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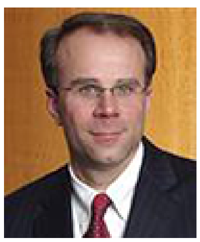
Facts v. Opinions: The Securities Laws and Accounting Estimates After *Fait v. RegionsFinancial Corp.*



BY SAMUEL P. GUNTHER AND MICHAEL Y. SCUDDER

The significance of the distinction between statements of fact and opinion under the securities laws continues to confront courts and remains the subject of much commentary. Two recent decisions by the U.S. Court of Appeals for the Second Circuit demonstrate the importance of that distinction in securities litigation concerning accounting matters and, more specifically, alleged misstatements of financial statements.

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In both cases, *Fait v. Regions Financial Corp.*[1] and *City of Omaha, Nebraska Civilian Employees' Retirement System v. CBS Corp.*,[2] the Second Circuit affirmed the dismissal of securities class action claims on the basis that the allegations pled statements of opinion—the adequacy of loan loss reserves and goodwill impairment in *Fait* and goodwill impairment in *City of Omaha*. In both cases, the court determined that plaintiffs failed to plausibly allege that the issuer-defendants did not believe the opinions at the time they were made.

Although these decisions received recognition in the legal news, this article considers their broader significance. We do so by examining the extent to which financial statements that employ generally accepted accounting principles (''GAAP'') contain statements of opinion and then suggesting a potential framework for assessing the implications of *Fait* and *City of Omaha* for future cases.

Statements of Fact v. Statements of Opinion in the Securities Laws. Sections 11 and 12 of the Securities Act of 1933 impose liability for a misstatement or omission of a material ''fact'' in specified securities filings.[3] Section 10(b) of the Securities Exchange Act of 1934 similarly prohibits a misstatement or omission of a material ''fact'' in connection with the purchase or sale of a security.[4] While these statutes, by their terms, apply only to misstated or omitted facts, courts have made clear that these provisions do not altogether exempt statements of belief or opinion. In *Virginia Bankshares v. Sandberg*,[5] the Supreme Court interpreted Section 14(a) of the 1934 Act and SEC Rule 14a-9 and held that a statement of opinion or belief is actionable to the extent it is objectively false and not believed by the

[1] 655 F.3d 105 (2d Cir. 2011).
[2] 679 F.3d 64 (2d Cir. 2012).
[3] 15 U.S.C. § 77k(a); 15 U.S.C. § 77l(a)(2).
[4] 15 U.S.C. § 78j(b).
[5] 501 U.S. 1083, 1095-96 (1991).

speaker at the time made. Subsequent decisions have applied the *Virginia Bankshares* standard to claims under Sections 11 and 12 of the 1933 Act and Section 10(b) of the 1934 Act and SEC Rule 10b-5.

The Second Circuit's Decisions in *Fait* and *City of Omaha*. The Second Circuit examined the dividing line between statements of fact and opinion in two recent decisions. In *Fait v. Regions Financial Corp.*, plaintiffs alleged violations of Sections 11 and 12 of the 1933 Act, contending that Regions Financial failed to report an impairment of goodwill and understated its loan loss reserves, contrary to the requirements of GAAP. The district court dismissed the complaint, ''[c]oncluding that the challenged statements were ones of judgment and opinion, rather than fact,'' and further determining that ''the statements in question were not actionable because the complaint failed to allege that defendants did not honestly hold those opinions at the time they were expressed.''[6] More specifically, the district court invoked the standard of *Virginia Bankshares* and held not only that the ''goodwill stated on [Regions Financial's] balance sheet reflected judgments as to values that were not objectively determinable,'' but also that the level of loan loss reserves ''reflect[ed] management's opinion as to the likelihood of future loan losses and their magnitude''—both matters of opinion and not objective fact.[7]

