

## ROBERT G. HUTCHINS – LEGAL ESSAYS

### *Public Companies – Evolving Trends in Financial Disclosure*

#### Part II - Identification and Disclosure of “Critical” Accounting Policies

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##### Preliminary Note

In December 2001, the SEC launched an ambitious program to improve financial reporting by public companies. By May 1, 2002, it had issued 4 Financial Releases and a series of related announcements advocating additional disclosure in specific areas. I analyzed the first Release, on the potentially misleading impression created by “pro forma” earnings, in Part I of this series.<sup>1</sup>

This Essay discusses the second Release, entitled “*Cautionary Advice Regarding Disclosure about Critical Accounting Policies*” and the SEC’s related “proposal” that companies disclose the manner in which they apply such policies to their financial statements. It begins with a review of the accounting and regulatory context in which the Release and proposal were issued.<sup>2</sup>

##### Current Requirements – Financial Statements and Supplementary Disclosure

The financial statements of US public companies must comply with SEC Regulation S-X. Rule 4-01(a) of that Regulation provides that the statements are presumed misleading unless, with minor exceptions, they are prepared in accordance with “generally accepted accounting principles” (“GAAP”).<sup>3</sup>

A company’s “accounting policies” are the criteria by which it selects and applies specific GAAP when preparing its financial statements. Since 1972, Accounting Principles Board Opinion No. 22 (“APB-22”) has required that financial statements disclose the policies that govern them, typically in footnote 1.

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<sup>1</sup> See this website, *Publications/Essays /Public Companies – Evolving Trends in Financial Disclosure – Part I – “Pro Forma” Financial Information in Earnings Releases*.

<sup>2</sup> The “Cautionary Advice” is found in Financial Release 33-8040, 34-45149, FR-60, dated December 12, 2001, the proposal in press release 2002-58 dated April 30, 2002.

<sup>3</sup> GAAP-based financial statements are required for primary offerings by Sections 7(a) and 10 of the Securities Act and by each of the Registration Forms (e.g. Item 11[e] of Form S-1). They are required for registration of a class of equity securities and for periodic reports by Sections 12 and 13 of the Securities Exchange Act and Rules 13a-1 (annual reports), 13a-13 (quarterly reports) and 13a-11 (current reports).

GAAP are evidenced by formally designated, sequentially numbered accounting pronouncements regarded as authoritative. Opinions of the Accounting Principles Board are no longer issued, but many of those extant, such as APB-22, are still followed. Today, the major pronouncements are issued by the Financial Accounting Standards Board (“FASB”) whose Statements of Financial Accounting Standards (each, a “FAS”) and Interpretations (each, a “FIN”) comprise the highest level of the so-called “GAAP Hierarchy.” Other authoritative pronouncements include Accounting Research Bulletins (each, an “ARB”).

The term GAAP, however, connotes a greater degree of precision, uniformity and consistency than is actually the case. Three broad examples will illustrate this:

First, GAAP often require (or tolerate) reported amounts based on estimates rather than objective data. A case in point concerns the value of intangible assets such as contract rights and “intellectual property.” As the economy has become increasingly service oriented, there has been a corresponding increase in the importance of these assets to competitors, consumers and investors. Intangible assets acquired by purchase are carried initially at the price paid for them, an objectively verifiable amount. Intangible assets other than goodwill that are developed internally are carried at the aggregate out-of-pocket cost of their development including research and testing. That amount also is verifiable. However, under FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, intangible assets other than goodwill must be tested for *impairment* each accounting period. The assets will be deemed impaired to the extent their carrying amounts are no longer recoverable from the remaining undiscounted cash flows they are expected to generate. The expected cash flows are *estimated* based on legal opinions respecting the ownership, enforceability and duration of the assets and business opinions respecting the impact of such factors as the depth of the relevant service market and technological innovation. As a result, the amounts recorded for these assets are not precise and may vary considerably between companies and accounting periods.

Second, GAAP permit companies to engage in so-called “off-balance sheet” financing. Examples include ARB 43, Chapter 2A, *Comparative Financial Statements*, ARB-51 *Consolidated Financial Statements* and FAS-94 *Consolidation of All Majority-Owned Subsidiaries*. Under those principles, a company may *omit* from its balance sheet the liabilities of a minority owned subsidiary. It does not matter that the subsidiary was organized at the direction of the company to conduct a business in which the company participates. The company can capitalize the business by investing in financial instruments issued by the subsidiary. As a primary source of capital, the company can exercise considerable influence over the subsidiary even without majority ownership. Usually the ultimate purpose is to benefit shareholders, e.g. by spinning off the subsidiary to them. Occasionally, however, the only purpose is to prevent attribution to the company of specific business liabilities. That purpose is achieved by conducting the business and incurring the liabilities through the subsidiary.

