a)(2).”).

58. *Id.* at 575. In the few circuits that permit a private cause of action under 17(a), a private plaintiff must also show reliance and loss causation as well. *See id.* at 579–80.

59. *Aaron v. SEC*, 446 U.S. 680, 701–02 (1980).

60. GARY M. BROWN, *SODERQUIST ON THE SECURITIES LAWS* § 8:3.4 (5th ed. 2006).

61. 17 C.F.R. § 240.10b–5 (2009).

62. *See BROWN, supra* note 60, § 8:3.4, at 8–27.

63. *See Vizcarrondo & Houston, supra* note 55, at 537–39.

64. *E.g.*, *CHOI & PRITCHARD, supra* note 5, at 241 (“[T]he private cause of action under Rule 10b-5 is judicially implied . . .”). Rule 10b-5 is the most widely used securities antifraud provision available, largely because it provides for a private right of action. *E.g.*, Lewis D. Lowenfels & Alan R. Bromberg, *SEC Rule 10b-5 and Its New Statute of Limitations: The Circuits Defy the Supreme Court*, 51 *BUS. LAW.* 309, 310 (1996). Also contributing to the frequency with which plaintiffs bring 10b-5 cases is that under 10b-5 plaintiffs can sue for misstatements made in any context, unlike under Sections 11 and 12(a)(2) of the Securities Act, which require the misstatement to arise in a registration statement and a prospectus, respectively.

65. *CHOI & PRITCHARD, supra* note 5, at 271.

66. *Id.* at 271–72.

67. *Id.* at 271.

purchase or sale of securities.⁶⁸ Private litigants, but not the SEC, must also prove reliance⁶⁹ and loss causation.⁷⁰

B. GAAP Violations as Probative of the Elements of Securities Antifraud Causes of Action

Companies are required to provide financial information to investors when they file registration statements and annual and quarterly filings with the SEC and issue statutory prospectuses, and companies voluntarily disclose financial information in a variety of other circumstances.⁷¹ In all cases, companies must prepare financial information in accordance with GAAP, or in the manner that is most directly comparable to GAAP.⁷² Though the failure to follow GAAP is, by itself, insufficient to support a securities-fraud claim,⁷³ evidence that a company has committed a GAAP violation is probative of the elements of securities antifraud causes of action, most notably the elements of misstatement and scienter.⁷⁴

1. Existence of a Misstatement

Sections 11, 12, and 17 of the Securities Act and Rule 10b-5 of the Exchange Act all require the plaintiff to identify a misstatement as a prerequisite to bringing suit.⁷⁵ The term misstatement is broad enough to encompass a wide range of activity that misleads the reasonable investor,⁷⁶ and since materiality is a separate inquiry,⁷⁷ the extent of the misrepresenta-

68. *Id.* at 248.

69. *Id.* at 305.

70. *Id.* at 315.

71. Examples include press releases, public announcements, and pro forma financials. Some commentators believe that the informal disclosure process has become the preferred way of communicating with the market. J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE*, at xxvii (3d ed. Supp. 2007).

72. See ROBERT N. ANTHONY & JAMES S. REECE, *ACCOUNTING PRINCIPLES* 16 (6th ed. 1989) (“The SEC requires [public] companies to file accounting reports prepared in accordance with GAAP.”). Regulation G, adopted by the SEC pursuant to the Sarbanes-Oxley Act, says that if a company voluntarily discloses material financial information, the company must also disclose “a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure.” CHOI & PRITCHARD, *supra* note 5, at 173.

73. *E.g.*, *Zaluski v. United Am. Healthcare Corp.*, 527 F.3d 564, 576 (6th Cir. 2008); *SEC v. Seghers*, 298 F. App’x 319, 331 (5th Cir. 2008).

74. See 3 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD* § 6:54.10 (2d ed. 2009) (noting that claims of GAAP violation can add support to allegations that financial representations are false and made with scienter).

75. See *supra* Section I.A.

76. 5C ARNOLD S. JACOBS, *DISCLOSURE & REMEDIES UNDER THE SECURITIES LAWS* § 12:2 (2001) (identifying eleven specific “duties” that flow from the general duty to avoid misrepresentations).

77. *Id.* § 12:5.

tion is irrelevant to the determination of whether a misrepresentation exists. A GAAP violation normally produces a misstatement for purposes of the securities antifraud causes of action.⁷⁸ In fact, the SEC presumes that a financial statement that does not comply with GAAP is misleading.⁷⁹ Financial statements containing inaccurate figures are most certainly misleading,⁸⁰ but so are transactions inaccurately reported. For example, courts have found financial statements misleading when earnings are manipulated through improper deferral techniques, debt of consolidated subsidiaries is omitted from a consolidated balance sheet, shipping costs are included in overhead rather than in operating expenses, earnings per share are stated without noting the dilution of residual securities, and in many other situations involving violations of GAAP.⁸¹

Not only are most GAAP violations also misstatements, but a large number of misstatements that give rise to fraud actions under the securities laws are GAAP violations. A study conducted by Cornerstone Research⁸² found that forty-four percent of securities-fraud complaints filed in 2008 alleged GAAP violations.⁸³

2. *Scienter*

Though negligent misrepresentations can give rise to liability under Sections 11, 12(a)(2), 17(a)(2), and 17(a)(3) of the Securities Act, a plaintiff must prove that the defendant acted with scienter to prevail under Section 17(a)(1) of the Securities Act and Rule 10b-5.⁸⁴ The Supreme Court has defined scienter as intent to defraud, but it has suggested that recklessness may be sufficient to satisfy the scienter requirement as well.⁸⁵ The current relationship between scienter and GAAP violations can be considered only in light of the requirements of the Private Securities Litigation Reform Act of 1995 (“PSLRA”)⁸⁶ which dictates the standard under which scienter allegations are scrutinized at the pleadings stage.

78. BROMBERG & LOWENFELS, *supra* note 74, § 6:54.120; JACOBS, *supra* note 76, § 12:23.

79. 17 C.F.R. § 210.4-01(a)(1) (2009).

80. JACOBS, *supra* note 76, § 12:23.

81. *Id.*

82. Cornerstone Research provides consulting and informational services to attorneys engaged in a wide variety of cases involving numerous industries. Cornerstone Research, <http://www.cornerstone.com> (follow “Practices” hyperlink) (last visited Aug. 25, 2009).

83. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2008: A YEAR IN REVIEW 21 (2009), <http://securities.cornerstone.com/pdfs/YIR2008.pdf>.

84. *See supra* Section I.A.

85. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

86. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

Congress enacted the PSLRA in 1995 as a means of discouraging meritless and abusive securities litigation.⁸⁷ Among other protective measures, the PSLRA requires plaintiffs to plead with particularity the facts evidencing scienter.⁸⁸ A complaint satisfies this requirement only if the stated facts “giv[e] rise to a strong inference that the defendant acted with the required state of mind.”⁸⁹ Characterized in this manner, essentially as a look into the defendant’s mind, scienter is inherently difficult to prove. Courts have, however, identified several “red flags” that may provide the “strong inference” necessary to satisfy the requirements of the PSLRA. Scienter may exist, for example, when an insider trades at a suspicious time or in an unusual amount, there is a divergence between internal reports and external statements on the same subject, an allegedly fraudulent statement is followed immediately by the disclosure of inconsistent information, the defendants have an interest in saving their jobs or salaries, or the most current factual information is disregarded before the allegedly fraudulent statements are made.⁹⁰

Allegations of garden-variety GAAP violations, standing alone, do not give rise to the “strong inference” of scienter necessary to satisfy the PSLRA.⁹¹ GAAP violations are, however, highly probative of scienter.⁹² Such a conclusion is logically sound. One commentator notes:

GAAP violation is supportive [of scienter] insofar as GAAP are a somewhat coherent and comprehensive and reasonably accessible scheme. They are professional standards with which accountants are supposed to be familiar. Licensing and continuing education requirements support that supposition. So do annual or more frequent requirements to certify con-

87. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) (“As a check against abusive litigation by private parties, Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA).”).