The Second Circuit affirmed. After reinforcing the application of *Virginia Bankshares* to statements of opinion under Sections 11 and 12 of the 1933 Act, the court addressed the GAAP standards applicable to accounting for goodwill and loan loss reserves. Those standards are embodied in Financial Accounting Standards Board (''FASB'') Statements of Financial Accounting Standards 141 and 142 for the former and Statement 114 for the latter.[8] The court then explained that ''[e]stimates of goodwill depend on management's determination of the 'fair value' of the assets acquired and liabilities assumed [by Regions Financial in its acquisition of AmSouth Bancorporation], which are not matters of objective fact.''[9] Because plaintiffs relied ''mainly on allegations about adverse market conditions to support the contention that defendants should have reached different conclusions about the amount of and need to test for goodwill,'' the court concluded that the complaint failed to ''plausibly allege that defendants did not believe the statements regarding goodwill at the time they made them''—a ''fatal'' pleading omission under the *Virginia Bankshares* standard.[10]

The same reasoning applied to plaintiffs' allegations of inadequate loan loss reserves. Establishing such reserves under GAAP ''is not a matter of objective fact,'' the Second Circuit reasoned, but rather ''reflect[s] management's opinion or judgment about what, if any, portion of amounts due on the loans ultimately might not be collectible''—''a determination [that] is inherently subjective, and like goodwill, estimates will vary depending on a variety of predictable and unpredictable circumstances.''[11] The court concluded that the district court properly determined that plaintiffs' ''complaint d[id] not plausibly allege subjective falsity'' or that the loss reserves were ''both false and not honestly believed,'' and thus failed to state a claim.[12]

In 2012, the Second Circuit revisited the same issues in *City of Omaha, Nebraska Civilian Employees' Retirement System v. CBS Corp.*[13] Plaintiffs there alleged securities fraud on the basis of CBS's belated testing for and recording of a goodwill impairment.[14] Applying the reasoning of *Fait* (and by extension, *Virginia Bankshares*) to claims under Section 10(b) of the 1934 Act,[15] the Second Circuit affirmed the district court's dismissal of plaintiffs' complaint, concluding that ''even if the second amended complaint did plausibly plead that defendants were aware of facts that *should* have led them to begin interim impairment testing earlier, such pleading alone would not suffice to state a securities fraud claim after *Fait*.''[16] The court emphasized that plaintiffs' complaint ''is devoid even of conclusory allegations that defendants did not believe in their statements of opinions regarding CBS's goodwill at the time they made them.''[17]

Although *Fait* and *City of Omaha* did not entirely break new legal ground, they stand in the Federal Reporter as two significant and recent applications of the *Virginia Bankshares* standard to federal securities claims alleging misstated financial statements. Whether and how the standard should apply to accounting matters other than goodwill impairments and loan loss reserves requires broader analysis of GAAP, including assertions in financial statements and the attributes of applicable financial statement accounts, as well as the precise misstatement or omission allegations before a court.

The Pervasiveness of Opinions, Estimates, and Judgments in GAAP-Based Financial Statements. Financial reporting in accordance with GAAP aims to provide financial- statement users with relevant and reliable information on a timely basis. It does so in large part through accrual (as opposed to cash-based) accounting and, more specifically, through the adherence to principles mandating the matching of revenues with related expenses and the recognition of revenues when earned and expenses when incurred, without regard to whether cash has changed hands. Complying with these principles, in turn, requires the continuous use of judgments and estimates about when and at what amounts at which to record and report assets and liabilities on a balance sheet and the revenues and expenses on an income statement. It therefore is incorrect to view GAAP-based financial statements as a series of ''facts'' (akin, for instance, to a math problem), in which the numbers are either right or wrong. Most often the opposite is true: the application of GAAP results in many of the line items in a company's financial statements incorporating estimates and judgments and thus more opinions than facts.

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[6] *Fait*, 655 F.3d at 108-09.

[7] *Fait v. Regions Fin. Corp.*, 712 F. Supp. 2d 117, 123-24 (S.D.N.Y. 2010) (Kaplan, J.).

[8] Statements 114, 141, and 142 were subsequently codified into FASB's Accounting Standards Codification (''ASC'').

[9] *Fait*, 655 F.3d at 110.

[10] *Id.* at 112.

[11] *Id.* at 113.

[12] *Id.*

[13] 679 F.3d 64 (2d Cir. 2012).

[14] *Id.* at 66.

[15] *Id.* at 67-68.

[16] *Id.* at 68.

[17] *Id.* at 68-69 (citing *Fait*, 655 F.3d at 112).

