

How Principles-Based Accounting Standards Impact Litigation

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The Financial Accounting Standards Board recently approved the final drafting of a new accounting standard that will likely bring a greater amount of lease assets and liabilities onto company balance sheets.[1] This standard, expected to be released any day now, is one in a series of new accounting standards designed to bring U.S. Generally Accepted Accounting Principles, generally considered “rules-based,” closer to more “principles-based” International Financial Reporting Standards (IFRS). There have been heated debates as to whether a move to more principles-based standards will lead to improved financial reporting, including a stern warning by U.S. Sen. Carl Levin, D-Mich., that the opposite is likely to occur.[2] However, regardless of whether financial reporting will be improved, there is another (perhaps related) question of interest that has received less attention: How will the new standards affect litigation?

Studies of trends in securities class actions and the accounting literature provide an empirical basis to predict how companies, auditors and prospective plaintiffs will respond to a shift toward principles-based rules. We analyze how these responses may affect the quality of financial reporting and what impact they could have on accounting-related litigation.

Convergence of GAAP and IFRS

In October 2002, the FASB and the International Accounting Standards Board (IASB), which promulgates IFRS, signed a memorandum of understanding to work toward making their financial reporting standards “fully compatible as soon as is practicable.”[3] To this end, the boards launched a series of convergence projects aimed at eliminating differences between the two sets of standards.[4] While the two boards have not been able to converge views in some areas, the FASB has issued new “principles-based” standards on a variety of topics, including most notably revenue recognition, but also business combinations, classification and measurement of financial instruments, and leasing.[5] Some of these standards are not yet in effect; for example, implementation of the new revenue recognition standard is

not required until 2017. Thus the impact of the new standards on both the quality of financial reporting and litigation is yet unknown.

Interaction between Accounting and Securities Class Actions

The interaction between accounting and litigation is not trivial. Consider, for example, securities class actions. According to data from Stanford Securities Litigation Analytics (SSLA), securities class actions involving allegations of accounting fraud represented the majority, or 54 percent, of 2,540 securities class actions filed between 2000 and 2015,[6] and resulted in disproportionately protracted and expensive litigation. The mean and median duration of accounting cases (settled or dismissed) was 1,010 and 901 days, respectively, compared to 768 and 627 days for other securities class actions.[7] Moreover, accounting cases represented a whopping 80 percent of total settlement dollars.[8] The mean and median settlement amount of accounting cases was \$71.5 million and \$8.1 million, respectively, versus \$38.4 million and \$6.3 million for other suits.[9] These statistics suggest that the ongoing changes in accounting standards could have a significant impact on the volume of litigation involving accounting issues and their outcomes.

Rules-Based Standards vs. Principles-Based Standards

To understand how the new rules are less “rules-based” and more “principles-based,” let us compare the existing lease accounting standard with the soon-to-be-released new lease accounting standard. Under existing rules, a lessee must record an asset and a liability on its balance sheet for leased equipment under certain specified conditions, such as when (for new equipment) the lease term is equal to 75 percent or more of the equipment’s estimated economic life, or the present value of the minimum lease payments equals or exceeds 90 percent of the equipment’s fair value.[10] Under the new rules, a lessee would record an asset and liability on its balance sheet unless “[t]he lease term is for an insignificant part of the total economic life of the underlying asset” or “[t]he present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date.” [11]

Two aspects of the new standard are striking. First, many observers have pointed out that the new rules will likely require lessees to recognize more assets and liabilities on the balance sheet.[12] For example, whereas under the existing rules an asset with a lease term equal to 70 percent of its useful life would not necessarily be recognized as an asset on a lessee’s balance sheet, under the new rules such a term would, in most people’s judgment, likely be considered more than an “insignificant” part of the asset’s life and necessitate such recognition. Second is the use of less precise language and the lack of bright lines in the new standard, e.g., “insignificant” rather than “75 percent.” This change is typical of the move from rules-based standards to principles-based standards, with the latter requiring the application of significantly more judgment in assessing, for example, when lease terms exceed the criteria of “insignificant.”

Pros and Cons of Principles-Based Standards

Many believe that the need to apply increased judgment under principles-based standards will result in financial reporting that better reflects the economic substance of underlying transactions and events. Some have criticized rules-based accounting for allowing, and perhaps even encouraging, the structuring of transactions to achieve specific accounting results. These critics point to, for example, Enron’s use of special purpose vehicles and Lehman Brothers’ use of “Repo 105” repurchase transactions. (In those cases, parties to ensuing litigation fought over questions of whether the accounting was in conformity with GAAP, whether GAAP required accounting that reflected economic substance, and whether the accounting reflected economic substance.) One argument in support of principles-based standards is that

in theory they force financial statement preparers (and auditors) to consider how possible accounting alternatives reflect economic substance and to judge the most suitable accounting treatment. On the other hand, some fear the lack of bright lines will give rise to more aggressive financial reporting. Whether auditors could or would impose a higher level of scrutiny to offset such potential reporting behavior is uncertain.