88. 15 U.S.C. § 78u-4(b)(1) (2006).

89. *Id.* § 78u-4(b)(2).

90. *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683–84 (6th Cir. 2005).

91. *E.g.*, *W. Pa. Elec. Employees Benefits Funds v. Ceridian Corp.* (*In re Ceridian Corp. Sec. Litig.*), 542 F.3d 240, 246 (8th Cir. 2008); *Central Laborers’ Pension Fund v. Integrated Elec. Servs, Inc.*, 497 F.3d 546, 552 (5th Cir. 2007); *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 432 (5th Cir. 2002); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999); Jonathan C. Dickey & Shoshanah V. Asnis, *Securities Litigation Update*, in AM. LAW INST.-AM. BAR ASS’N COMM. ON CONTINUING PROF’L EDUC., CURRENT DEVELOPMENTS IN FEDERAL SECURITIES LAW: ALI-ABA COURSE OF STUDY MATERIALS, at 505, 513 (2003) (“There is an emerging consensus among the courts that the mere allegation that an issuer violated generally accepted accounting principles (‘GAAP’), standing alone, is insufficient to meet the PSLRA’s scienter requirement.”).

92. *E.g.*, *In re MicroStrategy, Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 635–40 (E.D. Va. 2000) (“[W]hile it is true that it cannot be *strongly* inferred from bare allegations of a GAAP violation or a restatement of financials that a defendant acted recklessly, consciously, or intentionally, it is not true that *nothing* can be inferred from those facts at all”); *In re Triton Energy, Ltd. Sec. Litig.*, No. 5:98-CV-256, 2001 U.S. Dist. LEXIS 5920, at *33–34 (E.D. Tex. Mar. 30, 2001) (rejecting notion that GAAP violations are not probative of scienter).

formity with GAAP. Consequently, GAAP violations are more likely to be intentional than accidental.⁹³

Or, as one court put it, the “books do not cook themselves.”⁹⁴ Courts are more willing to defer to GAAP violations when they are accompanied by other evidence of scienter.⁹⁵ Many courts have held, however, that the requisite “other evidence” of scienter can derive from the nature of the GAAP violation itself.⁹⁶ Thus, despite the widely accepted mantra that evidence of GAAP violations alone is insufficient to establish scienter, violations that are particularly pervasive⁹⁷ or significant in magnitude⁹⁸ may be sufficient in themselves to sustain the scienter requirement under Section 17(a)(1) and Rule 10b-5.

93. BROMBERG & LOWENFELS, *supra* note 74, § 6:54.10; *see also In re MicroStrategy*, 115 F. Supp. 2d at 638 (“The inference invited by the large magnitude of the misstated financials and the repetitiveness of the GAAP violations takes on added significance if, as the Complaint alleges, the violated GAAP rules and Company accounting policies are, in fact, relatively simple. This is so because violations of simple rules are obvious, and an inference of scienter becomes more probable as the violations become more obvious.”); *In re Gilat Satellite Networks, Ltd.*, No. CV-02-1510 (CPS), 2005 WL 2277476, at *20 (E.D.N.Y. Sept. 19, 2005) (“GAAP violations that involve the premature recognition of revenue have been said to suggest a conscious choice to recognize revenue in a manner improper, and may therefore support a stronger inference of scienter.”) (internal quotation marks and citation omitted).

94. *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1273 (N.D. Cal. 2000).

95. *E.g.*, *City of Westland Police & Fire Ret. Sys. v. Sonic Solutions*, No. C 07-05111 CW, 2009 WL 942182, at *6 (N.D. Cal. Apr. 6, 2009) (“Though the magnitude of Defendants’ accounting violation alone does not demonstrate scienter, together with other allegations, it could amount to the requisite mental state.”).

96. *In re Microstrategy*, 115 F. Supp. 2d at 635 (“The mere fact that there was a restatement or violation of GAAP, by itself, cannot give rise to a strong inference of scienter; the nature of such a restatement or violation, however, may ultimately do so.”); *e.g.*, *Magruder v. Halliburton Co.*, No. 3:05-CV-1156-M, 2009 WL 854656, at *9 (N.D. Tex. Mar. 31, 2009) (“[E]ven though GAAP violations alone are insufficient to establish scienter, when the number, size, timing, nature, frequency, and context of the misapplication of accounting principles or restatement are taken into account, the balance of the inferences to be drawn from such allegations may shift significantly in favor of scienter.”) (internal quotation marks and citation omitted).

97. *In re Gilat*, 2005 WL 2277476, at *20 (“Repeated and pervasive GAAP violations may be sufficient to establish the requisite inference.”).

98. *In re PEC Solutions, Inc. Sec. Litig.*, 418 F.3d 379, 389 (4th Cir. 2005) (“[I]t is certainly possible that some egregious GAAP violations may support an inference of scienter for pleadings purposes.”); *In re UTStarcom, Inc. Sec. Litig.*, 617 F. Supp. 2d 964, 975 (N.D. Cal. 2009) (“[T]he magnitude and extent of the [GAAP violations] gives [sic] rise to at least an equally strong inference of scienter.”); *Chalverus v. Pegasystems, Inc.*, 59 F. Supp. 2d 226, 234 (D. Mass. 1999) (“Courts have held that significant overstatements of revenue tend to support the conclusion that the defendants acted with scienter.”) (internal quotation marks omitted); Sherrie R. Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff’s Perspective*, in SECURITIES LITIGATION AND ENFORCEMENT INSTITUTE 2006, at 35, 88 (PLI Corp. Law & Practice, Course Handbook Series No. B-1557, 2006) (“Many courts have held that the sheer magnitude of GAAP violations, overstatements, or write-offs are [sic] a sufficient ‘red flag’ to support a strong inference of scienter.”). *But see In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 155 (D. Mass. 2001) (“The magnitude of the misstatement, combined with the internal documents . . . at most supports a garden-variety inference of recklessness or a strong inference of negligence—but that is not enough.”); *In re SCB Computer Tech., Inc. Sec. Litig.*, 149 F. Supp. 2d 334, 359 (W.D. Tenn. 2001) (declining to follow cases holding “that the magnitude or obviousness of accounting errors alone can support a strong inference” of scienter).

Thus, GAAP violations are probative of two of the elements of the securities antifraud causes of action, the existence of a misstatement and scienter. If GAAP and IFRS were identical in all material respects, a U.S. conversion to the latter would have no significant effect on the functioning of the securities antifraud regime. As Part II explains, however, this is not the case.

II. THE DIFFERENCES BETWEEN GAAP AND IFRS

This Part highlights the significant differences in the accounting rules under IFRS as compared to the accounting rules under GAAP. Section II.A discusses the broad conceptual difference between IFRS and GAAP, namely, that the former is “principles based” while the latter is “rules based.” Section II.B delves into a smattering of specific differences between the two accounting systems. It gives particular attention to the accounting treatments where the differences are the most profound and the issues appear most frequently in securities-fraud cases.