   ISSN 0037-0665

The accounting and auditing profession and accounting regulators have long recognized the pervasiveness of accounting estimates and judgments in GAAP-based financial statements. In 1978, for example, the FASB observed:

> The information provided by financial reporting often results from *approximate, rather than exact*, measures. *The measures commonly involve numerous estimates*, classifications, summarizations, *judgments* and allocations. The outcome of economic activity in a dynamic economy is uncertain and results from combinations of many factors. Thus, despite the aura of precision that may seem to surround financial reporting in general and *financial statements in particular, with few exceptions the measures are approximations*, which may be based on rules and conventions, rather than exact amounts.[18]

In 2010, the FASB reiterated the same view in slightly different language: ''To a large extent, financial reports are based on *estimates, judgments, and models rather than exact depictions*.''[19]

The Panel on Audit Effectiveness also has observed that accounting estimates are ''pervasive'' and ''involve subjective estimates and judgments.''[20] The Panel stated, ''Financial statements generally are replete with accounting estimates and judgments.''[21]

The auditing standards issued by the Public Company Accounting Oversight Board (''PCAOB'') define an accounting estimate as an ''approximation of a financial statement element, item, or account.''[22] The PCAOB has explained that accounting estimates are necessary for two often interrelated reasons—because ''[t]he measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events;'' and ''[r]elevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis.''[23]

Recognizing the subjectivity inherent in GAAP-based financial statements does not mean that anything goes when preparing the financial statements. To the contrary, GAAP requires that estimates and judgments used in financial reporting be reasonable. What is reasonable requires consideration of all facts and circumstances as well as numerous considerations that may include use of personnel who have adequate backgrounds and training and who are aware of and can seek out pertinent factors bearing upon estimates; the use of relevant and reliable data; historical trends and current conditions of the business, the industry, and broader economy; the volatility of financial statement components and assumptions underlying an estimate that may have significant impact on the estimate; recent changes in company policy or strategy; assumptions about conditions the company expects to exist and possible actions the company might take depending upon those assumptions; and events external to the company that may affect the company, such as recent or proposed laws, regulations or litigation.

As new information is obtained, amounts previously reported as accounting estimates must be changed in current financial statements to give effect to the newer information. The FASB has defined a change in an accounting estimate as:

> A change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. *A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities*. Changes in accounting estimates result from new information. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, and warranty obligations.[24]

Because of the pervasiveness and recognized impact of estimates in GAAP-based financial statements, GAAP mandates that the notes to the financial statements disclose that the financial statements ''require the use of management's estimates.''[25] The FASB has explained the purpose of the disclosure this way:

> This disclosure is intended to inform users of the *inherent uncertainties* in measuring assets and liabilities and related revenues and expenses and contingent assets and liabilities, and that subsequent resolution of some matters could differ significantly from the resolution that is currently expected. Such disclosure alerts users that *uncertainties are present in the financial statements of all reporting entities*.[26]

The FASB also has provided an illustrative note disclosure:

> The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.[27]

Estimates and Judgments in MD&A Disclosures. The SEC requires the presentation of Management's Discussion and Analysis of Financial Condition and Results of Operations (''MD&A'') in filings that include financial statements.[28] Reporting the effects of estimates and judgments extends not only to GAAP-based financial statements but also to disclosures made in the MD&A. The purpose of the MD&A is to provide information ''necessary to an understanding of [a company's] financial condition and results of operations.''[29] The SEC recognizes that accounting estimates and changes in accounting estimates are inherent in the financial re-

[18] FASB, Statement of Financial Accounting Concepts No. 1 ''Objectives of Financial Reporting by Business Enterprises,'' ¶ 20 (Nov., 1978) (emphasis added).

[19] FASB, Statement of Financial Accounting Concepts No. 8 ''Conceptual Framework for Financial Reporting – Chapter 1, the Objective of General Purpose Financial Reporting,'' ¶ OB11, Sept. 2010 (emphasis added). This Statement supersedes Statement of Financial Accounting Concepts No. 1.

[20] The Panel on Audit Effectiveness, Report and Recommendations, ¶ 2.149 & n. 40, Aug. 31, 2000. The Panel was appointed in 1998 by the Public Oversight Board at the request of the Chairman of the SEC.

[21] *Id.* at ¶ 2.143.

[22] PCAOB Standards and Related Rules, AU § 342.01.