A corporate parent accounts for its purchase of financial instruments issued by a minority owned “off-balance sheet” subsidiary under FAS 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with concentrations of Credit Risk*. The parent records the balance due on the instruments as an investment. It provides footnote disclosure of the risk of default based on a legal analysis of the instruments and any collateral for them plus an accounting estimate of the financial loss the parent would sustain if the subsidiary or another counter-party failed to perform. The disclosure is *not* based upon an analysis of the *solvency* of the subsidiary or the risks of its business. It is not exaggeration to observe that the estimates can vary and the risk may be understated.

Third, GAAP permit important transactions to be recorded using only one of two or more alternative principles, each “generally accepted.” Obviously, when a company selects one alternative, it necessarily discards the others. Since, by definition, the selected alternative is “generally accepted,” the resulting financial statements conform, at least technically, to GAAP. However, if one of the discarded alternatives would reveal a significantly different financial outcome, the statements will be misleading unless the discrepancy is explained.

Examples of alternative principles applicable to the same accounting entry include the GAAP relating to inventory. They are comprised of APB-28, *Interim Financial Reporting*, ARB-43, *Inventory Pricing*, FAS-2, *Accounting for Research and Development Costs*, and FIN-1, *Accounting Changes Related to the Cost of Inventory*. Under those principles, the cost of sold items removed from inventory can be determined (a) by calculating the specific cost of the removed items, (b) by calculating the average cost of all existing items, (c) by calculating specific costs assuming the first items sold are the oldest (“First in-First Out”), or (d) by making that calculation using the opposite assumption (“Last in-First Out”). The first method may not reflect *prevailing* costs. The other three may not reflect *actual* costs. Any of the four can produce misleading financial statements.

The accounting response to the risk of misleading GAAP selection has been tentative. APB-22.06 requires that selected GAAP be “the most appropriate in the circumstances....” APB-22.12 requires that the disclosure of accounting policies describe (a) any GAAP that are chosen from among “acceptable alternatives,” (b) any GAAP that are “peculiar” to the relevant industry, and (c) any GAAP requiring “unusual or innovative applications.” There can be substantial disagreement about which GAAP are “appropriate” or should be specially described.

The legal response has been only marginally better. Rule 4-01(a) provides that literal compliance with the applicable SEC Forms, Regulations and Rules produces only *minimum* disclosure, so that additional information must be furnished to the extent necessary to ensure that the disclosure actually made is not misleading. As is the case with the accounting literature, the details are omitted.

Companies *are* required legally to disclose *known* “trends, demands, commitments, events or [...] uncertainties” that are “reasonably likely” to have a material effect on their “liquidity, capital resources and results of operations.” The disclosure must appear in both periodic reports and registration statements under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”<sup>4</sup>

This aspect of MD&A disclosure has been a perennial source of concern to corporate managers because of the difficulty of identifying “trends” or future “uncertainties” about which investors should be informed. On the other hand, companies are not required to speculate about hypothetical events that are not reasonably likely to occur or would not be significant. Moreover, companies can insert “forward-looking” statements in MD&A with the understanding that the statements are “expressly covered by the safe harbor for projections [...]”<sup>5</sup>

The SEC has also issued a series of accounting bulletins that describe the views of its staff respecting selected disclosure issues. Staff Accounting Bulletin No. 101, for example, summarizes the staff’s views on applying GAAP to revenue recognition. These bulletins are not the equivalent of SEC Rules, nor do they otherwise have the SEC’s official approval. They provide practical insights, but compliance with them does not immunize a company from investor misrepresentation claims or SEC enforcement actions. In the event of a conflict or ambiguity, the bulletins defer to the authoritative accounting literature.

The current disclosure regime can thus be summarized as follows:

⇒ Under Regulation S-X, the financial statements published by US public companies must conform to GAAP.

⇒ Under APB-22, selected GAAP must be “appropriate” and financial statements must contain disclosure of the underlying accounting policies, occasionally with specific identification of selected vs. discarded principles, but there are no detailed guidelines.

