Post-Enron Corporate Disclosure Initiatives

Janice C. Hartman
Kirkpatrick & Lockhart, LLP
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Links

Securities and Exchange Commission (SEC):

- Proposed Rule: Disclosure in Management’s Discussion and Analysis about the Application of Critical Accounting Policies
- Proposed Rule: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports
- Proposed Rule: Form 8-K Disclosure of Certain Management Transactions
- Written Testimony by SEC Chairman Harvey L. Pitt concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies
- SEC v. John P. Gallo (Complaint)
- Statement about Management’s Discussions and Analysis of Financial Condition and Results of Operations
- Cautionary Advice regarding Disclosure about Critical Accounting Policies
- Guidance for Consulting with the Office of the Chief Accountant
Links

Other Links:


I. Enron – A Business Failure?

- Audit Environment
  - Rules-based; “sales oriented”
- Short-term Management Incentives
II. Universe of Initiatives

- Enforcement
- Financial Disclosure
- Structural Reform
- Management Incentives
- Range of Players
III. Enforcement

- More Cases (over 50% involve revenue recognition)
- Accounting/financial disclosure generally not susceptible to criminal charges (not black and white)
- SEC seeking increased sanctions legislatively
  - Increased penalties
  - Bar (in House bill)
  - Disgorgement (in House bill)
III. Enforcement

- *Gallo* case (permanent bar, disgorgement)
- *Waste Management*:
  - General Counsel named for recklessly and deliberately hiding financial fraud in periodic reports
- Staff will be monitoring all Fortune 500 annual reports for 2002 (House bill mandates once every three years and development of a risk rating system)
IV. Financial Disclosure

- Releases and speeches have set out imminent rulemaking initiatives and aspirational goals
- “Real time” disclosure
  - Proposed rules
    - Shortening filing deadlines
    - Disclosure regarding company Web site access to periodic reports
IV. Financial Disclosure

- Accelerated disclosure of insider transactions on Form 8-K (House bill mandates SEC to require Section 16 reports be filed electronically the next day and to include expanded universe of transactions)
  - Expected proposal for expanded 8-K list of items and accelerated filing deadline (House bill mandates for code of ethics waivers)
    - FEI suggests a non-exclusive list and principles-based 8-K reporting
IV. Financial Disclosure

• On the horizon
  - Disclosure on a “current” basis of “unquestionably significant events”
  - House bill mandates current disclosure for information concerning financial condition or operations that the SEC determines necessary for investor protection or the public interest
  - Mandatory company Web site and posting in real time
IV. Financial Disclosure

- Better Disclosure
  - Critical Accounting Policies/Proposed Rule
    - Separately captioned section in MD&A
    - “Critical accounting estimate”
    - If it requires assumptions about highly uncertain matters, and different reasonable estimates would have a material financial impact
IV. Financial Disclosure

- Must disclose information regarding methodology, significance, sensitivity analysis, material changes to the estimate in the last three years
- Initial adoption of material accounting policies
IV. Financial Disclosure

- MD&A Release (January 2002)
  - Liquidity and “off-balance sheet” arrangements (House bill would require disclosure where likely to materially affect financial circumstances)
  - Trading activities that include non-exchange traded contracts accounted for at fair value
IV. Financial Disclosure

- Transactions with related parties and parties not “clearly independent”
  - Initiatives on the horizon
    - Evaluative information
      - Trends (key performance measures) that management follows
      - SEC may clarify duty to update issues
      - May require strengthening safe harbors
IV. Financial Disclosure

• Modernization
  ➢ Clarity and readability
  ➢ “Layers” of financial disclosure
• Principles-based accounting
• CEO accountability
  ➢ Certification that any significant information known to the CEO has been disclosed
  ➢ Possible rulemaking calling for procedures designed to bring significant matters to CEO’s attention
IV. Financial Disclosure

- FASB Initiatives
  - SPEs
    - Interpretive guidance by June
    - Retroactive
    - Likely 10% equity; third party must take first dollar risk
    - Consolidation with party who has the risk
    - Will have implications for R&D arrangements, some joint ventures, triple net leases
IV. Financial Disclosure

- Revenue recognition
- Stock Options
- Convergence with international standards
V. Structural Reform

- Auditing
  - Regulatory Oversight Board
    - Private sector; independent funding; quality control and discipline (not standard setting)
    - House bill
      - SEC jurisdiction
      - Five members, two must be accountants and one a non-accountant
V. Structural Reform

- Independence
  - House bill would prohibit IS design or implementation and internal audit services
V. Structural Reform

- Analysts
  - SEC approved on May 8 NASD and NYSE rules to address analyst conflicts of interest
    - Prohibit analysts from altering or threatening to withhold favorable research
    - Limitations on investment banking influence and related compensation
    - Disclosure of relationships and percentage of ratings in buy/sell/hold categories
    - Restrictions on personal trading
V. Structural Reform

- Credit Rating Agencies
  - House bill mandates SEC study

- Investment Banks
  - House bill mandates GAO study

- FASB
  - SEC intends to become much more actively involved in FASB
    - Selection of members, selection of projects, timing, movement toward principles-based accounting
V. Structural Reform

• FEI recommending a blue-ribbon committee to study
  ➢ Organization, timeliness, substance
  ➢ FASB has announced change to majority standard for approval
V. Structural Reform

- Lawyers
  - Comptroller General to review Model Rules of Professional Conduct
    - Is there sufficient guidance as to ethical responsibilities
    - Warn clients of possible fraudulent or illegal activities of clients and possible consequences
    - Disclose to appropriate regulators or law enforcement
    - Management of conflicts of interest
V. Structural Reform

- Susan Koniak testimony
  - Rollback PSLRA
  - Clarify use of Rule 102(e)
  - SEC set standards for securities lawyers
VI. Management Incentives

- Increased pressure for short-term results has led to short-term stock appreciation incentives
  - As grants have increased in size, encouraged high risk to reap high rewards
VI. Management Incentives

- Need to rebalance compensation
  - “Tone at the top”
  - Incentivize “real” financial performance
  - Encourage holding stock (perhaps in part through tax legislation)
  - Prompt disclosure of transactions
  - Avoid stock grants to directors
VII. Action Items

- Comment on proposals
- Establish processes for reporting insider transactions
  - Consider single broker
- Web site posting
- Begin analysis and disclosure strategy for critical accounting policies
- Consider what other “evaluative” information might be disclosed