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DISCLOSURE

A Leap of Faith: Jumping into Disclosure of Accounting Issues and Thriving

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In the movie, *Butch Cassidy and the Sundance Kid*, Paul Newman and Robert Redford are standing on a cliff overlooking a river after being chased by government soldiers wanting to arrest them. While discussing jumping from the cliff, the Sundance Kid admits, ''I can't swim,'' to which Butch Cassidy responds with a shrug, ''Are you crazy? The fall will probably kill you.'' For the draftsperson who does not know enough about accounting concepts, the feeling of jumping off a cliff into a river and drowning to avoid the government may come to mind when drafting disclosure about accounting issues in today's regulatory environment. But as we know from the movie, both of our heroes survive the jump and live to fight another day. Disclosure lawyers can also thrive by jumping into accounting issues despite the cliffhangers described below.

With increasing frequency, accounting principles require narrative disclosure to accompany the numerical presentation. Generally accepted accounting principles (''GAAP'') applicable to domestic issuers and international financial reporting standards (''IFRS'') in accordance with the International Accounting Standards Board (the ''IASB'') applicable to foreign private issuers, require that footnotes to the financial statements explain and augment the presentation in the balance sheet, income statement or cash flow statement.[1] More-

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[1] An example is Financial Accounting Standards Board (''FASB'') Accounting Standards Codification (''ASC'') 815-10, *Derivatives and Hedging* (ASC 815-10, formerly FASB Statement No. 161, *Disclosure About Derivative Instruments and Hedging Activities* (''FAS 161''), which amended and expanded the disclosure required by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (''FAS 133,'' now also codified at ASC 815-10). Since ASC 815-10 requires additional footnote disclosure, it affects the footnotes but not the financial statements themselves. Another example is *Fair Value Measurements and Disclosures*, FASB ASC 820-10, (''ASC 820-10'') (formerly FASB Statement No. 157, Fair Value Measurements) which provides a three-level approach for classifying financial instruments. Which level or tier management assigned to an instrument can be a matter of judgment resulting in different values for a financial instrument, which can materially affect financial condition and results of operations. In November 2009, the FASB amended ASC 820-10 to require separate disclosure for significant transfers in and out of Level 1 and Level 2 fair value measurements as well as the reasons for the transfers. With respect to Level 3 fair value measurements, the amended standard requires disclosure about purchases, sales issuances and settlements on a gross basis, rather than on a net basis. In adopting the amended standard, the FASB deferred a proposal that would have required sensitivity analyses to describe how reasonably possible changes in assumptions would have affected fair value measurements when observable market data was not available. FASB, *Project Update, FAS 157—Improving Disclo-*

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over, GAAP has become so complex that it is now necessary to have narrative disclosure accompany the financial statements in an annual or quarterly report to facilitate investor understanding and to put the financial statements themselves into the proper context.[2]

With the credit crisis that began in August 2007, we entered a new regulatory environment—one in which Congress is considering regulatory reform[3] and the Commission is adopting new rules. In this new regulatory world, legislatures, courts and regulators[4] may not be as sympathetic to or understanding of the compliance challenges faced by the managers and directors of public companies as they were in the past.[5] Moreover, Congress, the courts and the Commission may not agree with each other.[6]

While economists say the recession ended in the third quarter of 2009 and Wall Street says it ended in March 2009, Main Street is saying the recession is still with us. There is also disagreement on what form the recovery will take[7] as well as when the economy will produce real prosperity. Some say no matter the shape or timing of the recovery, the economy will be deleveraged,[8] more government controlled and more risk-averse. It may also be one where different accounting issues or variations of the same accounting issues will command our attention.[9] The only thing we know for sure is that we have a known uncertainty. Past may not be prologue and the disclosure that was adequate in the past to describe accounting issues may not be sufficient now or in the future. Moreover, as we learned in the fall of 2008, unexpected events with related accounting consequences may occur without any foreshadowing and with lightning speed.

Given these known trends and uncertainties, what is a lawyer to do? Should he or she say that accounting is

sure about Fair Value Measurements (last updated Feb. 12, 2010), *available at* http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176154534254&pf=true%20(1%20of%204).