A. “Rules Based” vs. “Principles Based”

Regardless of the industry subject to regulation,⁹⁹ regulators need to decide between implementing a rules-based system or a principles-based system.¹⁰⁰ Generally speaking, rules provide detailed guidance on how an entity should behave.¹⁰¹ They decline to inquire into the substance of a specific situation and opt instead to focus on the form.¹⁰² Under a rules-based system, a predetermined legal result flows from the existence of certain particularized facts.¹⁰³ A parent who tells his child to be home at

99. The debate between rules and principles arises in many different industries. *See generally* Daniel Bodansky, *Rules vs. Standards in International Environmental Law*, 98 AM. SOC'Y INT'L L. PROC. 275 (2004) (regulation of environmental law); John Braithwaite & Valerie Braithwaite, *The Politics of Legalism: Rules versus Standards in Nursing Home Regulation*, 4 SOC. & LEGAL STUD. 307 (1995) (regulation of nursing homes); Daniel A. Crane, *Rules Versus Standards in Antitrust Adjudication*, 64 WASH. & LEE L. REV. 49 (2007) (regulation of antitrust law); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (discussing the decision between rules and standards generally); Sumit K. Majumdar & Alfred A. Marcus, Research Note, *Rules versus Discretion: The Productivity Consequences of Flexible Regulation*, 44 ACAD. MGMT. J. 170 (2001) (the regulation of electric utility companies).

100. Note, however, that the dichotomy between rules and standards is not strict. Regulations can occupy every inch of the vast middle ground between the two. *See, e.g.*, Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 30 (2000) (“The legal forms of rules and standards, then, are better understood as spanning a spectrum rather than as being dichotomous variables.”).

101. Jim Psaros & Ken T. Trotman, *The Impact of the Type of Accounting Standards on Preparers' Judgments*, 40 ABACUS 76, 76 (2004) (“Some accounting standards are very specific in their wording and very direct in their requirements of account preparers . . .”).

102. William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents*, 48 VILL. L. REV. 1023, 1037 (2003) (“[R]ule-based systems tend toward formalism, with the statement of the rule dominating over both the purpose at hand and the particulars of a given case.”).

103. Korobkin, *supra* note 100, at 23.

midnight sharp, but then provides a list of fifteen specific contingencies that will justify a late arrival, is a parent who governs his household under a rules-based regime.¹⁰⁴

Conversely, principles provide an entity with a broadly stated directive,¹⁰⁵ but allow the entity flexibility in choosing a course of conduct.¹⁰⁶ The regulator will then scrutinize the substance of the entity's activity to determine if it comports with the spirit of the objective embodied by the principle.¹⁰⁷ So characterized, principles often require an ex post determination of compliance.¹⁰⁸ A parent who tells his child to be home at a reasonable hour, and then determines reasonableness by taking into account the weather, the age of the child, and the next day's activities, governs his household under a principles-based regime.¹⁰⁹

Accountants consider GAAP a rules-based system and IFRS a principles-based system.¹¹⁰ IFRS consistently incorporates the concept of reasonableness,¹¹¹ while GAAP provides accountants with a much more particularized and thorough set of requirements.¹¹² As one prominent accounting firm has noted, the goal of GAAP is accordance with GAAP,

104. Lawrence M. Gill, *IFRS: Coming to America*, J. ACCT., June 2007, at 70, 71.

105. Psaros & Trotman, *supra* note 101, at 76 (“[Some accounting] standards are more general in their wording and guidance to users . . .”); Alix Nyberg Stuart, *Standing on Principles: In a world with more regulation than ever, can the accounting rulebook be thrown away?*, CFO MAG., Sept. 1, 2006, at 45, 49, available at <http://www.cfo.com/article.cfm/7852613> (“[P]rinciples offer only ‘a modicum’ of implementation guidance and few scope exceptions or bright-lines.”).

106. E.g., Robert Hall, *The Difference Between Principles and Rules*, ABA BANK MKTG., June 2002, at 11, 11 (“[Principles] leave latitude for how [a desired] outcome might be reached . . .”).

107. Korobkin, *supra* note 100, at 23 (“Standards, in contrast, require legal decision makers to apply a background principle or set of principles to a particularized set of facts in order to reach a legal conclusion.”).

108. See Kaplow, *supra* note 99, at 559–62.

109. Gill, *supra* note 104, at 70, 71.

110. GEORGE J. BENSTON ET AL., *WORLDWIDE FINANCIAL REPORTING* 214 (2006); Remi Forgeas, *Is IFRS That Different From U.S. GAAP?*, CPA INSIDER, June 16, 2006, available at <http://www.ifrs.com/overview/General/differences.html>. If, through case law or by other means, IFRS does in fact become much more detailed, then IFRS will become a rules-based system, the flexibility in financial reporting will be gone, and the problems caused by the flexibility in financial reporting identified in this Note will not be problems anymore. Though it is possible that IFRS may evolve into a rules-based system, it is impossible to predict the likelihood of this happening or how long it would take. Further, the SEC has not indicated that it will require such an evolution as a condition of acceptance in the United States. Thus, all along the SEC has contemplated adopting a flexible, principles-based system, a decision that would have significant implications on the domestic antifraud regime.

111. E.g., Paul Laska, *A Comparison: IFRS vs. US GAAP*, RELEVANTE NEWSLETTER (Relevante, Media, Pa.), Nov. 2007, at 1, http://www.relevante.com/images/audit_whitepapers/ifrs/nov07_ifrs_gaap.pdf (“[A]n IFRS guideline to the purchasing manager might be ‘pay a reasonable price for an appropriately sized computer.’ GAAP, on the other hand, would say something like ‘pay no more than \$1,000 for a computer.’”).

112. E.g., Bert J. Zarb, *The Quest for Transparency in Financial Reporting: Should International Financial Reporting Standards Replace U.S. GAAP?*, CPA J., Sept. 2006, at 30, 32 (“U.S. GAAP consists of a set of complex and detailed accounting rules that leave little room for individual judgment.”).

while the goal of IFRS is to give a “fair view” of a company’s financial position.¹¹³ The lack of guidance and emphasis on substance under IFRS commonly requires management to employ estimates, assumptions, and judgment calls in financial reporting.¹¹⁴

A crude, but perhaps the most effective, way to illustrate the broad conceptual difference between the two systems is to compare the sheer volume of GAAP and IFRS literature.¹¹⁵ Though new promulgations are issued on an ongoing basis, IFRS regulations, in their entirety, currently compose approximately 2000 pages of text.¹¹⁶ From all its sources, U.S. GAAP consists of 2000 separate pronouncements, many of which are several hundred pages long.¹¹⁷

B. *Specific Differences Between the Two Systems*

While a comprehensive line-by-line comparison of IFRS and GAAP is outside the scope of this Note, there are a few key differences that merit special attention. It is important to understand the differences between GAAP and IFRS with respect to revenue recognition, uncertain tax positions, and the consolidation of special purpose entities. These differences stand out because they are either particularly consequential or they play a uniquely significant role in securities-fraud cases.

1. *Revenue Recognition*

The accounting treatments addressing revenue recognition are particularly relevant in light of the frequency with which plaintiffs bring cases alleging improper revenue recognition. Over ten percent of all securities class actions brought in 2008 alleged that the defendant recognized revenue in violation of GAAP.¹¹⁸ Thus, the plaintiff’s bar is sure to take particular notice of any changes in the rules governing revenue recognition.

SEC Staff Accounting Bulletin No. 101 (“SAB 101”) is the first line of authority in determining whether revenue should be recognized under the GAAP system.¹¹⁹ According to SAB 101, revenue should be recognized

113. KPMG, IFRS COMPARED TO U.S. GAAP: AN OVERVIEW 8–9 (2008), available at [http://www.kpmgifrsinstitute.com/documents/IFRS/721200810043IFRS%20compared%20to%20U.S.%20GAAP%20An%20Overview%20\(2008\).pdf](http://www.kpmgifrsinstitute.com/documents/IFRS/721200810043IFRS%20compared%20to%20U.S.%20GAAP%20An%20Overview%20(2008).pdf).

114. Navin Agrawal, *The Impact of IFRS on Corporate Governance*, LIVEMINT.COM, Oct. 2, 2008, <http://www.livemint.com/2008/10/02001719/The-impact-of-IFRS-on-corporat.html?d=1>.

