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As published in the January 15, 2002, edition of

New York Law Journal

Reviewing Materiality in Accounting Fraud

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In a September 1998 speech at New York University, former SEC Chairman Arthur Levitt announced a crackdown on accounting fraud. In his speech, Chairman Levitt criticized what he described as a "game of nods and winks" practiced by managers, auditors, and analysts who operate in a "gray area where the accounting is being perverted." The result of this "game," according to Chairman Levitt, was an environment where "integrity in financial reporting is under stress" and, in some instances, "earnings reports reflect the desires of management rather than the underlying financial performance of the company."[1]

In the few years since Chairman Levitt's speech, accounting fraud has emerged as a top enforcement priority for both the SEC and federal prosecutors. The crackdown has resulted in a string of high-profile SEC enforcement actions, sometimes accompanied by parallel criminal indictments. In May 2001, for example, the SEC filed civil enforcement charges against Albert J. Dunlap, the well-known former chairman and CEO of Sunbeam Corporation; other Sunbeam executives; and a partner in the "Big Five" accounting firm who supervised the audits of Sunbeam's financial statements.[2] A number of prominent accounting-fraud cases preceded the Dunlap action, and others have followed on its heels.

The goal of this enforcement effort is, in Chairman Levitt's words, to promote "transparent, timely and reliable financial statements."[3] However, financial statements of a public company need not — and, as a practical matter, cannot — be perfectly accurate down to the last penny. Preparation of financial statements is a complex job, requiring the exercise of professional judgment. In recognition of this fact, the securities laws do not mandate perfection in financial reporting; rather, they require that an issuer's financial statements be accurate in all material respects.[4] Materiality recognizes that some discrepancies are so minor that they have no reporting significance.

Materiality judgments can be hotly disputed. Over time, accounting professionals have developed numerical thresholds as "rules of thumb" for evaluating materiality. For example, many auditors have traditionally looked for a 5 to 10 percent impact on a company's financial statements before concluding that a particular accounting discrepancy is material.[5] Misstatements or omissions with a smaller impact could, under this view, be disregarded.

In the years since Chairman Levitt's speech, however, the landscape has changed. As recent developments in the law make clear, exclusive reliance on numerical thresholds is now perilous. Courts are likely to treat materiality not as a mechanical exercise of calculating percentages, but rather as a complex, multi-faceted question whose resolution will depend on the particular facts and circumstances of an individual case.

1999 Bulletin

In August 1999, about a year after Mr. Levitt's seminal speech, the SEC staff published Staff Accounting Bulletin 99 (SAB 99), which proclaims that, in assessing materiality, "exclusive reliance on … any percentage or numerical threshold has no basis in the accounting literature or the law."[6] Although acknowledging that numerical "rules of thumb" can be a useful starting point in the materiality analysis, SAB 99 mandates a more comprehensive assessment of "all relevant considerations," including "the factual context in which the user of the financial statements would view the financial statement item."[7]

SAB 99 lists a number of "qualitative factors" which might cause even small misstatements to reach the level of materiality, including whether a misstatement: (a) changes a loss into a profit or vice versa; (b) masks a change in earnings or other trends; (c) hides a failure to meet analyst expectations; (d) affects compliance with loan covenants; or (e) increases executive compensation, for example by satisfying criteria for a bonus.

Moreover, SAB 99 assigns great importance to management's intent. Thus, even where an accounting adjustment is numerically small, evidence of materiality may be "compelling" if management "has intentionally misstated items in the financial statements to 'manage' reported earnings."[8]

SAB 99 also rejects the view that particular misstatements can be netted together to offset one another, and mandates that accounting discrepancies be considered both individually and on an aggregated basis. Other qualitative factors that may be relevant to materiality, under SAB 99, include: the volatility of the issuer's stock price (and hence the likely effect of accounting irregularities); the location of the misstatement on the financial statements (i.e., whether it pertains to an important segment of an issuer's business operations); and the impact of any accumulated misstatements from prior reporting periods.[9]

Cases on Materiality

Courts have overwhelmingly endorsed the multi-faceted approach to materiality that is set forth in SAB 99. To date, the leading case on SAB 99 is *Ganino v. Citizens Utilities Co*., 228 F.3d 154 (2d Cir. 2000). *Ganino*, a private lawsuit, arose out of alleged accounting fraud at Citizens Utilities Company (Citizens). As of 1995, Citizens had reported more than 50 consecutive years of increased revenue, earnings, and earnings per share. According to the *Ganino* complaint, Citizens earned certain revenue in 1995, but management improperly delayed recognition of the revenue until 1996, when it was needed to continue Citizens' historical profit trend.