[23] *Id.*

[24] FASB ASC § 250-10-20 Glossary (emphasis added).

[25] ASC § 275-10-50-4.

[26] ASC § 270-10-55-7 (emphasis added).

[27] ASC § 275-10-55-6.

[28] Regulation S-K, Item 303.

[29] *Id.*

porting process and may require comment in the MD&A.[30]In 2002, the SEC stated:

> Currently, GAAP and generally accepted auditing standards acknowledge that there are numerous circumstances in which companies, in applying accounting policies, exercise judgment and make estimates for purposes of the financial statements. For example, they call for companies to communicate in a number of circumstances about the use of estimates in the preparation of financial information. The use of estimates results in the presentation of many amounts that are in fact approximate rather than exact.[31]

Subsequent to that Release, the SEC added the requirement that the MD&A disclose critical accounting estimates or assumptions that ''have a material impact on reported financial condition and operating performance and on the comparison of such reported information over different accounting periods.''[32] Accordingly, the impact of the estimation process applies not only to financial statements that are fairly presented in accordance with GAAP, but also to MD&A that analyzes and comments upon those financial statements. Indeed, the MD&A is an analysis of estimates and judgments that yields additional estimates and judgments.

Examples of Estimates and Judgments in GAAP-Based Financial Statements. Cataloguing all estimates and judgments that may be involved in preparing GAAP-based financial statements is not possible. However, common examples of accounting matters that require the exercise of judgment, employment of estimates, and consideration of contingencies include:

Receivables: If a balance sheet receivable, including a loan receivable, has ''probably'' been impaired (meaning that it is likely that a future event or events will confirm the loss) *and* if the probable amount of that loss can be ''reasonably estimated,'' the impairment requires a present reduction of the receivable in the balance sheet, through the creation of an allowance for bad debts on the balance sheet (a contra-asset that reduces the receivable to a lesser amount) and the simultaneous reporting of a loss in the income statement as a bad debt expense.[33]

Non-Receivable Loss Contingencies: A balance sheet liability and a related income statement expense should be recorded when the dual ''probable''/''reasonably estimable'' tests are satisfied.[34] If either or both of those tests is (are) not met, the liability should not be recorded but may require disclosure as a contingent liability. That determination requires an analysis of all facts and circumstances often involving complex judgments that may change over time as facts and circumstances change. A non-exhaustive list of other judgmental ''loss contingencies'' that must be analyzed under the ''probable''/''reasonably estimable'' tests to determine whether liabilities must be reported on a balance sheet includes evaluating warranty obligations, examining guarantees of the indebtedness of others, and estimating obligations for product defects.[35]

Investments (including derivatives): Accounting for these assets requires identification of the status of investments (*e.g.*, whether they are being held to maturity, or available for sale or held for sale), consideration of how to estimate fair values (whether the investments are valued as so-called ''level one inputs,'' (the use of quoted prices for identical assets in active markets),''level two inputs'' (the use of quoted prices for similar but not identical assets in active or inactive markets that are observable), or ''level three inputs'' (unobservable inputs requiring use of the reporting company's own assumptions and estimates of value)) and the effects of changes in those amounts and changes in status.[36] For certain entities, all or almost all of their assets are investments and thus may be based upon estimates.

Property, Plant and Equipment or Long-Lived Assets (''PPE''): PPE originally is recorded at cost and then depreciated over its estimated useful life. Even if ''cost'' is initially a ''fact,'' immediately afterwards that ''fact'' is subject to a series of ongoing estimates. The amount of depreciation is based on estimates of how long and how the assets will be used and of estimated salvage value.[37] On occasion, the net un-depreciated cost of a PPE asset group may have to be tested for possible impairment. Impairment may occur because of current and prior period operating or cash flow losses, ''significant adverse changes'' in legal factors or in the business climate of a reporting company that affects the values of the asset group, or a ''significant adverse change'' in the extent to which the asset group is being used, or in its physical condition.[38]