115. A comparison of GAAP and IFRS literature provides a sense of the differences in the detail and the extent of the regulatory coverage of the two systems.

116. Gill, *supra* note 104, at 71.

117. *Id.*

118. CORNERSTONE RESEARCH, *supra* note 83; see also Kathy S. Moffeit & A. Elaine Eikner, *Implementation of SAB 101*, CPA J., Jan. 2003 at 56, 56 (“The SEC has indicated that revenue recognition is the largest cause for financial statement restatements.”).

119. See SEC Staff Accounting Bulletin No. 101, 17 C.F.R. pt. 211 (1999), available at <http://www.sec.gov/interp/account/sab101.htm>.

when pervasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectability is reasonably assured.¹²⁰ But SAB 101 is just the starting point. There are at least fifteen other authoritative statements prescribing the proper treatment of revenue recognition in specific and nuanced contexts,¹²¹ and SAB 101 explicitly defers to them when they are applicable.¹²² For example, SAB 101 does not provide dispositive guidance on how to handle revenue recognition when the purchaser of a good has the right to return it. In such a situation, even if all the requirements of SAB 101 are met, the company may not recognize the revenue from the sale unless the requirements of Statement of Financial Accounting Standards No. 48 ("FAS 48") are met as well.¹²³ According to FAS 48, when a right of return exists, a seller may recognize the revenue from the sale of a product only if all of the following conditions are met:

- a) [t]he seller's price to the buyer is substantially fixed or determinable at the date of sale[;]
- b) [t]he buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product[;]
- c) [t]he buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product[;]
- d) [t]he buyer acquiring the product for resale has economic substance apart from that provided by the seller[;]
- e) [t]he seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer[;]
- [and] f) [t]he amount of future returns can be reasonably estimated.¹²⁴

To further deprive companies of discretion in determining if revenue should be recognized when a right of return exists, GAAP provides guidelines on guidelines. There is, for example, a four-factor test to help determine whether the amount of future returns can reasonably be estimated, the last of the core conditions of FAS 48.¹²⁵ The regulators have determined that the sale of products subject to a right of return is a subset of the broader revenue-recognition category that warrants special attention and regulation beyond that provided in FAS 48, and it is by no means the only one. The regulators have also provided special, and somewhat extensive,

120. *Id.*

121. *Id.*

122. *Id.* ("If a transaction is within the scope of specific authoritative literature that provides revenue recognition guidance, that literature should be applied.")

123. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 48: REVENUE RECOGNITION WHEN RIGHT OF RETURN EXISTS (1981).

124. *Id.* ¶ 6.

125. *Id.* ¶ 8 The following factors impair the ability to reasonably estimate future returns: "a) The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand[;] b) Relatively long periods in which a particular product may be returned[;] c) Absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers[;] [and] d) Absence of a large volume of relatively homogenous transactions." *Id.*

guidelines for companies that receive revenue pursuant to franchise fees,¹²⁶ software sales,¹²⁷ real estate sales,¹²⁸ and a host of other transactions in which either the nature of the revenue or the manner in which it is collected is deemed unique.¹²⁹

International Accounting Standard No. 18 (“IAS 18”) governs revenue recognition under IFRS.¹³⁰ According to IAS 18, a company should recognize revenue only when the seller has transferred the risks and rewards of ownership of the goods to the buyer, the seller surrenders control of the goods to the buyer, the amount of revenue can be reasonably measured, it is probable that the economic benefits associated with the transaction will flow to the seller, and the costs incurred by the seller by virtue of the transaction can be measured reliably.¹³¹ Besides the general pronouncement contained in IAS 18, however, IFRS provides very little microregulation of specific factual circumstances.¹³² There is, for example, no specific IFRS authority dictating when a company should recognize revenue after selling a product subject to a right of return. There are a few contexts in which IFRS supplements IAS 18 with additional guidance, such as revenue recognition for long-term construction contracts,¹³³ but in general IAS 18 typifies the principles-based approach of IFRS by giving companies only a broadly stated directive.

2. Uncertain Tax Positions

The treatment afforded to uncertain tax positions is another area in which GAAP and IFRS take dramatically different approaches. For a variety of reasons, companies often take aggressive tax positions, such as with respect to deductions, without knowing whether the position would ulti-

126. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 45: ACCOUNTING FOR FRANCHISE FEE REVENUE (1981).

127. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, STATEMENT OF POSITION NO. 97-2: SOFTWARE REVENUE RECOGNITION (1997).

128. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 66: ACCOUNTING FOR SALES OF REAL ESTATE (1982).

129. See e.g., SEC Staff Accounting Bulletin No. 101, *supra* note 119; see also FINAL REPORT OF THE ADVISORY COMM. ON IMPROVEMENTS TO FINANCIAL REPORTING TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 49 (2008) [hereinafter ADVISORY COMM. FINAL REPORT] (“[T]here is extensive revenue recognition guidance under U.S. GAAP spread across more than 140 pieces of literature, including specific guidance for software revenue and sales of real estate.”); BARRY J. EPSTEIN ET AL., WILEY GAAP: INTERPRETATION AND APPLICATION OF GAAP 1248 (2008) (noting that GAAP provides for “specific guidance on limited matters (e.g. software development, construction)”); Rapp & Zell, *supra* note 20, at 3 (“Revenue recognition under U.S. GAAP . . . is controlled by specific standards and rules that require industry-specific reporting practices.”).

130. INT’L ACCOUNTING STANDARD NO. 18: REVENUE (1993) [hereinafter IAS No. 18].

131. *Id.*

132. See ADVISORY COMM. FINAL REPORT, *supra* note 129, at 49 (“[A] single IFRS standard [IAS 18] provides general principles and illustrative examples to address virtually all revenue-generating activities”); Rapp & Zell, *supra* note 20, at 3 (“Revenue recognition under IFRS is based upon two broad standards and relatively few interpretations”).

133. INT’L ACCOUNTING STANDARD NO. 11: CONSTRUCTION CONTRACTS (1993).

mately be sustained in an Internal Revenue Service (“IRS”) audit.¹³⁴ Since financial reports are often issued, voluntarily or otherwise, prior to a final determination of the propriety of an uncertain tax position,¹³⁵ accounting regulations provide guidance as to whether, and to what extent, that position should appear on a financial report. Accounting for uncertain tax positions can significantly affect a company’s bottom line.¹³⁶

Financial Accounting Standards Board (“FASB”) Interpretation 48 (“FIN 48”) governs the manner in which uncertain tax positions must appear on a company’s financial reports. FIN 48 permits a company to recognize a financial benefit from an uncertain tax position only if “it is [more likely than not] that the position will be . . . sustained based on its technical merits.”¹³⁷ A position is “more likely than not” to be sustained if there is “more than a 50 percent likelihood that the position would be sustained if challenged and considered by the highest court in the relevant jurisdiction.”¹³⁸ To the extent possible, GAAP discourages management guesswork in the determination of whether an uncertain tax position is “more likely than not” to be sustained, and instead instructs companies to look to the “technical merits” of the position. Companies must objectively scrutinize the sustainability of the position by considering tax law, case law, rulings and regulations issued by taxing authorities, and informal interactions with taxing authorities.¹³⁹

134. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, PRACTICE GUIDE ON ACCOUNTING FOR UNCERTAIN TAX POSITIONS UNDER FIN 48, at 3 (2006), available at <http://tax.aicpa.org/NR/rdonlyres/8D2A444D-D158-4D5A-9F87-D8ED12A8A221/0/FIN48final.pdf> [hereinafter AICPA PRACTICE GUIDE].

135. See Teresa Iannaconi, *Accounting for Income Tax Uncertainties*, KPMG DEFINING ISSUES, July 2006, in CORPORATE GOVERNANCE 2007: COUNSELING YOUR CLIENT FOR THE 2007 PROXY SEASON, at 673, 675 (PLI Corp. Law & Practice, Course Handbook Series No. B-1581, 2007).