The district court dismissed the *Ganino* complaint, finding that the scope of the deferred revenue, "1.7 percent of Citizens' revenue for the relevant time period," made the deferral legally immaterial.[10] In support of this conclusion, the district court cited a newspaper article which asserted that it had become "standard practice in corporate America" to treat as immaterial any accounting adjustments that failed to meet a numerical threshold in the range of 3 percent to10 percent.[11]

The U.S. Court of Appeals for the Second Circuit reversed. The Court of Appeals described SAB 99 as "thoroughly reasoned and consistent with existing law" on materiality, and concluded that it offered "persuasive guidance for evaluating the materiality of an alleged misrepresentation."[12]

Turning to the particular facts of *Ganino*, the Second Circuit noted that Citizens' management allegedly deferred recognition of the revenue for two of the "qualititative" reasons set forth in SAB 99: (1) to avoid a change in the company's 50-year upward earnings trend, and (2) to stave off the accompanying failure to meet analysts' expectations.[13] On this basis, the Second Circuit ruled that the litigation should proceed.

Other courts have reached similar results. In *In re Kidder Peabody Securities Litigation*, 10 F. Supp. 2d 398 (S.D.N.Y. 1998), a case which predates both Chairman Levitt's speech and the issuance of SAB 99, Judge Barbara Jones rejected an argument that overstatements of Kidder Peabody's earnings as a result of the Joseph Jett trading scandal were immaterial because they had only a small numerical effect on the consolidated financial statements of Kidder Peabody's parent company, General Electric.[14] When it issued SAB 99 some 13 months after Judge Jones' decision, the SEC staff cited *Kidder Peabody* as supporting authority for the rejection of a purely numerical approach to materiality.[15]

In a more recent decision, *In the Matter of Albert Glenn Yesner, CPA*, Admin. Proc. File No. 3-9586 (May 22, 2001), an SEC administrative law judge endorsed a multi-factored approach to materiality.[16] In *Yesner*, the SEC staff brought administrative charges against a mid-level controller at Sensormatic Electronics Co. During the trial before an ALJ, the controller offered expert testimony that "a materiality threshold in the range of 8 to 10 percent is not uncommon for quarterly financial statements filed with the Commission," and that "even though attendant circumstances are considered, materiality judgments are primarily quantitative.[17]

The ALJ found, however, that "courts and the accounting literature reject numerical benchmarks as the sole determinants of materiality."[18] Citing *Kidder Peabody* and *Ganino*, the ALJ went on to find the Sensormatic misstatements material because they were intended to fulfill analysts' expectations, enabled Sensormatic to publicize a continuous growth rate, and violated Sensormatic's publicly-stated revenue-recognition policy.[19]

The changing approach to materiality is perhaps most graphically illustrated in the pending *Dunlap* case. There, the SEC alleges a smorgasbord of accounting fraud.[20] The SEC alleges that Sunbeam's outside auditor uncovered some of the disputed entries, and proposed their reversal, but ultimately acquiesced when management insisted on keeping them on the company's books.[21] In pretrial motion papers, the auditor has explained that he rendered an unqualified audit opinion, notwithstanding the disagreements with management, because the disputed entries were immaterial—they fell "well within the 5 to 10 percent benchmark used by independent auditors at that time to assess materiality."[22]

Thereafter, however, SAB 99 was promulgated, and numerical materiality benchmarks were rejected by the SEC and courts. Whether the *Dunlap* court should apply the old or new standards raises fairness concerns similar to those protected by the Ex Post Facto Clause in criminal cases.

Discussion

As demonstrated by *Ganino*, *Kidder Peabody*, and *Yesner*, courts have endorsed the SEC staff's qualitative approach to materiality. The ascendancy of qualitative materiality judgments presents challenges and risks for persons who are responsible for the preparation and review of financial statements. Although courts have recognized that numerical thresholds remain relevant in assessing materiality, recent decisions leave no doubt that accountants must also investigate and consider the full range of surrounding circumstances.

Many of these surrounding facts will be murky—particularly the intent of management, upon which SAB 99 places such heavy reliance. Direct evidence of intent is rarely available; to the contrary, intent is often a difficult question that is open to multiple competing inferences. Given the ambiguities and difficulties that are frequently wrapped up in questions of intent, it seems unrealistic to require—as does SAB 99—that auditors or accountants divine the intent of management in making materiality judgments.[23]

Other factors listed in SAB 99—e.g., the prohibition on netting and the now-required examination of the correlation, if any, between accounting errors and analysts' forecasts—will add additional layers of complexity and expense to the process of preparing and auditing financial statements.

Further, the characterization of materiality as fact-bound and contextual means that when a dispute arises, questions of materiality will have to be resolved, in the majority of cases, by the fact-finder, rather than the court on a preliminary motion. This dovetails with Supreme Court precedent declaring that materiality questions generally defy mechanical resolution and are the province of the jury, rather than the court.[24]

Thus, in accounting fraud cases where materiality is an issue, extensive litigation—with its attendant expense and uncertainty—will usually be required.