Acquisitions and Goodwill: When one company acquires another company, all of the assets acquired and the liabilities assumed are recorded on the balance sheet of the acquirer based on their estimated respective fair values at the time of the acquisition.[39] That process may impact most or all of the acquiring entity's consolidated financial statement elements after the acquisition, when the financial statements of the acquirer include the acquired entity's ''fair valued'' accounts. Goodwill represents the excess of the price paid by one company to acquire the net assets (*i.e.*, the fair value of assets acquired minus fair value of liabilities assumed) of an acquired company. After assigning/allocating fair values to every asset acquired and to every liability assumed, any remaining excess is, by definition, accounted for as goodwill.[40] Once goodwill is recorded as an asset, GAAP requires periodic evaluation of goodwill to ascertain whether that value has been impaired. If goodwill is judged as impaired, the balance sheet carrying amount of goodwill must be reduced by the amount of the impairment. A loss in value due to impairment must also be reported as an expense in the income statement as a result of a change in estimate.[41]

Revenue Recognition: GAAP requires revenues to be recorded when realized or realizable and earned. Judgments about when revenue has been earned may include determinations of whether and when delivery occurred, an estimation of the effects of rights of return,

[30] SEC Codification of Financial Reporting Releases § 501.14.
[31] Securities Act Release No. 8098, May 14, 2002.
[32] SEC Codification of Financial Reporting Releases § 501.14.
[33] ASC § 450-20-25-2.
[34] *Id.*
[35] ASC § 450-20-05-3.
[36] ASC § 320-10-20 Glossary, ASC § 320-10-30, ASC § 320-10-35, ASC § 820-10-20 Glossary, ASC § 820-10 Generally.
[37] ASC § 360-10-30, ASC § 360-10-35.
[38] ASC § 360-10-35-15 through 25.
[39] ASC § 805-20-30-1.
[40] ASC § 350-10-20 Glossary, ASC § 805-30.
[41] ASC § 350-20-35.

   ISSN 0037-0665

whether services required by an agreement were rendered, and whether a lease was actually a sales event (a sale-type lease) or whether it was a true lease (an operating lease). A special application of GAAP permits revenue recognition on certain long-term contracts to be reported as the contracts progress based on estimates instead of when performance has been completed. Revenue is thus estimated and reported based upon costs incurred measured as a percentage of estimated total costs. Measuring progress requires the application of numerous judgments and changes in judgments and is commonly the subject of contractual disputes.[42]

Insurance Company Loss Reserves (Liabilities): Insurance companies accept premiums in exchange for promising to pay the insured entities if risks insured against occur. Those insurance companies then invest the premiums in the hope that premiums received plus returns on investments exceed claim payouts. These companies must estimate the impact of claims that have been made against them, including claims that have been incurred but which have not yet been reported to the insurance company (''IBNR''). A balance sheet claims liability contains numerous estimates, including estimates of claims that will be made but have not yet been made and when the related events are estimated to occur. To the extent that estimated loss reserves increase a liability, a corresponding income statement expense must also be reported by the insurance company.

Restructurings: Periodically, companies restructure operations following determinations to change direction or to recognize changes in their business environments. Restructuring expenses may include employee severance costs, the costs of abandonment of leases, facility relocations, estimated losses on sales of equipment and write-downs of assets. Underlying decisions require evaluations of whether and when estimated losses must be reported and how those losses should be presented in income statements along with related effects on balance sheets. Those judgments are necessary not only to measure the effects on the financial statements during the period of the restructuring but also to evaluate whether certain potential impacts of the restructurings should be reported in subsequent periods, not in the current period.[43]

Deferred Tax Benefits Assets: GAAP provides that a deferred tax asset may be included on a balance sheet for a tax benefit that may be received in the future *(e.g.*, a net operating loss carryforward). This type of asset is not evaluated under the ''probable''/''reasonably estimable'' tests of realization in order to be considered an asset. Instead, the estimated future benefit is accounted for as an asset if it is estimated as ''more likely than not,'' *i.e.*, more than 50% likely to be realized. The subjective assessment of the application of the ''more likely than not'' standard—which one judge recently characterized as ''nebulous''[44]—requires significant judgment, consideration of surrounding facts and circumstances and projection of expectations into the future, including tax planning alternatives.[45] When an estimated deferred tax asset is recorded on the balance sheet, a corresponding tax benefit, which increases net income, is presented in the income statement. That results in a corresponding increase of retained earnings (equity) on the balance sheet.