136. For example, in 2006 GlaxoSmithKline agreed to pay the IRS \$3.4 billion to settle a long-time dispute over Glaxo’s tax liability. Press Release, Internal Revenue Service, IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute (Sept. 11, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=162359,00.html>.

Glaxo violated the internal revenue code in taking the position it did, and uncertain tax position accounting rules govern whether those tax computation errors, if they appeared on financial statements, were also accounting violations.

137. AICPA PRACTICE GUIDE, *supra* note 134, at 4.

138. *Id.* If a portion of an uncertain tax position does not meet the more-likely-than-not threshold, then the portion that does may still be recognized. For example, if there is a 49 percent probability that a benefit of \$100 will be sustained, but that probability rises to 51 percent if the benefit is reduced to \$90, the company may recognize a \$90 tax benefit. See Iannaconi, *supra* note 135, at 677.

139. AICPA PRACTICE GUIDE, *supra* note 134, at 5; see also Iannaconi, *supra* note 135, at 676 (“A company’s position may be supported, in whole or in part, by unambiguous tax law, prior experience with the taxing authority, and analysis that considers all relevant facts, circumstances, and regulations, including widely understood administrative practices and precedents of the taxing authority.”).

IFRS currently does not explicitly address uncertain tax positions.¹⁴⁰ Thus, under the current IFRS regime, companies are free to adjust uncertain tax positions as they see fit, or even disregard the uncertainty of a tax position altogether, subject only to the broad constraints contained in various other IFRS provisions addressing income-tax reporting such as International Accounting Standards No. 12 (“IAS 12”).¹⁴¹

3. Consolidation of Special-Purpose Entities

A special-purpose entity (“SPE”), sometimes called a special-purpose vehicle, is an entity created and capitalized by a company to carry out a specific purpose or transaction.¹⁴² SPEs are commonly used only as a method of keeping debt off of the balance sheet of the sponsor company.¹⁴³ The GAAP treatment of SPEs rose to special prominence on the national and international stage after the collapse of Enron.¹⁴⁴ Embarrassed by the debacle, the regulators took to the task of tightening the rules governing when a company needs to consolidate the financial statements of SPEs with its own.¹⁴⁵

Statement of Financial Accounting Standards No. 140 (“FAS 140”) governs the consolidation of SPEs under GAAP.¹⁴⁶ According to that provision,

140. Sheryl Vander Baan, *Tax Issues Lurk in Conversion to IFRS*, CROWE TAX NOTES, March 2009, at 6, <http://www.crowehorwath.com/Crowe/Publications/generatePubPDF.cfm?id=2063> (“[N]o current IFRS guidance covers uncertain tax positions.”). The IASB is expected to address this omission, but the proposed regulation will likely bear little resemblance to FIN 48. *Id.* Instead, the IASB plans to adopt the approach of International Accounting Standard No. 37 (“IAS 37”), which applies to contingent assets and liabilities, in crafting the regulatory structure governing uncertain tax positions. *Id.* Applying IAS 37 to uncertain tax positions would result in a regime under which a putative tax benefit is always recognized, but the amount of recognition is adjusted for the uncertainty of the position taking into account the probability weighted average of all possible outcomes, as measured by management’s virtually unchecked expectations. KPMG TAX GOVERNANCE INST., IFRS: TAX CONSIDERATIONS WHEN CONVERTING FROM U.S. GAAP 4 (2008), <http://www.taxgovernanceinstitute.com/documents/TGI/1032008173555080636TGI%20IFRSTag.pdf>; Vander Baan, *supra*.

141. INT’L ACCOUNTING STANDARD NO. 12: INCOME TAXES (2000).

142. Jalal Soroosh & Jack T. Ciesielski, *Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R)*, CPA J., July 2004, at 30, 30.

143. *Id.*

144. The most visible of Enron’s many accounting violations appears to have been the failure to consolidate the financial statements of three SPEs with its own, a violation that, when discovered, led to a \$586 million reduction in reported earnings and the exposure of debt that had previously been hidden. William A. Niskanen, *Don’t Count Too Much on Financial Accounting*, in AFTER ENRON 47, 47–48 (William A. Niskanen ed., 2005).

145. SCOTT, *supra* note 12, at 453 (noting that the FASB issued FIN 46 in response to Enron); Soroosh & Ciesielski, *supra* note 142, at 33 (“As the Enron crisis brought attention to the use of SPEs, FASB responded by issuing a proposed interpretation of existing accounting principles aimed at putting many off-balance-sheet entities back onto the balance sheet of the companies that created them.”).

146. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140: ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES (2000) [hereinafter FAS 140]. The discussion of SPE consolidation in this section is extremely simplified. In addition to FAS 140 and FIN 46, the full GAAP

a company must consolidate the financials of an SPE unless all of the following conditions are met: (a) the assets transferred to the SPE have been isolated from the sponsor company, meaning they have been put beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership; (b) the SPE has the right to pledge or exchange the assets, and no condition constrains the SPE from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor; and (c) the transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the sponsor company to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets.¹⁴⁷ If, however, the SPE is classified as a variable-interest entity (“VIE”), consolidation is always required.¹⁴⁸ According to FASB Interpretation No. 46(R) (“FIN 46(R”),¹⁴⁹ a VIE is an SPE¹⁵⁰ that meets at least one of the following criteria: (1) The equity investors lack the direct or indirect ability through voting rights or similar rights to make decisions about the entity’s activities that have a significant effect on the success of the business; (2) The equity investors lack the obligation to absorb the expected losses of the entity; (3) The equity investors lack the right to receive the expected residual returns of the entity; (4) The total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders.¹⁵¹ For purposes of the last avenue to VIE status, an equity investment of less than ten percent is presumed insufficient to permit the entity to finance its own activities, although the existence of one of three enumerated conditions can rebut the presumption.¹⁵²

The IFRS rules governing the consolidation of SPEs are much less detailed than the GAAP rules, reflecting the principles-based approach of IFRS.¹⁵³ According to International Accounting Standard No. 27 (“IAS 27”),¹⁵⁴ a company must consolidate the financial information of an SPE into

treatment of SPE consolidation is governed by a combination of FSP FIN 46-3, FSP FIN 46-4, FSP FIN 46-6, and FSP FIN 46-7. Soroosh & Ciesielski, *supra* note 142, at 33.

147. FAS 140, *supra* note 146, ¶ 9.

148. Soroosh & Ciesielski, *supra* note 142, at 34.

149. FIN. ACCOUNTING STANDARDS BD., FASB INTERPRETATION NO. 46: CONSOLIDATION OF VARIABLE INTEREST ENTITIES (2003) [hereinafter FIN 46(R)].

150. Some VIEs are not SPEs. Soroosh & Ciesielski, *supra* note 142, at 33.

151. FIN 46(R), *supra* note 149, ¶ 5; Soroosh & Ciesielski, *supra* note 142, at 33–34.

152. The three conditions are the following: 1) “[t]he entity has demonstrated that it can finance its activities without additional subordinated financial support”; 2) “[t]he entity has at least as much equity invested as [comparable] entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support”; and 3) “[t]he amount of equity invested in the entity exceeds the . . . entity’s expected losses based on reasonable quantitative evidence.” FIN 46(R), *supra* note 149, ¶ 9.

