

Investor Advocates Worried About Potential Accounting Rule Change

By Patrick Temple-West
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There's a battle brewing over the footnotes buried inside public companies' financial disclosures.

Firms occasionally reveal juicy tidbits in the footnotes of their financial statements that scrupulous investors like hedge funds trawl for clues about a business's well-being. For example, Enron Corp.'s bankruptcy in December 2001 was foreshadowed in its 2000 financial statement footnotes.

Now, investor advocates are worried the industry group tasked by the SEC with establishing accounting standards is considering a change that could limit information companies have to tell shareholders about their business problems.

On Thursday, the members of the SEC's Investor Advisory Committee requested a public briefing from officials in the SEC chief accountant's office about the implications of a policy change proposed in September by the Financial Accounting Standards Board, which sets the "Generally accepted Accounting Principles." FASB's standards govern the preparation of financial reports and are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants.

FASB issued two "exposure drafts" to weigh changes for what's considered a material problem as part of a broader effort to update GAAP. The public has until Dec. 8 to comment on the proposal.

In interviews with POLITICO, some of the Investor Advisory Committee members said they are concerned FASB's proposal could be bad for investors.

"The reason why this is important is because the definition of what's material is a foundation of all corporate disclosure," said Damon Silvers, the associate general counsel at the AFL-CIO and an SEC investor adviser. "It's like changing the First Amendment," he said. "It's quite clear what's being proposed is in the direction of less disclosure. If the AFL-CIO is not satisfied that this is benign, [then] we will weigh in and I suspect other people in the public advocacy community will too."

Requiring companies to disclose "material" facts dates back to Congress's securities laws of the 1930s. But there remains a gray area of what's material and what's not.

The Supreme Court has acknowledged that companies might try to bury shareholders with too much information to avoid getting sued. In balancing what's material, the High Court said in 1976 that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the total mix of information made available."

In response to concerns raised by Silvers and others, FASB said on Monday its proposal would conform its standards with the legal definition that the SEC already enforces.

"The proposed amendment would not change the legal definition of materiality - the FASB does not have that authority," said FASB spokesman Robert Stewart.

The proposal would only apply to how FASB itself considers materiality as part of its process for setting GAAP, he said. "It would not apply to preparers and auditors. The proposed amendment is part of a broader project to improve the effectiveness and relevance of disclosures in the notes to financial statements."

But that didn't allay concerns raised by some of the SEC investor advisers. While FASB's response is technically accurate, "this proposed standard would likely reduce the extent of disclosure in financial statement notes," Joseph Carcello, a member of the SEC's Investor Advisory Committee and an accounting professor at the University of Tennessee, said on Monday.

"The FASB will argue that the disclosures omitted will only be those that are immaterial, and they could be correct," he said.

"But in the absence of a framework for evaluating the materiality of note disclosures, especially those disclosures that are qualitative in nature, there is a risk that the corporate community will use this perceived flexibility to omit disclosures that are less than flattering, particularly if the materiality of the disclosure is debatable," he said.

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