Evidence from Empirical Research

With regard to leasing specifically, research has generally found that a move from rules-based standards toward principles-based standards results in less aggressive reporting, perhaps for fear of litigation. In a survey of nearly 100 U.S.-based financial reporting executives with regard to hypothetical lease transactions, Agoglia, Douppnik and Tsakumis (2011) found that because lessees were concerned about second-guessing and possible costs imposed through regulation and litigation, they were “less likely to report aggressively” (i.e., they were more likely to recognize leased assets and liabilities on the balance sheet) under principles-based standards than under rules-based standards.[13] Similarly, in an experiment with 97 auditors (again regarding hypothetical lease transactions), Cohen, Krishnamoorthy, Peytcheva and Wright (2013) found auditors more likely to “constrain aggressive reporting” under principles-based accounting standards, perhaps also because of an increased perception of accountability.[14] Consistent with the survey evidence, Collins, Pasewark and Riley (2012), using 2007–2009 lease classifications from a sample of Fortune Global 500 companies, found lessees under the rules-based standards more likely to report aggressively (less likely to recognize lease assets and liabilities) than comparable companies under principles-based IFRS.[15]

Research findings outside lease accounting, however, are mixed. While U.S. GAAP is generally considered more rules-based than IFRS as a whole, Folsom, Hribar, Mergenthaler and Peterson (2015) examined different standards within U.S. GAAP and quantified the extent each standard was “rules-based.” Analyzing data from SEC Form 10-K filings, the authors then determined the extent to which a firm relies on “rules-based” standards and found that firms that rely more on principles-based standards report earnings that better predict future cash flows, which is consistent with managers using the discretion provided by such standards to better communicate underlying economics.[16] By contrast, Ahmed, Neel and Wang (2013) compared firms from 20 countries that adopted IFRS in 2005 with firms from countries that did not adopt IFRS and found that mandatory IFRS adoption resulted in reduced earnings quality (i.e., IFRS adopters displayed more signs of income smoothing, aggressive reporting of accruals, and less timely reporting of losses).[17]

Research is thin regarding the effect of accounting standards on litigation. Reviewing U.S. securities class actions involving alleged accounting violations from 1996 to 2005, Donelson, McInnis and Mergenthaler (2012) found that plaintiffs were more likely to cite principles-based areas of GAAP, perhaps in part because rules-based standards can provide defendants with an “innocent mistake” defense. [18] This research suggests that making all the GAAP standards more principles-based, even if it improves the quality of financial reporting, could result in a greater volume of litigation. However, this conjecture assumes that no other responses have an offsetting effect. If, as described above, auditors would be more likely to constrain aggressive accounting reporting, it is unclear what the overall effect on the level of litigation will be.

At the same time, principles-based standards may have a dampening effect on the litigation outcomes. Kadous and Mercer (2011) found that when the client engages in aggressive accounting, the flexibility of principles-based standards works in favor of auditors: mock juries return fewer verdicts against auditors in a principles-based regime. “When the aggressive reporting violates a precise standard, a majority of mock

juries return verdicts against the auditor. However, this same reporting choice is viewed less negatively by jurors when the accounting standard is imprecise — a majority of juries then return verdicts in favor of the auditor.”[19] (Unfortunately, there is a dearth of research regarding hypothetical verdicts against companies or their directors and officers.) If in fact, the move to more principles-based standards results in outcomes that are more favorable to defendants in general, plaintiffs may be less inclined to sue and the overall level of litigation may fall.

The Role of Accounting Experts in Litigation

In summary, the move to principles-based standards may have multiple competing effects on litigation. On the one hand, companies may be less likely to report aggressively, and auditors may be more likely to constrain aggressive reporting, resulting in fewer accounting disputes. Also, litigation outcomes may be more favorable to defendants, resulting in a disincentive for plaintiffs to sue. On the other hand, without the bright-line standards, companies may report more aggressively, and plaintiffs may find a wider menu of areas to attack under principles-based standards, so that allegations of accounting malfeasance may increase. While the net effect of these competing forces is uncertain, the latter suggests that the need for accounting experts in litigation will remain prevalent. Moreover, as the new standards will require financial statement preparers and their auditors to apply increased subjective judgment, the guidance of accounting experts will be more critical than ever in explaining the possible divergent interpretation and application of those standards.

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[1] “FASB votes to proceed with final standard on leases,” FASB news release, November 11, 2015.

[2] Letter from Senator Carl Levin to Financial Accounting Standards Board, October 14, 2014.

[3] http://www.fasb.org/intl/MOU_09-11-08.pdf

[4] http://www.fasb.org/intl/convergence_iasb.shtml

[5] “Comparability in International Accounting Standards – An Overview,” FASB.
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http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=900000011123

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[8] Stanford Securities Litigation Analytics (SSLA), Stanford Law School. Available at sla.law.stanford.edu.

[9] Stanford Securities Litigation Analytics (SSLA), Stanford Law School. Available at sla.law.stanford.edu.

[10] Accounting Standards Codification 840-10-25.

[11] FASB Exposure Draft, "Proposed Accounting Standards Update (Revised), Leases (Topic 842), 842-10-25-6," issued May 16, 2013.

[12] Key Tysiac, "FASB's leases standard gets preliminary approval," *Journal of Accountancy*, November 11, 2015.

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[15] Collins, Denton L., William R. Pasewark, and Mark E. Riley. "Financial reporting outcomes under rules-based and principles-based accounting standards." *Accounting Horizons* 26, no. 4 (2012): 681-705.

[16] Folsom, David, Paul Hribar, Richard Mergenthaler, and Kyle Peterson. "Principles-based standards and earnings attributes." Available at SSRN 2046190 (2015).

[17] Ahmed, Anwer S., Michael Neel, and Dechun Wang. "Does mandatory adoption of IFRS improve accounting quality? Preliminary evidence." *Contemporary Accounting Research* 30, no. 4 (2013): 1344-1372.

[18] Donelson, Dain C., John M. McInnis, and Richard D. Mergenthaler. "Rules-based accounting standards and litigation." *The Accounting Review* 87, no. 4 (2012): 1247-1279.

[19] Kadous, Kathryn, and Molly Mercer. "Jury verdicts against auditors under precise and imprecise accounting standards." *Emory Public Law Research Paper* 10-132 (2011): 10-85.