153. SCOTT, *supra* note 12, at 454.

154. INT’L ACCOUNTING STANDARD NO. 27: CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS (rev. 2008).

its own financial statements if the SPE is under the company's "control."¹⁵⁵ Control is presumed if the company owns more than one-half of the voting power of an SPE. Control may also exist if, in substance, the company appears to obtain the benefits of the SPE's operations, the company retains the decision-making powers sufficient to obtain the benefits of the SPE's operations, or the company otherwise has the right to obtain the benefits of the SPE's operations, and is therefore also exposed to the risks incident to the activities of the SPE.¹⁵⁶ Though the one-half voting power rule is relatively clear cut, the other indicators of control evade the level of clarity that typifies GAAP, giving management considerable discretion in self-classifying.¹⁵⁷

III. THE IMPACT OF THE DIFFERENCES ON THE SECURITIES ANTIFRAUD REGIME

The principles-based approach of IFRS, if adopted by the United States, will have a significant effect on the functioning of the securities antifraud regime. Section III.A argues that the flexibility of IFRS will hinder a plaintiff's ability to prove the various elements of the securities antifraud causes of action, in particular the existence of a misstatement and scienter. Section III.B dissects *Carpenters Health & Welfare Fund v. Coca-Cola Co.*,¹⁵⁸ a typical 10b-5 case based on a GAAP violation in which shareholders sued Coca-Cola for improper revenue recognition. Section III.B demonstrates how the complaint and pleadings in that case would have been different had the alleged improper revenue recognition occurred under IFRS instead of GAAP.

A. *The Impact of IFRS on the Securities Antifraud Regime*

A great deal of ink has been spilled over the impact the principles-based system of IFRS will have on a company's incentives to commit fraud.¹⁵⁹ Some commentators suggest that IFRS will discourage companies from committing fraud because they will want to report conservatively to avoid the possibility of litigation.¹⁶⁰ Other commentators have concluded that IFRS

155. *Id.*

156. See SCOTT, *supra* note 12, at 571.

157. See also Psaros & Trotman, *supra* note 101, at 78 (noting that some IFRS countries think of control only as "the capacity to dominate decision making").

158. 587 F. Supp. 2d 1266 (N.D. Ga. 2008).

159. See generally Psaros & Trotman, *supra* note 101.

160. See *id.* at 77 (noting that commentators in the United States, Australia, Canada, and Europe all believe that principles systems discourage a "show me where it says you can't do it attitude" from financial-statement preparers) (internal quotation marks omitted). Rules-based systems of regulation, the argument goes, "are always open to manipulation in the hands of clever and high-priced accountants and lawyers pursuing regulatory arbitrage." Bratton, *supra* note 102, at 1041. Fraudsters can exploit loopholes to manipulate data while technically complying with the strict letter of the rule. Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the*

will encourage companies to commit fraud because they will see the flexibility of IFRS as an opportunity for aggressive reporting.¹⁶¹ Though the differences between IFRS and GAAP may sway the level of corporate fraud pervading the American business environment in one direction or another, this Note does not seek to enter this debate. It is instead concerned with answering a different question: what will the differences between IFRS and GAAP mean for any given securities-fraud claim that has been filed?¹⁶²

With the knowledge that corporate fraud exists, whatever its level,¹⁶³ the SEC has designed a system to stop it.¹⁶⁴ GAAP violations play a significant role in that system.¹⁶⁵ Since IFRS has been shown to be drastically different than GAAP with respect to its financial-reporting requirements, the debate over the prudence of U.S. conversion to GAAP is not complete without considering whether the differences between IFRS and GAAP will cause the various securities antifraud provisions to operate differently on any particular claim that has been filed under one of them. IFRS will hamper the current level of plaintiff success under the various securities antifraud provisions because the elements of existence of a misstatement and scienter will be harder to prove under IFRS than they are under GAAP.¹⁶⁶

PSLRA, 39 CONN. L. REV. 1097, 1108 (2007) (“[I]n numerous respects GAAP and (to a lesser degree) GAAS have facilitated and even encouraged the recent accounting scandals.”); Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach*, 10 U. PA. J. BUS. & EMP. L. 833, 878 (2008) (“Bright line rules can also be easier to evade given the flexibility of financial instruments today, leading to behavior that is superficially within the letter of the law but violates the spirit of it.”); Karim Jamal, *Going by the numbers: how do we stop corporate fraud?*, EXPRESS NEWS (Edmonton, Alta.), June 11, 2004, available at <http://www.expressnews.ualberta.ca/article.cfm?id=5880>. Under principles, on the other hand, management cannot rely on technical compliance with the regulation as a scapegoat, because liability flows only when conduct appears offensive to a broadly stated objective. Since, under principles, companies are deprived of the virtual safe harbor from litigation for reports that comply with the strict letter of the rule, litigation-adverse companies will avoid aggressive and fraudulent reporting.

161. See Psaros & Trotman, *supra* note 101, at 79 (citing several studies that all suggest that the managers and auditors will report more aggressively under principles-based systems than they will under rules-based systems). The line between “aggressive” reporting and “fraudulent” reporting is not entirely clear. A finder of fact may be required to determine if a report is misleading.

162. Whether IFRS will increase the level of fraud in the U.S. business environment has no bearing on the answer to this question. This question centers on whether the various securities antifraud provisions will operate differently after a claim has been filed, not on how many claims will be filed or how many claims should be filed.

163. Mark, *supra* note 160, at 1097 (“Corporate accounting fraud has been widespread . . . in recent years.”); Jamal, *supra* note 160, para. 7 (“[T]he U.S. has experienced a level and sophistication of fraud that is simply breathtaking, and more extreme than fraud observed in any other developed country in the world . . .”).

164. See *supra* Section I.A.

165. See *supra* Sections I.B.1 and I.B.2.

166. It is important to note that this conclusion is a relevant consideration in the debate over whether IFRS will encourage or discourage fraudulent reporting in the United States. See *supra* notes 159–161 and accompanying text. If it is harder for plaintiffs to prove the elements of the securities antifraud causes of action under IFRS, then companies may perceive a greater chance of getting away with securities fraud, and they will thus be more willing to commit securities fraud. In this sense, IFRS will increase the level of corporate fraud in the United States. The level of corporate fraud in the United States, however, has no bearing on whether the domestic securities antifraud

The existence of a misstatement, an element required in all securities-fraud cases, is much easier to prove under GAAP than it would be under IFRS. When a company misrepresents its financial data under GAAP, it essentially gift wraps and delivers the misstatement element to the plaintiff.¹⁶⁷ First, the sheer amount of GAAP rules creates a high likelihood that the company violated at least one of them.¹⁶⁸ Second, the black-and-white, highly detailed nature of the rules¹⁶⁹ enables investors to easily expose the violation. Conversely, when a company misrepresents its financial data under IFRS, the existence of a misstatement can be a very difficult element to prove. The plaintiff must first identify a rule addressing the accounting treatment in question, and the infrequency with which IFRS dedicates itself to specific situations may make this a difficult task.¹⁷⁰ Even if the plaintiff is able to identify a governing rule, the latitude in reporting given to management under IFRS may hinder the ability of the plaintiff to demonstrate that the company actually violated it.¹⁷¹ At the very least, the lack of IFRS rules

regime will function differently after a case has been filed if IFRS is adopted. For this reason, the debate over whether IFRS will increase or decrease the level of corporate fraud in the United States, though an important consideration in the debate over whether the United States should adopt IFRS, has no place in a discussion over what IFRS will do to the current functioning of the securities anti-fraud regime, the focus of this Note.

167. Even GAAP, however, is occasionally susceptible to bona fide disputes over whether its mandates have been violated. For example, some courts require expert testimony to establish if there has been a violation of GAAP. *See, e.g., SEC v. Guenther*, 395 F. Supp. 2d 835, 847 (D. Neb. 2005) (“Whether defendant’s actions . . . complied with GAAP is a question that requires technical, and specialized knowledge. The standards of conduct . . . under these circumstances is [sic] not within the court’s general knowledge and experience. The need for expert testimony in this case is analogous to the need for expert testimony on the standard of care in a professional malpractice case.”). But the fact that a court may request expert testimony to explain a particular GAAP rule and opine as to whether there was a violation does not necessarily mean that the violation was not clear to the expert. There are situations, however, in which even accounting experts will disagree about whether a GAAP rule has been violated. *E.g., In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994) (discounting the extent to which a GAAP violation was probative of scienter at the summary judgment stage because reasonable accountants could resolve differently the complex issues of accounting). But since the ambiguity of a certain GAAP provision may occasionally make it difficult for a plaintiff to establish the existence of a misstatement, plaintiffs will face greater difficulty establishing the existence of a misstatement under IFRS to the extent IFRS is more unclear and ambiguous, as shown to be the case. *See supra* Part II.