[2] Examples from the Securities and Exchange Commission (the ''SEC'' or the ''Commission'') include critical accounting estimates which is part of Management's Discussion and Analysis of Financial Condition and Results of Operations (''MD&A''). This disclosure requires management to discuss the judgments, qualitative and quantitative estimates and assumptions that underlie the results in the financial statements. Moreover, this disclosure should not duplicate the footnotes to the financial statements. Another example is Item 305 of Regulation S-K, which requires quantitative and qualitative disclosures about market risk. Under IFRS in accordance with the IASB, market risk disclosure is part of the financial statements and therefore covered by the audit opinion, but under GAAP, it is part of the narrative of the periodic report. Examples under GAAP that require extensive footnote disclosure include fair value accounting under ASC 820-10. The critical accounting estimates section of the MD&A frequently includes fair value accounting. As the Supreme Court observed, GAAP ''is far from being a canonical set of rules that will ensure identical treatment of identical transactions'' but instead ''tolerate[s] a range of reasonable treatments, leaving the choice among alternatives to management.'' *Thor Power Tool Co. v. Comm'r of Internal Revenue*, 439 U.S. 522, 544 (1979).

[3] The House of Representatives passed its regulatory reform bill in 2009 (H.R. 4173, 111th Cong. (2009), and Senator Dodd introduced his on March 15, 2010 (S. ____, 111th Cong. (2010)) which is now pending in the Senate. David Cho and Brady Dennis, *Senate panel passes financial regulation bill*, Wash. Post A1 (Mar. 23, 2010). Either bill would result in more regulation of financial institutions. Washington would ''play a more active role in policing Wall Street.'' Sewell Chan, *Reform Bill Adds Layers of Oversight*, New York Times, B1 (March 16, 2010).

[4] After being criticized for lax enforcement, particularly with respect to not identifying the Bernie Madoff Ponzi scheme, the Commission is reasserting its ''Cop on the Beat of Wall Street'' persona. Actions brought to date range from: *SEC v. Mozilo*, No. 2:09-cv-3994 (C.D. Cal. filed June 4, 2009), which represents a 53-page complaint cataloguing a variety of traditional securities law violations; to *SEC v. General Electric Co.*, No 3:09-cv-01235 (D. Conn. filed Aug. 4, 2009), which settled a seven-year investigation in which the SEC Enforcement Staff observed that the company had been too aggressive in its accounting, SEC Litigation Release No. 21149 (July 23, 2009); to novel applications of the federal securities law, such as the complaint against Maynard Jenkins, the former chief executive officer of CSK Auto Corporation. *SEC v. Maynard L. Jenkins*, No. 2:09-cv-1510 (D. Ariz. filed July 22, 2009), Lit. Rel. No. 21149A (July 23, 2009), where the Commission is seeking the return of bonuses and profits from the sale of stock options under Section 304 of the Sarbanes-Oxley Act of 2002 (''SOX'') from an executive who is not accused of engaging in fraudulent conduct. While *SEC v. Maynard L. Jenkins* represents a novel application of Section 304, it is part of a growing use of Section 304 by the SEC's Division of Enforcement. *See, e.g.*, *SEC v. Home Solutions of America, Inc.*, Lit. Rel. No. 3071 (Nov. 30, 2009) and *SEC v. Brad Morrice*, Lit. Rel. No. 21327 (Dec. 7, 2009).

[5] Public opinion appears to support the move to more regulation. A Harris Poll conducted in February 2010 found that 82% of the public believe Wall Street should be subject to tougher regulations while 14% do not think so and 4% are not sure. In the same poll, 66% thought ''most people on Wall Street would be willing to break the law if they believed they could make a lot of money and get away with it'' while 29% disagreed and 5% were unsure. The Harris Poll is available at http://news.harrisinteractive.com/profiles/investor/ResLibraryView.asp?ResLibraryID=36766&GoTopage=1&Category=-1777&BzID=1963&t=30.