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<sup>4</sup> MD&A disclosure is governed by Item 303 of SEC Regulation S-K. Item 303 is incorporated by reference in most of the relevant Forms. See, e.g. Part II, Item 7 of Form 10-K, the general Form for annual reports, Part I, Item 2 of Form 10-Q, the general Form for quarterly reports and Item 11(h) of Form S-1, the general Form for registration statements.

<sup>5</sup> The safe harbor excludes, as a basis for misrepresentation claims, statements labeled “forward looking” if they are accompanied by “meaningful” warnings that actual results may differ from anticipated ones. See Item 303(a) Instruction 7 and 303(b) Instruction 6 of Regulation S-K, Securities Act Section 27A and Rule 175, Exchange Act Section 21E and Rule 3b-6. There is no safe harbor for financial statements, which are based on existing data.

⇒ Under Regulation S-K, companies must also disclose known trends or foreseeable future events (whether or not certain) that are “reasonably likely” to have a material subsequent effect on their liquidity, capital resources or results of operations. Again, the guidelines are cursory.

⇒ There is no current requirement that companies disclose the extent, if any, to which trends or future events might render their financial statements misleading, *as such*, or might require changes in the accounting principles selected for those statements.

### **The December 12 Financial Release and “Cautionary Advice”**

On December 12, 2001, the SEC published, in the form of a Financial Release, its “Cautionary Advice regarding Disclosure about Critical Accounting Policies.” The Release introduces, for the first time, the notion that supplementary disclosure is *inherently* necessary to explain the ongoing effects on financial statements of the accounting policies that shape them. The Release observes that a “technically accurate” application of GAAP may “fail to communicate important information.” It then declares that the SEC will “consider” new rules requiring “more precise disclosures” about accounting policies that are “critical.” To justify that project, the Release “reminds” managers, auditors and their advisors that “the selection and application of accounting policies must be appropriately reasoned” and that “investors increasingly demand full transparency of accounting policies and their effects.” No one could quarrel seriously with those propositions.

Unfortunately, the ensuing “advice” is deprived of practical utility by a hapless definition of “critical.” Accounting policies are deemed “critical,” and thus candidates for “more precise” disclosure, if (a) they are “most important to the portrayal of [...] financial condition and results” *and* (b) they “require management’s most difficult, subjective or complex judgments” *including* “estimates about the effect of matters that are inherently uncertain.” Nothing in the Release suggests that a simple, easily explained policy could also be “critical.” A policy will attain that status only if it survives a long night of the soul. I suspect that managers to whom this truth has not previously occurred will find the Release either discomfiting (“subjective implications of inherent uncertainties?”) or easily circumvented (“our policies are simple, *ergo* none are critical”). I doubt the SEC had either reaction in mind.

Nor does the Release explain why, to inform investors properly, it is first necessary to segregate “critical” policies from ordinary ones. The issue here is whether additional disclosure is required when *any* policy, “critical” or not, results in the use of accounting principles that may produce misleading financial statements. What concerns investors most is the risk that a company’s disclosed results are belied by undisclosed but equally valid alternatives, not the difficulty, subjectivity or complexity of the company’s accounting policies.

Nevertheless, with its “advice” straitjacketed by its own definition, the Release plunges on: companies are “encouraged” to adopt a new “disclosure regimen” without waiting for specific rules. The regimen should position companies to “defend the quality and reasonableness” of “critical” policies, explain their “effects” and underlying “judgments” and disclose the likelihood of changed results if “different assumptions were to prevail.” To be “appropriate” the regimen should include “proactive” discussions between auditors, senior management and audit committees about “evaluative criteria” for “critical” policies. (Apparently, mere active discussions will not suffice.) Companies should be prepared to disclose, in “plain English,” the “implications” of “environmental and operational trends, events and uncertainties” for the “methods, assumptions and estimates” used for “recurring and pervasive accounting measurements.”