168. Bratton, *supra* note 102, at 1037 (noting that accounting rules “constrain managers . . . most of the time”).

169. Hague, *supra* note 15, at 2 (“The IFRS are unlike U.S. GAAP, which tends to go into much greater detail.”).

170. John J. Huber, *Client Alert: SEC Accepts Final Statements from Foreign Private Issuers Without Reconciliation to U.S. GAAP if Prepared Under International Financial Reporting Standards*, in FOREIGN ISSUERS & THE U.S. SECURITIES LAWS 2008: STRATEGIES FOR THE CHANGING REGULATORY ENVIRONMENT, at 219, 223 (PLI Corp. Law & Practice, Course Handbook Series No. B-1669, 2008) (“The SEC also acknowledged that there are a number of areas for which IFRS does not yet provide a specific standard or interpretation. For example, the SEC recognized there are currently no specific standards or interpretations for the accounting treatment of common control mergers, recapitalizations, reorganizations, and acquisitions of minority interests.”); *see also supra* Part II.

171. *See* Bratton, *supra* note 102, at 1037 (“So long as we lack confidence in management incentives respecting accounting treatments and doubt that auditors are independent of management interests, we have no actor plausibly positioned to make the delicate law-to-fact determinations

and the flexibility that they provide management will frequently force heated and costly litigation to adjudicate the misrepresentation element,¹⁷² and the flexibility of IFRS will rear its head again at the litigation stage as a powerful defense to charges that a company's financial statements do not comport with standardized accounting practices.

The existence of scienter, another commonly required element in securities-fraud cases, is also easier to prove under GAAP than IFRS. Under current case law, a plaintiff who establishes the misstatement element by demonstrating a GAAP violation can often use that misstatement as persuasive evidence of scienter.¹⁷³ To the extent that IFRS hinders a plaintiff's ability to prove the existence of a misstatement, IFRS presents a corresponding detriment to a plaintiff's ability to prove scienter. But IFRS will diminish a plaintiff's ability to prove scienter in another way. The rationale behind using GAAP violations as evidence of scienter is that GAAP is a very cut-and-dry system.¹⁷⁴ It instructs companies exactly how to behave and provides rules for nearly every conceivable contingency.¹⁷⁵ Since companies have such a detailed handbook at their disposal, some courts employ a presumption that any derogation from its mandates is likely to be intentional.¹⁷⁶ A child who comes home at 1:00 a.m. after being told to come home at midnight not only violated the rule, he probably did so culpably since it is such an easy rule to follow. Conversely, companies charged with violating IFRS can argue that the violation is merely a product of the innocent exercise of discretion given to them under that system. A child who comes home at an unreasonable hour after being told to be home at a reasonable hour violated the rule, but it is not clear that he did so culpably since his parent gave him so little guidance. Thus, the flexibility of IFRS provides companies with two opportunities to shirk responsibility under the

called for in a principles-based system. If the regulator is not neutral, then a principle always can be manipulated in favor of the presentation that suits management interests.”).

172. See Niskanen, *supra* note 144, at 47–51 (“The primary reason why the U.S. GAAP is especially complex appears to be an attempt to reduce the risks of litigation.”); Katherine Schipper, *Principles-Based Accounting Standards*, 17 *ACCT. HORIZONS* 61, 69 (2003); Letter from Donna J. Fisher, Am. Bankers Ass’n Dir. of Tax and Accounting, to Nancy M. Morris, Sec’y of the SEC (Sept. 21, 2007) (on file with the *Michigan Law Review*) (“[M]any preparers [of financial statements] tend to prefer rules-based accounting in order to mitigate [the] litigation risk.”).

173. See *supra* Section I.B.2.

174. See *supra* notes 92–94 and accompanying text.

175. See *supra* Part II.

176. See *supra* notes 92–94 and accompanying text. This is not to say that there are no GAAP provisions that are ambiguous, confusing, or broadly stated. Indeed, even the most sophisticated accountants and corporate officers may have trouble complying with some GAAP provisions. Many courts have recognized this and refused to infer scienter from the mere presence of a violation of a GAAP provision, especially an unclear one. *E.g.*, *In re IMAX Sec. Litig.*, 587 F. Supp. 2d 471, 482 (S.D.N.Y. 2008) (“If this were merely a GAAP violation case, we might have been persuaded that the complaint fails to allege scienter with respect to the IMAX defendants because the applicable accounting rules appear to be highly complex . . .”). However, since some courts are willing to exculpate corporate officers for violating unclear GAAP provisions, courts should be more willing to exculpate corporate officers for violating IFRS provisions to the extent those provision are less clear and direct, as shown to be the case. See *supra* Part II.

securities antifraud laws, one at the misstatement stage of proof and another at the scienter stage.

B. *Carpenters Health & Welfare Fund v. The Coca-Cola Co.*

The likely impact of IFRS on the domestic securities antifraud regime is illustrated best when the arguments in Section III.A are applied to a typical 10b-5 case involving an allegation of a GAAP violation.¹⁷⁷ Though it is impossible to determine how *Carpenters Health & Welfare Fund v. Coca-Cola Co.*¹⁷⁸ would have been resolved had IFRS been the governing accounting system, it is safe to say that the plaintiff shareholders would have faced drastically different challenges at the complaint and pleadings stages.

In 1999 and 2000, the Coca-Cola Company (Coke) shipped several hundred million dollars worth of “excessive, unwanted, and unneeded” beverage concentrate to its various bottling companies, causing the inventories of these companies to balloon uncontrollably.¹⁷⁹ The bottling companies accepted the shipments because Coke assured them, sometimes contractually and sometimes informally, that Coke would either accept return of later unused concentrate or help the bottler unload the excess concentrate by delivering it to other bottlers if it did not sell.¹⁸⁰ The interests that Coke owned in these companies were not sufficient to require the consolidation of their financial statements with its own,¹⁸¹ and so Coke recorded the transfer of massive amounts of concentrate as unqualified revenue on its financial statements immediately upon shipment.¹⁸² According to the complaint, these excess shipments netted Coke over \$600 million in increased revenue.¹⁸³

177. As mentioned at *supra* note 83 and accompanying text, a significant percentage of cases filed every year under the various securities antifraud causes of action allege GAAP violations. As mentioned at *supra* note 118 and accompanying text, a significant portion of these cases allege a violation of GAAP due to improper revenue recognition. Though plaintiffs will face greater difficulty in establishing the elements of misstatement and scienter when they bring suit pursuant to an improperly recorded uncertain tax position, the improper consolidation or nonconsolidation of an SPE, or any other accounting treatment where IFRS gives management more discretion than does GAAP, the *Coke* case is profiled here because of the prevalence with which revenue-recognition cases are brought, the considerable clarity of the issues in the case, and its relatively high-profile nature. The purpose of the presentation of this revenue-recognition case is merely to illustrate the impact of flexibility in financial reporting, in any context, on the elements of misstatement and scienter, and not to detract from the importance of the other areas of standardized accounting where IFRS provides for greater flexibility than does GAAP.

178. 587 F. Supp. 2d 1266 (N.D. Ga. 2008).