[6] *See, e.g.*, the refusal of U.S. District Court Judge William H. Pauley III to modify the 2003 settlement that forbids analysts and bankers from talking without a compliance officer which modification had been agreed to between the Commission and the 13 investment banking signatories to the original settlement. Susanne Craig and Kara Scannell, *SEC Tried to Ease Curb* Wall Street Journal, A1, (Mar. 18, 2010); and Susanne Craig, Kara Scannell and Randall Smith, *SEC Didn't Expand Upon Stock Abuse Settlement*, Wall Street Journal, C1 (Mar. 19, 2010). The Senate's version of financial regulatory reform may include an amendment being requested by Senator Dodd, chairman of the Senate Banking Committee, requesting the Government Accounting Office to determine ''whether the Chinese wall between analysts and investment bankers should be reinforced rather than relaxed.'' Tom Braithwaite, *Call for US banking practices to be probed*, Financial Times, 3 (Mar. 22, 2010).

[7] The form the recovery will take has been described as taking the shape of a U, V, L, and W and has also included other symbols, such as a check mark and a square root sign. Russ Banham, *The Shape of Things To Come*, CFO, 48 (Mar. 2010).

[8] Too much leverage and too little capital have been identified at a macro level as causes for the credit crisis, but the specific capital level that regulators will require financial institutions to have in the future is still being determined.

[9] For example, the Raptors of Enron and the Repo 105s and Repo 108s of Lehman, both dealt with consolidation, an accounting principle that has been addressed many times in the past 40 years. *See, e.g.*, Tammy Whitehouse, *Lehman Mess: Bad Intent or Just Bad GAAP?* Compliance Week (Mar. 23, 2010) available at http://www.complianceweek.com/article/5855?printable=1.

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the domain of accountants? Should his or her response be: ''It's not my problem – I was told there would be no math.'' While this would have been the convenient answer prior to the passage of SOX, it may not be the right approach today.

In the current regulatory environment, it is advisable for lawyers to focus on the disclosure aspects of accounting. With the trends described above resulting in more disclosure requirements linked to accounting, the lines between accounting and disclosure are increasingly blurred. Decision makers, whether board director, manager or regulator, may think that lawyers are responsible for disclosure even when it can be argued that the responsibility is attributable to others. Focusing on disclosure will not make lawyers into accountants, but can make them better securities lawyers. They would not replace the finance staff in drafting disclosure or the accounting staff in preparing financial statements, but by increasing their focus on accounting related disclosure lawyers can become part of a multi-disciplinary team that prepares full, fair and accurate disclosure.

In advising audit committees, lawyers should understand both accounting concepts and internal control over financial reporting (''ICFR'') to counsel management and members of the audit committee about the issues, risks and alternatives available. This can range from accounting policies to systems and processes used to prepare financial statements, as well as to discussing accounting issues with accountants, whether internal auditors, outside auditors or forensic accountants at committee meetings.[10] Lawyers having this familiarity are not accounting experts so they do not replace the accountant, but are better able to understand what the accountant is saying and consequently advise committee members on the legal aspects of the issues being discussed. Understanding accounting can also help in counseling the board of directors as well as committees other than the audit committee, such as the compensation committee. Many option backdating restatements were driven in large part by lack of knowledge of the interplay between the legal requirements in option and benefit plans and how to comply with the accounting requirements applicable to the plans, as well as to the accounting consequences of making executive compensation decisions.

Familiarity with accounting concepts does not come overnight and cannot be done all at once. It is a continuous process, one where understanding may not result from just reading the literature or having training sessions on a regular basis. It is one that results from experience in seeing how accounting principles are applied in real life. Moreover, given the rapidity with which accounting principles are changing, having a grounding in how it was disclosed in the past can be instrumental in understanding what is required to be disclosed this year. An accountant assigned to the legal department is one way to jump start this process, but does not relieve lawyers from becoming familiar with accounting concepts.

The following Rules of the Road are intended to assist counsel in advising on the disclosure aspects of accounting issues and preparing or reviewing such disclosure or disclosure relating to ICFR and certifications under Sections 302 and 906 of SOX.