It is unclear whether SAB 99 can, or should, be applied retroactively. Although the SEC staff went to great lengths, in drafting SAB 99, to assert that it did not change existing standards, some commentators—including current SEC Chairman Harvey Pitt, in an article written while he was still in private practice—have disagreed.[25]

As noted above, ex post facto arguments might preclude the application of SAB 99 in criminal cases arising from pre-August 1999 conduct; in civil cases, the legal basis for a retroactivity argument is less clear.

However, reliance on traditional numerical thresholds could, in an appropriate case, provide strong evidence of good faith, especially in a case arising from conduct that predates the issuance of SAB 99.

Conclusion

As the SEC Enforcement Division and federal prosecutors have devoted enormous resources to the investigation and prosecution of accounting fraud, courts have accepted a broad, contextual notion of materiality. To minimize the risk of regulatory or criminal penalties, auditors and accountants who become aware of an accounting irregularity must not limit their materiality judgments to numerical thresholds, but must carefully consider the full range of surrounding circumstances in determining whether the discrepancy must be corrected.

Similarly, audit committees may need to take a second look at proposed adjustments deemed to be immaterial by auditors, since the auditors' materiality judgments may later be second-guessed by the SEC or by a court.

Finally, lawyers who are called upon to defend materiality decisions must prepare for lengthy, fact-intensive proceedings.

Notes

* Matthew Atlas, a summer associate, assisted in the preparation of this article.

1 Remarks by Chairman Arthur Levitt, "The 'Numbers Game,' " NYU Center for Law and Business, at 2 (hereinafter "Chairman Levitt Speech") (Sept. 28, 1998) (available on the SEC's Web site, www.sec.gov).

2 See SEC Litigation Release No. 17001 (May 15, 2001).

3 Chairman Levitt Speech, at 2.

4 See, e.g., 15 U.S.C. §§ 77q, 78j(b) & 78ff.

5 SEC Staff Accounting Bulletin No. 99 – Materiality, at 2 (Aug. 12, 1999); see also M. Young, Accounting Irregularities and Financial Fraud: A Corporate Governance Guide, at 238-40 (2000); "Comment, Staff Accounting Bulletin 99: Another Ill-Advised Foray Into The Murky World Of Qualitative Materiality," 95 *N.W.U.L.R.* 361, 363 (2000); Fang and Jacobs, "Clarifying and Protecting Materiality Standards in Financial Statements: A Review of SEC Staff Accounting Bulletin 99," 55 *The Business Lawyer* 1039, 1039 n.1 (2000).

6 SAB 99, at 2.

7 Id. at 2-3.

8 Id. at 4-5.

9 Id. at 4-6.

10 Id. at 227.

11 *Ganino v. Citizens Utility Co.*, 56 F. Supp. 2d 222, 226 (D. Conn. 1999) (quoting MacDonald, "SEC Readies New Rules for Companies About What Is 'Material' For Disclosure," *Wall Street Journal*, (Nov. 3, 1998)). The district court also relied on precedents which had applied a similar numerical analysis. Id. at 226-27 (collecting cases).

12 Id. at 163.

[13] Id. at 163.

[14] 10 F. Supp. 2d at 410-11.

[15] See SAB 99 at 10 n.6.

[16] The *Yesner* decision became final on June 19, 2001.

[17] Id. at 21-22.

[18] Id. at 47 n.46.

[19] Id. at 25-26.

[20] See Complaint, *Securities and Exchange Commission v. Albert J. Dunlap, et al*., 01-8437-Civ-Dimitrouleas (S.D. Fla. May 15, 2001) (hereinafter *Dunlap* Complaint).

[21] See *Dunlap* Complaint, ¶¶ 25, 87, 91.

[22] Memorandum of Law of Defendant Phillip E. Harlow in Opposition to Plaintiff's Motion to Strike Affirmative Defenses, *SEC v. Dunlap, et al*., 01-8437-Civ-Dimitrouleas (S.D. Fla. Sept. 4, 2001).

[23] Further complicating matters for auditors, the SEC made clear in SAB 99 that intentional, immaterial accounting misstatements may be unlawful under Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1. Section 10A requires auditors to report intentional misstatements—even if immaterial—to the client's management and assure that the audit committee, and in certain circumstances the SEC, is made aware of the misstatement. Only if the misstatement is "clearly inconsequential" is it outside the reporting requirement of Section 10A. Therefore, the SEC has broadened and complicated an auditor's materiality inquiry even as it has required more nuanced, complex examination of immaterial misstatements.

[24] See *Basic, Inc. v Levinson*, 485 U.S. 224, 236 (1988); see also *United States v. Gaudin*, 515 U.S. 506 (1995).

[25] See Pitt et al., "The SEC's New Materiality Pronouncement; Materiality By Hindsight?," *PLI/Corp. Law and Practice Course Handbook Series* (Sept. 21, 2000) (noting that "SAB 99 departs from authoritative accounting literature, implying that qualitative and quantitative factors are at least of equal import"); see also Fang and Jacobs, supra n. 8, at 1040 (asserting that the effect of SAB 99 has been "dramatic," and that "the SEC has ventured into a previously unexplored area").

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