179. *E.g.*, Amended Consolidated Class Action Complaint for Violation of the Securities Exchange Act of 1934 at ¶ 4, *Carpenters Health & Welfare Fund*, 587 F. Supp. 2d 1266 (No. 1:00-CV-2838-WBH) [hereinafter Plaintiffs’ Amended Complaint]. When this case eventually settled, Coke refused to admit any liability. The SEC, however, found the allegations to be true. Harry R. Weber, *Justice Dept. Ends Probe of Coca-Cola; Firm Settles With SEC*, WASH. POST, Apr. 19, 2005, at E2.

180. Plaintiffs’ Amended Complaint, *supra* note 179, ¶ 129.

181. *E.g.*, *id.* ¶¶ 54, 55.

182. *Id.* ¶ 45.

183. *E.g.*, *id.* ¶ 101(b).

On October 27, 2000, shareholders filed suit alleging, *inter alia*, that Coke recognized revenue from the sales of excessive concentrate in violation of GAAP.¹⁸⁴ The plaintiffs relied on FAS 48 as the governing rule, which applies to the recognition of revenue from products that are subject to a right of return.¹⁸⁵ As discussed in Section II.B.1, FAS 48 permits revenue from the sale of a product subject to a right of return to be recognized only if six conditions are met. According to the plaintiffs, the second condition, that the buyer's obligation to pay the seller is not contingent upon resale of the product, had not been met because Coke had told the bottlers that they were not obligated to pay for the concentrate if they could not use it.¹⁸⁶ Likewise, the fifth condition, that the seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer, had not been met because Coke had a future obligation to find another buyer of the concentrate if the original bottler could not use it.¹⁸⁷ Since only four of the six conditions of FAS 48 were met, Coke violated GAAP when it recognized the revenue from the sales of excess concentrate. Not only did this GAAP violation form a misstatement sufficient to support a cause of action under 10b-5,¹⁸⁸ argued the plaintiffs, but it was convincing evidence of scienter as well because it was such a significant violation that it probably would not have occurred if the defendants had not authorized it.¹⁸⁹

After about eight years of litigation, Coke settled with a class of shareholders for an aggregate total of \$137.5 million.¹⁹⁰ Though many issues arose during the course of the prolonged litigation, a linchpin of the plaintiffs' success was their argument that recognizing the revenue from the shipment of excessive concentrate, which was intended to inflate Coke's financial standing, was a violation of GAAP.¹⁹¹

But how convincing would this argument have been under IFRS? Since there is no IFRS provision specifically governing the sale of products subject to a right of return,¹⁹² the propriety of Coke's actions would have to

184. *Id.* ¶ 123.

185. *Id.* ¶ 134.

186. *Id.* ¶ 135.

187. *Id.*

188. *Id.* ¶ 32.

189. *Id.* ¶ 36(b) ("The bases for allegations regarding defendants scienter include [that the] . . . [d]efendants' scheme to artificially inflate Coke's reported financial performance and stock price involved numerous and significant violations of GAAP . . . and these GAAP violations necessitated defendants' direct involvement as they consented to, authorized and participated in these wrongful practices . . .").

190. *See* *Carpenters Health & Welfare Fund v. Coca-Cola Co.*, 587 F. Supp. 2d 1266, 1268 (N.D. Ga. 2008).

191. For example, in Coke's motion to dismiss, Coke does not even challenge the plaintiffs' contention that Coke violated FAS 48, essentially conceding the point. *See* Defendant's Motion to Dismiss the Amended Complaint for Violation of the Securities Exchange Act of 1934, *Carpenters Health & Welfare Fund*, 587 F. Supp. 2d 1266 (No. 1:00-CV-2838-WBH).

192. *See supra* notes 131–132 and accompanying text.

have been examined under the general revenue recognition guidelines set forth in IAS 18. As discussed in Section II.B.1, revenue recognition is proper under IAS 18 only when (a) the seller has transferred the risks and rewards of ownership of the goods to the buyer; (b) the seller surrenders control of the goods to the buyer; (c) the amount of revenue can be reasonably measured; (d) it is probable that the economic benefits associated with the transaction will flow to the seller; and (e) the costs incurred by the seller by virtue of the transaction can be measured reliably.¹⁹³ The third and fifth conditions are unquestionably satisfied in the Coke case. Neither the price nor quantities of the concentrate delivered were in question, and provisions three and five inquire only into the monetary characteristics of the transaction. The existence of the other three conditions, however, is not as clear. Facilitating the lack of clarity are several ambiguous terms contained in these provisions. For example, IAS 18 provides no additional guidance as to what constitutes “control” and when it has been “surrendered,” what the “risks and rewards of ownership” actually are and when they are deemed “transferred,” or when the likelihood of benefits flowing to the seller meets the “probable” threshold. Even if the plaintiffs were able to convince the court that Coke violated IAS 18, and thus committed a misstatement when it recognized revenue from the sales of the concentrate, the violation itself would be of negligible value in the attempt to establish scienter. The defendants could simply argue that their decision to recognize revenue, though ultimately deemed incorrect, was reasonable in light of the ambiguity of the governing IFRS rule.

Although the revenue-recognition techniques employed by Coke during the turn of the century unquestionably created a false impression of its financial position, it is not difficult to conceptualize either how a defense to these allegations would sound if IFRS had been the governing system or the obvious viability of that defense. The flexibility of the IFRS guidelines makes this defense possible, and flexibility is a systematic characteristic of the IFRS standards, not one confined only to revenue recognition.¹⁹⁴ GAAP, on the other hand, as demonstrated by the Coke case, reduces the evidentiary burden of plaintiffs who suspect that a corporation is up to something funny by creating bright-line rules that allow for easy implementation and detection when they are violated.

CONCLUSION

A PricewaterhouseCoopers memorandum informing executives on the details and likelihood of the accounting change noted that, if the United States made the switch from GAAP to IFRS, “the legal and regulatory en-

193. IAS No. 18, *supra* note 130.

194. *See supra* Part II.

vironment will need to evolve in ways that remain to be seen.”¹⁹⁵ Though the full effects of IFRS implementation in the United States might not become evident until it actually happens, this Note anticipates a significant one: the diminished ability of plaintiffs to prove the elements of existence of a misstatement and scienter under the various securities antifraud provisions.

IFRS sacrifices rules for principles in an attempt to ensure a “true and fair view” of a company’s financial position. But regardless of the effects IFRS will have on a company’s incentives to misrepresent its financial data before suit is filed, the debate over conversion is not complete without considering what IFRS will do to the securities antifraud regime after suit has been filed.

Evidence that a company committed a GAAP violation is currently probative of the elements of existence of a misstatement and scienter under the securities antifraud laws. To the extent the flexibility of IFRS makes it harder for plaintiffs to prove that a company committed an IFRS violation than it is for plaintiffs to prove that a company committed a GAAP violation, plaintiffs will face greater difficulty establishing the existence of a misstatement if IFRS is adopted. Further, since the flexibility of IFRS will provide a viable defense to allegations that a company acted culpably in misrepresenting its financial data, plaintiffs will face greater difficulty establishing scienter if IFRS is adopted. Since IFRS will occasionally result in a finding of no misstatement or no scienter when GAAP would not,¹⁹⁶ the domestic securities antifraud regime will function differently under IFRS than it currently does under GAAP.

195. *International Financial Reporting Standards: The Right Move for US Business*, 10 MINUTES ON IFRS (PricewaterhouseCoopers), Oct. 2007, at 3, available at http://www.pwc.com/en_US/us/10minutes/assets/pwc_10minutes_102007.pdf.

196. It is possible for GAAP to require a finding of no misstatement or no scienter when IFRS does not. However, the general flexibility of IFRS as compared to GAAP naturally suggests that the opposite will more commonly be true. Further, it is worth noting that there is cause for concern anytime the two systems require a different outcome, regardless of the directions.