1. **Look at the Tone at the Top** - ''Tone at the top'' is not just a saying, it is the foundation upon which everything else is built. The right tone at the top can encourage lawyers and accountants to work together as a multi-disciplinary team, rather than in silos. Although a multi-disciplinary team may not come naturally, tone at the top can foster and reward a collaborative process which can produce filings and other disclosure documents, like earnings releases, that not only comply with current and future requirements, but avoid potential liability for the company, its officers and its directors, as well as inform the investing public.

2. **Plan Ahead and Follow Your Procedures** - The best time to put these multi-disciplinary procedures in place is before there is a problem—not when one is at your doorstep. Your disclosure committee can provide an effective forum for establishing the procedures as well as monitoring results. Coordination between business, finance, accounting and legal at the disclosure committee level can be instrumental in avoiding accounting issues before they become accounting problems, much less restatements. Your disclosure committee charter can provide the framework for this cooperative effort. But do not adopt procedures that will not be followed or are only followed sporadically. If you ever are the subject of an investigation by the Commission's Division of Enforcement (''Enforcement''), an early and a very easy request that Enforcement can make is to have you provide them with copies of the charters for your board committees, as well as for your disclosure committee. Enforcement can then compare what the charters say you are doing with what you actually did. This may result in a list of nettlesome inconsistencies that may have to be addressed, and possibly a course of conduct in your disclosure policy which cannot be fully or convincingly explained.

3. **Master the SAB 99 Memo** - When a board of directors or an audit committee is confronting an accounting issue that could ripen into a restatement,[11] it may al-

[10] Section 141(e) of the Delaware General Corporation Law allows the board of directors to rely on experts, which includes experts for accounting issues.

[11] Although the number of restatements and the negative effect of the restatements on net income as well as the number of issues and the periods subject to restatement have declined in each of the last three years, the number of restatements of financial statements was still higher in 2009 than in 2001, the year before SOX became law: 674 in 2009 compared to 614 in 2001. Audit Analytics, *2009 Financial Restatements, A Nine Year Comparison* at 3 (February, 2010) (hereinafter ''Audit Analytics''). The top nine reasons for a restatement in 2009 were:

''■ Debt, quasi-debt, warrants and equity. . .security issues;

Note to Readers

The editors of BNA's *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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ready be too late for the lawyer to get up to speed on the accounting issue so that he or she is able to advise on materiality under Staff Accounting Bulletin, No. 99, *Materiality* (''SAB 99''). The SAB 99 memo should include a discussion of the effect of quantitative factors on ''key performance indicators.''[12] It should also include a qualitative discussion focusing on the factors relating to your particular company. A fulsome discussion of qualitative factors is often given short shrift in a SAB 99 memo. Different qualitative factors can result in different outcomes among and between companies with the same error, even if the quantitative factors are of approximately the same size.[13] With an understanding of the underlying accounting concepts, lawyers can advise on other restatement issues as well as on the disclosure that should be included in the initial press release and Item 4.02 of Form 8-K announcing the restatement and in the amended periodic reports filed with the Commission.

4. **Recognize the Relationship to Risk** - Monitoring accounting practices and ICFR can prevent legal issues from arising and facilitate enterprise risk management (''ERM'').[14] Raising questions, such as what is the business rationale for the accounting treatment of a particular matter and whether the company would have engaged in the conduct, but for the accounting that was applied, can result in early identification of risks[15] to the enterprise that others in the company did not foresee or thought were immaterial. Changes in accounting can be a red flag for counsel that an accounting or financial reporting change is being used to present financial condition, results of operations and even cash flows in a more favorable manner than prior to the accounting change. Early identification of an accounting issue can also result in avoiding litigation, not just for the company, but also personally for the officers and directors of the company. A lawyer should be able to follow the ripples from accounting and ICFR through ERM[16] to the disclosure in the financial statement footnotes and then to the narrative disclosure in the filing. Lawyers who are able to do so can then ask, and possibly answer, the common sense question of ''What does all of this mean to a person making an investment decision concerning the company?''