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Now, with all respect to the importance of its subject matter, *that* is some Release. It clearly is well intentioned, but taken literally I doubt it will do much to improve the lives of corporate managers or public investors. The regulatory pronouncements that constrain companies should be grounded in common sense and conveyed with reasonable clarity. On its face, this Release has neither attribute. To require disclosure of the theoretic shortcomings of “critical” accounting policies is to invite theoretic responses helpful to no one. To equate “critical” policies only with judgments that are “most difficult, subjective or complex” is to disregard policies that may be easy to articulate but nevertheless produce imprecise or ambiguous financial measurements. To require unqualified disclosure, in “plain English” no less, of even subjective “implications” of “environmental and operational trends, events and uncertainties” is to open a Pandora’s Box of angst-ridden speculation. I think this Release is neither realistic nor a model for the “plain English” it purports to require. My primary concern is that it may prompt abstract and irrelevant disclosure about arcane accounting policies while encouraging continued silence when straightforward policies produce questionable entries.

### **The Need for Rule-Making**

On the other hand, the Release draws attention to a growing problem and its *premise*, at least, is sound. Financial statements contain the heart of the information on which investors rely. Management’s overriding duty when preparing them is to adopt accounting policies that ensure a fair presentation of results. The duty cannot be avoided merely because it is burdensome. Of course estimates are imprecise, but the factors on which they are actually based can be disclosed succinctly. To choose between competing but equally authoritative accounting alternatives may well be difficult, and in the final analysis is always subjective, yet companies make such choices every day. When the chosen alternatives produce results that the discarded ones would not, the differences must be disclosed if investors are to be adequately informed. By the same token, no prediction of the future is “certain,” but many

foreseeable events have a significant enough probability of occurrence that it would be foolhardy not to take account of them in corporate financial planning. Investors are better able to evaluate a company's future performance if they understand all ramifications of its current financial position.

The SEC's task, which is formidable, is to devise disclosure rules that respond to the rapidly increasing complexity of the US financial environment. The Release is a poor beginning, but only because it focuses too much on the disclosure of esoteric accounting *theory*. I believe investors can grasp the limitations inherent in financial statements if they are provided with an explanation of the GAAP *actually used* to produce them, plus an itemization of any materially different *entries* that would be produced by using alternative GAAP of equal relevance. When drafting the Release, the SEC seems to have assumed, I think unnecessarily, that when alternative entries are omitted the entire theoretic basis for the omission should be explained. Hopefully, the SEC will abandon the intellectual high ground in favor of a practical approach when it turns from cautionary advice to formal rule making.

There is hope for such an approach. The Financial Release lacks the binding effect of a final rule even though it will have an interim bully-pulpit impact. The SEC has never required disclosure of hypothetical risks for which there is no objective support and its April 30 proposal suggests it will exercise similar restraint in the present context.

#### **The April 30 Proposal – “Application of Critical Accounting Policies”**

On April 30, 2002, the SEC followed its Financial Release with a proposal that companies add a new section to their MD&A disclosure called “Application of Critical Accounting Policies.” In lieu of the abstractions contained in the Release, the new section would contain relatively concrete disclosure of the basis for and effects of accounting “*estimates*.” The section would also contain disclosure of the initial adoption of *any accounting policy*, whether or not “critical,” that would have a material impact on financial statements. The proposal is subject to a 60-day comment period. Here is a summary of its essential provisions:<sup>6</sup>

#### **Proposed disclosure respecting accounting estimates.**

Under the proposal, a company's accounting *estimate* is deemed “critical” and must be specially disclosed if (a) it is based on assumptions that the company itself regards at the time as “highly uncertain” *and* (b) the company's financial condition, changes in financial condition or results of operations would be materially impacted by *either* (i) a different estimate that reasonably could have been used *or* (ii) a change in the estimate actually used that is reasonably likely to occur. The

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<sup>6</sup> Instructions for the new section would be added to Item 303 of Regulation S-K.

proposal thus defines “critical” in terms of material estimates the company actually made, reasonably could have made or is likely to change.

Once it has classified an accounting estimate as “critical” a company would:

⇒ Identify the estimate and describe (a) the method by which it is applied, (b) the underlying assumptions and (c) any likely changes.

⇒ Explain the significance of the estimate for the company’s financial condition, changes in financial condition or results of operations and identify the line items in the company’s financial statements affected by the estimate.

⇒ Quantify the line item changes and changes in financial performance that would be shown if the estimate were changed to reflect “reasonably possible near term changes” in the assumptions or the “reasonably possible range” of entries permitted by the assumptions.

⇒ Disclose both quantitatively and qualitatively any material changes in the estimate actually made in the past three years with attention to the reasons for the change and the effect on line items and overall financial performance.