A Framework for Distinguishing Facts from Opinions in Financial Statements. Recent decisions like *Fait* and *City of Omaha* turn upon the distinction between statements of fact and statements of opinion in litigation alleging misstatements of financial statements. The distinction matters for purposes of what plaintiffs must plead (to survive a motion to dismiss) and ultimately prove (to prevail on the merits). Alleged misstatements of fact may be actionable if stated in terms sufficient ''to raise a right to relief above the speculative level''[46] and rooted in ''factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.''[47] Claims of fraud under Section 10(b) of the 1934 Act and SEC Rule 10b-5 further require complaints to ''specify each statement alleged to have been misleading'' and to ''state with particularity facts giving rise to a strong inference that the defendant acted with the required [fraudulent] state of mind.'' 15 U.S.C. § 78u-4(b)(1) & (2).[48]

Those who allege misstatements of opinion must go a step farther. They must satisfy not only the pleading requirements otherwise applicable to claims brought under the 1933 and 1934 Acts, but also must allege that the challenged opinions ''were both false and not honestly believed when they were made.''[49] *Fait* and *City of Omaha* make clear that this standard requires more than conclusory allegations grounded in after-the-fact observations of adverse corporate news and related generalized contentions that a defendant-issuer waited too long to record a goodwill impairment or loan loss reserve. The precise level of particularity required to satisfy the *Fait* (and, derivatively, the *Virginia Bankshares*) standard of subjective falsity will emerge in future cases, as courts confront new complaints and specific facts and circumstances underlying alleged misstatements of specific accounts and line items within financial statements.

A threshold issue in future cases will be deciding whether an alleged accounting misstatement is a statement of fact or a statement of opinion. The legal and accounting considerations outlined above demonstrate that a proper answer requires a rigorous, multi-stepped assessment focused on the following:

- Step #1: *Identify the Alleged Misstatement or Omission:* The beginning point must be the identification of the alleged misstated account or line item. This inquiry should focus on how the issuer allegedly overstated or understated the account at issue and the impact the misstatement or omission had on the financial

[42] ASC § 605-35-05-7 through 11.

[43] ASC § 420, ASC § 420 Glossary, ASC § 420-10-25-1 through 15.

[44] *Kuriakose v. Federal Home Mortgage Corp.*, No. 08 Civ. 7281 (JFK), 2012 WL 4364344, at *9 (SDNY Sept. 24, 2012) (Keenan, J.).

[45] ASC § 740-10-20 Glossary, ASC § 740-10-25.

[46] *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555 (2007).

[47] *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009).

[48] The Supreme Court has held that pleading a ''strong inference'' of scienter requires allegations of particularized facts such that ''a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.'' *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007).

[49] *Fait*, 655 F.3d at 113; *see also City of Omaha*, 679 F.3d at 67 (applying the same standards in affirming dismissal of claims under Sections 10(b) and 20(a) of the 1934 Act).

statements. These initial questions shape the requisite identification and assessment of the accounting principles at issue and ultimately whether the applicable pleading and proof requirements have been satisfied.

■ Step #2: *Identify the Challenged Assertions in the Alleged Misstated Account*: Longstanding auditing standards recognize that financial statement accounts embody the five distinct assertions of (a) existence or occurrence, (b) completeness, (c) rights and obligations, (d) valuation or allocation, and (e) presentation and disclosure. Inventory provides a good illustration. In reporting inventory on a balance sheet, an issuer asserts the actual existence of the inventory (for example, in a warehouse), the reporting of all (and not just part) of the inventory to which it holds legal title, the valuation of the inventory at the lower of cost or market, and appropriate presentation of the components of the inventory (often raw materials, work in process, and finished goods). The same approach applies to evaluating liabilities. For a balance sheet loss contingency, for example, an issuer asserts the likely future occurrence of an event rendering the existence of a present obligation at least probable, the recording of the entirety of the obligation, appropriate valuation of that amount, and necessary disclosure of the nature of the obligation in the notes. Pinpointing the challenged account assertion helps facilitate an assessment of whether the alleged misstatement or omission concerns a statement of fact or opinion.

■ Step #3: *Review Applicable Accounting Principles*: Upon identification of the precise account assertion being challenged, the inquiry should proceed to identify the governing GAAP standards. Doing so requires at least two steps.