5. **Communicate with the Auditors** - The auditor is required under Generally Accepted Auditing Standards (''GAAS'') to review the filing, whether it be an Annual Report on Form 10-K or a Quarterly Report on Form 10-Q. This review goes beyond the footnotes of the financial statements.[17] Communication with the auditor is important to ensure not only that you are both dealing with the same fact pattern but also that you will be in agreement in discussing the matter with management and the audit committee. A similar approach should be followed with the internal auditor.

6. **Understand the Story the Numbers and Narrative Tell** - Accountants may not be as good at writing narrative disclosure, just as lawyers may not be as good at numbers. But both the accountant's numbers and the attorney's disclosure must be accurate reflections of each other. While accountants usually take the lead in drafting footnotes to the financial statements, lawyers can and should serve a valuable role in preparing narrative disclosure if they are able to grasp accounting principles and are consulted at an early stage of the disclosure process. Technical compliance with GAAP may not be enough for investors to gain a fair understanding of a company's financial condition, results of operations and liquidity.

7. **Look for Tripwires** - Not only is accounting complex, but many principles under GAAP are prescriptive to the point of having a hair-trigger between compliance and an error. The lines that accounting principles draw between compliance with GAAP on the one hand and violating GAAP on the other can appear artificial and may not follow common sense, but may be a tripwire for an error under the accounting rules, or for disclosure or for both. With increasing frequency, compliance is also judged by documentation, which may not be complete or prepared on a timely basis. The classic example of how documentation can determine whether or not your accounting complies with GAAP is hedge accounting. Under ASC 815-10, *Derivatives* (formerly FAS 133), a company can lose the ability to use the short cut method and have to use the long haul method when the actual hedging transactions deviate from the documentation which is required by GAAP to avoid the

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- Expense (payroll, SGA, other) recording issues;
- Account/loans receivable, investments and cash issues;
- Deferred, stock based and/or executive compensations issues;
- Liabilities, payables, receives and accrual estimate failures;
- Revenue recognition issues;
- Acquisitions, mergers, disposals, reorganization accounting issues;
- Tax expense, benefit, deferral and other (FAS 109) issues; and
- Cash flow statement (FAS 95).''

Audit Analytics at 9.

[12] SEC Regulations Comm., Joint Meeting with Staff - *Highlights*, at 4 (April 3, 2009) available at http://www.thecaq.org/resources/secregs/pdfs/highlights/2009_0403_highlights.pdf.

[13] *Id.*

[14] In 2004, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published Enterprise Risk Management – Integrated Framework. COSO also published one of the primary frameworks for ICFR. The two frameworks are intended to work in tandem. Other ERM frameworks include International Organization for Standard Risk Management – Principles and Guidelines, ISO 31000:2009 (November 2009) and Risk Management - Risk assessment techniques, ISO/IEC 31010:2009 (Dec. 2009).

[15] The Public Company Accounting Oversight Board (the ''PCAOB'') re-proposed for comment seven auditing standards concerning the auditor's assessment of and response to risk. PCAOB Release 2009-007 (December 17, 2009). Since the comment period for these proposals closed on March 2, 2010, they can be expected to be adopted this year. It would be anomalous for management to conclude that they have identified, assessed and monitored the risks that are disclosed in Part III of the Form 10-K and upon which the compensation committee has granted management bonuses and then have the auditor find risks in its assessment as part of its year-end audit.

[16] ERM includes: strategic risk; operational risk; financial risk; compliance risk; legal risk; reputational risk; environmental risk; information technology risk; and political risk. Alarna Carlsson-Sweeny, *Enterprise Risk Management* Vol. 2, Issue 2, Practical Law, The Journal at 46 and 48 (Mar. 2010).

[17] GAAS requires the auditor to ''read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements,'' AU Section 550.04, *Other Information in Documents Containing Audited Financial Statements*. *See, also,* AU Section 722.16 (F), *Interim Financial Information*.

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hedging from being viewed as speculation. Documentation is also increasingly important in assisting your auditor in his or her audit or review of your financial statements.

8. **Use Precedent Wisely** - Precedent can be helpful but is not determinative. What others are disclosing about similar issues can help to frame the issue and enable you to ask questions about what the facts are and show the client that he or she will not be alone in making similar disclosure. However, your disclosure should be customized to the facts and the issues of each particular situation. Your facts and circumstances may not be the same as that in the precedent you are following. Disclosure that is similar to that in other situations may be acceptable under normal circumstances but may not pass the test in litigation.