⇒ Disclose whether the company’s management has discussed the development and selection of the estimate, and the required disclosure for it, with the company’s audit committee.

⇒ Identify all material segments of the company’s business that are affected by the estimate and, to the extent necessary to avoid misleading investors, repeat the above disclosure for each affected segment, and

⇒ Update the disclosure on a quarterly basis to reflect material changes.

**Proposed disclosure respecting the adoption of accounting policies.**

Under the proposal, the new section would also contain disclosure of the initial adoption of an accounting policy within the past year if the policy had a material impact on financial condition, changes in financial condition or results of operations. The disclosure would cover:

⇒ The events or transactions giving rise to the policy, the GAAP selected because of the policy and the methods for applying GAAP required by the policy.

⇒ The specific impact of the policy on financial condition and changes therein or results of operations.

⇒ The relevant alternative GAAP and their potential material impacts plus the reasons for the GAAP selection actually made, and

⇒ In the absence of supporting accounting literature, the reasoning behind the selection process for both principles and *methods*.

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In most respects, the proposal is a significant improvement over the Financial Release. The proposal provides a specific framework for warnings that current financial statements might not be indicative of future performance. It concentrates on the assumptions used to support material estimates and on the alternative assumptions or alternative GAAP that would change reported results. It does not require a discussion of accounting theories, subjective impressions, purely hypothetical risks or “inherent uncertainties” unless such factors were actually considered in the preparation of financial statements.

The proposal will be read together with the Release, however, and that could detract somewhat from the utility of the proposal as a stand-alone guideline. Moreover, the proposal is silent on the extent to which specific disclosure should be provided of material transactions that reflect “off-balance sheet” financing. The duty to disclose all material risk, whether on or off the balance sheet, exists under current law, but the rationale for the SEC’s improvement program is that current requirements are not specific enough to be effective. I think public companies should describe the essential terms and underlying risks of material financial instruments with “off-balance sheet” origins. The companies’ balance sheets and statements of income, cash flows and changes in stockholder’s equity should, to the extent implicated, be cross-referenced to the description. I assume the SEC will address this subject in a separate proposal.

### **Interim Recommendations**

Until new rules are actually adopted, companies must cope with the Release, the proposal and all of their “implications.” I offer the following guidelines:

√ **Formalize the accounting and auditing process:** The annual schedule of any public company should include regular, formal meetings between senior managers, audit committee members (or other directors with corresponding responsibility) and outside auditors. I suggest the meetings be held on at least a quarterly basis, more often when dictated by unanticipated events. The agenda should include a review of the continuing appropriateness of the company’s accounting policies and an evaluation of known or foreseeable events that could require special disclosure. During these meetings, the company’s managers should be interrogated carefully about the assumptions and estimates that underlie their internal financial reports and any weaknesses or ambiguities should be investigated.

√ **Let sound business judgment dictate the choice of GAAP:** Directors and officers should use their own good faith business judgment when adopting accounting policies in consultation with their advisors. Selected GAAP should be appropriate, but need not be the most conservative available. If the selected principles are in fact generally accepted, they should be used unless their primary effect is merely cosmetic, e.g. the creation of financial statements showing artificially inflated results.

√ **Explain the factors supporting potentially controversial GAAP:** While GAAP need not be selected with an eye to the most conservative financial presentation possible, the fact that conservative alternatives have been excluded should be disclosed if the differences in reported results would be material. The disclosure should be contained in a separately designated narrative statement. When preparing the statement, companies should build upon the proposal and APB-22 by explaining the factors *actually considered* when selecting GAAP from among equally authoritative alternatives. For example, an explanation of the estimated amount recorded for major patents should not be limited to a statement that intangible assets are depreciated over their estimated useful lives in accordance with FAS 144. What specific lives were estimated for the patents involved? What specific factors were taken into account to arrive at the estimates? If there are numerous patents, a range of estimated lives and examples of relevant factors could be furnished.

√ **Itemize alternative results in a narrative statement cross referenced to the financial statements:** Any narrative statement disclosing the exclusion of alternative GAAP should itemize the results that would be produced if the alternatives were applied. The impacted sections of the financial statements should be cross-referenced to the itemization.

√ **Include a discussion of material “off-balance-sheet” financings and underlying risks:** Off-balance-sheet financial instruments will inevitably be targeted by new disclosure rules. Companies should add systematic disclosure of the terms and risks associated with such instruments without waiting for the SEC to act.

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