■ As outlined above, GAAP requires adherence to general and specific standards and principles of accounting for, valuing, and reporting financial statement accounts. In *Fait*, for example, the Second Circuit identified Statement of Financial Accounting Standards 141 and 142 as the principles applicable to the proper accounting for goodwill. The objective in identifying the applicable GAAP standard is to ascertain whether adherence to the standard leads to the conclusion that the account at issue can be evaluated as an assertion of objective fact (for example, the amount of cash on hand at the balance sheet date) or instead as requiring the application of judgments, estimates, and assessments of contingencies (for example, the amount of a reserve for losses on the collection of accounts receivable).

■ More exacting consideration then needs to be given to the precise nature of a challenge to a particular account. Even though the account at issue generally may be one having the hallmarks of judgment and opinion, the challenge at issue may be one concerning objective verifiable facts. This more refined inquiry requires consideration of the precise account attribute or assertion being challenged and the accounting principles underlying the assertion.

■ Step #4: *Assess Whether Estimates, Judgments, and the Evaluation of Contingencies are Necessary to Comply with GAAP*: Typically, alleged misstatements or omissions of account assertions regarding the (a) occurrence (or non-occurrence) of an event—often at the center of a determination whether to recognize impairment of an asset or to record or disclose a liability—or (b) valuation or allocation, will signal a challenge to a statement of opinion. Here again *Fait* aptly illustrates the point. In *Fait*, the Second Circuit recognized that plaintiffs' challenges to the adequacy of Regions Financial's loan loss reserve and alleged failure to record an impairment of goodwill were based on subjective estimates and judgments about loan losses (that ''will vary depending on a variety of predictable and unpredictable circumstances'') and the fair value of particular assets (that ''will vary depending on the particular [valuation] methodology and assumptions used'').[50]

■ Step #5: *Evaluate Whether the Legal Pleading or Proof Requirements Are Satisfied*: The final step requires determining the legal consequences that follow from the preceding accounting analysis. If that analysis determines that the assertion being challenged constitutes principally considerations of opinion rather than fact, the subjective falsity standard of *Fait* (and thus *Virginia Bankshares*) will control. That conclusion, in turn, will require plaintiffs to plead and ultimately prove that defendant did not actually believe its own statement of opinion at the time it was made.

In essence, the suggested framework requires immediate identification of the account assertion being challenged and a corresponding assessment of whether that assertion and its related attributes requires the exercise of judgment, the employment of estimations, or the consideration of contingencies in an issuer's financial statements.[51] This analysis should enable a determination of whether the alleged misstatement or omission is one about estimates and judgments or about verifiable facts. In all instances, the answer will turn upon the exact allegations before a court and the precise circumstances underlying the specific financial statement account or line item at issue.

Conclusion. The Second Circuit's decisions in *Fait* and *City of Omaha* confirmed that alleged misstatements of opinion on accounting matters require satisfaction of the subjective falsity test of *Virginia Bankshares*. The decisions also established that, on the complaints before the district courts, the specific allegations of overstated goodwill and understated loan loss reserves were based on estimates and judgments under the applicable accounting standards rather than objective facts. Thus, the challenged statements were opinions. *Fait* and *City of Omaha* stopped there, however. The Second Circuit did not address what other accounts might require estimation, judgment, and assessment of contingencies—the factors most commonly distinguishing statements of opinion from fact. The framework of-

[50] *Fait*, 655 F.3d at 111-13.

[51] The proposed framework resembles the approach recently employed in *MHC Mut. Conversion Fund, L.P. v. United Western Bancorp, Inc.*, No. 11-cv-00624-WYD-MJW, 2012 WL 6645097 (D. Colo. Dec. 19, 2012), where the court invoked the applicable FASB standard for accounting for investments, applied the requirements of objective and subjective falsity articulated in *Virginia Bankshares* and *Fait*, and held that plaintiffs' ''Amended Complaint is void of any allegations that Bancorp's statements regarding OTTI [''Other-Than-Temporary Impairment'' of investment value] were subjectively false *i.e.*, that Bancorp did not believe its statements regarding OTTI were true when they were made.'' *Id.* at *11.

   ISSN 0037-0665

fered here provides a roadmap for making these distinctions in future cases.