9. **Be Consistent** - Consistency is important, not just within the financial statements, but between the financial statements and the narrative disclosure, as well as between your SEC filings and the press releases, analyst calls and informal statements that management makes to investors and the public. The statements do not have to be identical, but they should be consistent. This is not just because the review process of the Commission's Division of Corporation Finance focuses on consistency, but also because analysts and the investing community focus on inconsistencies, especially when they can be viewed as a pattern or practice by management.

10. **Examine How Judgments Are Made** - ''Management judgment'' is the new catch phrase. Whether because of principles-based accounting, complex accounting principles or just really complicated transactions, exercising professional judgment is what regulators and standards setters are relying on and talking about. Exercising judgment, much less professional judgment, is tough. ''Applying professional judgment means faithfully trying to reflect the principles and objectives in the standards, as opposed to looking for ways to bend GAAP to the company's will.''[18] Disclosure accompanying the financial statements, especially in critical accounting estimates, can describe the process in which judgments were made, as well as to put the results into context so that investors understand the range of possibilities in which judgment was exercised. Doing so can protect management and the judgments it has made – especially when they turn out to be wrong.

11. **Understand What Can Go Wrong** - It may sound trite, but an ounce of prevention really is worth a pound of cure. Accounting mistakes, whether in the close process, on the general ledger, in the chart of accounts or in the contracts for various transactions can be costly in time, effort and expense to correct, once they are identified. Having policies and procedures in place and having personnel with the authority to correct anomalies when they are identified may sound expensive to implement and monitor, but can be the least expensive, most effective way of avoiding accounting issues that, unchecked, become problems that can require a restatement. The cost to restate financial statements, to remediate control deficiencies in ICFR, to rebuild investor confidence and to settle litigation and regulatory issues after a restatement is publicly announced can dwarf whatever the cost would have been to take preventative measures to begin with.

12. **Consider the Long Term** - Although lawyers often draft disclosure based on what they know and believe to be the fact pattern on the day they are writing the draft, a more long term perspective in drafting can have benefits. Ask yourself, ''How will this disclosure look in the future, such as six months from now?'' For example, inserting a risk factor concerning impairment of goodwill in the Form 10-Q for the first quarter can have positive effects when an impairment becomes a certainty at year end. Typically, the ''reward'' from the Staff during the review process for a company having taken an impairment or obsolescence charge in a recent period is ''Now that you've taken the charge let's discuss when you should have taken it.'' So, thinking ahead in drafting can be helpful to you and your client.

Following these Rules of the Road can help you in a number of ways, including:

■ Knowing which accounting issues are the Staff's current hot buttons, what the Staff considers important with respect to a particular accounting issue and how the Staff has handled the accounting issue in past comments can help you guide your client through the minefield and avoid comment letters, restatements or shareholder lawsuits.

■ Understanding what the numbers are saying can enable you to provide added protection for your client pursuant to the safe harbor provisions for forward-looking statements under the Private Securities Litigation Reform Act of 1995 (''PSLRA''). How is that possible? Although PSLRA excludes a forward-looking statement in the footnotes to the financial statements from the safe harbor, the exact same statement will receive safe harbor protection if it is included in the MD&A. Why? The MD&A in either Form 10-K or Form 10-Q is a separate, distinct disclosure item from the financial statements. Is there a catch? The rest of PSLRA's requirements to gain safe harbor protection need to be complied with. These include: identifying the statement as forward-looking, even though you don't have to specify each and every one; and including a meaningful cautionary statement that is not boilerplate and is customized to be tailored to the specific situation and issues of the company so that investors are able to gain an appreciation of how the forward-looking statement can change.[19]

■ Knowing accounting rules can facilitate the preparation of representations and warranties in bank loan agreements, indentures and acquisition agreements. This can enable counsel to avoid a Titan issue[20] or to advise on whether a material adverse change has occurred in a merger agreement.[21]

■ Having an idea where lease accounting is heading in the near future can be instrumental in negotiating a

[18] Scott A. Taub, *FASB's New Start on Old Menace to Balance Sheets*, Compliance Week, 1 (Aug. 2009).

