

---

# Post-Enron Corporate Disclosure Initiatives



---

Janice C. Hartman

Kirkpatrick & Lockhart, LLP

May 2002

# 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

CONTINUED

## Other Links:

- ["New SEC Rules -- The Deluge Begins"](#), *K&L Securities Law Commentary*, April 2002
- ["New SEC Rules -- The Deluge Continues"](#), *K&L Securities Law Commentary*, May 2002
- ["Interpretative Guidance on the Consolidation of Special Purpose Entities -- An Overview"](#), *K&L Special Purpose Entities Alert*, May 7, 2002
- ["Carpe Diem" – 'Enron' Facilitates Major Changes in SEC Corporate Disclosure Rules](#), *K&L Securities Law Commentary*, February 2002
- ["SEC Enforcement Chief Threatens Officers and Directors of Public Companies with Increased Sanctions for Deliberate Violations of the Securities Laws"](#), *K&L Securities Enforcement Alert*, February 21, 2002

# 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

CONTINUED

- *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

CONTINUED

- 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

CONTINUED

- 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

CONTINUED

- 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

CONTINUED

- ❑ 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

CONTINUED

- 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

CONTINUED

- 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

CONTINUED

- 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

CONTINUED

- 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

CONTINUED

- 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

CONTINUED

- Independence
  - House bill would prohibit IS design or implementation and internal audit services

# V. Structural Reform

CONTINUED

- 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

CONTINUED

- 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

CONTINUED

- FEI recommending a blue-ribbon committee to study
  - Organization, timeliness, substance
  - FASB has announced change to majority standard for approval

# V. Structural Reform

CONTINUED

- 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

CONTINUED

- 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

CONTINUED

- 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