[19] Section 21E(a)(2)(A) and Section 21E(c) of the Securities Exchange Act of 1934, as amended. *See, e.g.,In re American Express Co. Securities Litigation*, No. 02-5533, 2004 WL 632750 (S.D.N.Y. Mar. 31, 2004), appeal docketed, No. 08-5442 (2nd Cir. Nov. 7, 2008).

[20] *Titan Corp.*, SEC Litigation Release No. 19107 (Mar. 1, 2005).

[21] *See, e.g., Hexion Specialty Chems., Inc. v. Huntsman Corp.*, No. 3841, 2008 WL 4409466 (Del. Ch. Sept. 29, 2008).

new, long-term lease using current accounting principles.[22]

■ Being familiar with derivative accounting requirements can be valuable not just in drafting derivative contracts but also in balancing the accounting issues with safe harbor provisions in the Bankruptcy Code to ensure the contract meets both accounting and applicable safe harbor definitions in the event a counterparty becomes insolvent.

■ In litigation, an understanding of accounting can serve counsel in applying potential causes of action to the facts presented in determining whether an error occurred, but also whether improper conduct was involved in the preparation of financial statements.[23]

■ Knowing disclosure controls and procedures, as well as ICFR, enables counsel to prepare or review appropriate and responsive ''Controls and Procedures'' disclosure for Item 9A and Item 4 in Form 10-K and Form 10-Q, respectively.[24]

■ Being familiar with accounting principles can assist underwriters' counsel in conducting due diligence, in auditor interviews and comfort letter procedures. Financial statements filed with the Commission that are not prepared in accordance with GAAP ''will be presumed to be misleading or inaccurate, despite footnote or other disclosures . . .''[25] and can lead to future headaches, such as restatement or shareholder lawsuits. If accounting issues come to counsel's attention during the due diligence process, counsel can advise on whether additional steps, such as retaining forensic accountants, may be warranted, before the registration statement is filed or declared effective.

Since financial statements are so critical to the disclosure process, disclosure lawyers can add real value by being able to understand, evaluate and draft disclosure concerning accounting issues. Although jumping in can be challenging at first, thriving in drafting disclosure relating to accounting issues can benefit you and your clients.

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[22] The Discussion Paper published by FASB proposed amendments to lease accounting that, if adopted, would facilitate the planned convergence between IFRS and GAAP by changing the current GAAP standard to one more like the standard under IFRS. FASB, Discussion Paper, *Leases: Preliminary Views* (Mar. 19, 2009) (hereinafter ''Lease Discussion Paper''). These proposed amendments would remove the requirement to classify leases as capital or operating leases, requiring companies to effectively capitalize all leases. These new standards, if adopted as drafted, would cause significant changes to companies' balance sheets and income statements along with EBITDA or other financial ratios. The proposed changes would require companies and counsel to closely scrutinize existing agreements that may be affected by such changes in financial ratios or other financial criteria, and discuss such risks in the disclosure. Additionally, companies may need to more fully disclose their material lease arrangements in disclosure so as to distinguish among the entirety of leases being added to the balance sheets.

[23] Financial statement and accounting fraud typically represents approximately 25% of the actions brought by the SEC's Division of Enforcement, *speech by SEC Staff: SEC and PCAOB Developments by Robert Khuzami, Director, Division of Enforcement, Securities and Exchange Commission (December 8, 2009) available at* http://sec.gov/news/speech/2009/spch120809rsk.htm.

[24] Jeremy Perler, CFA Institute, *Transparency and Other Issues in Financial Statement Analysis: Uncovering Misleading Metrics and Avoiding Financial Shenanigans* (June 2009). Lawyers in the SEC's Division of Corporation Finance issue comments on disclosure controls and procedures as well as ICFR disclosure in Item 4 and Item 9A under Form 10-Q and Form 10-K, respectively. Of course, they coordinate with the accountants in the Division.

[25] Regulation S-X Rule 4-01(a)(1)

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