

Client Alert: SEC Proposes New Rules On Disclosure in MD&A of Critical Accounting Policies

A. Introduction

On May 10, 2002, the SEC published for comment proposed rules that would require additional disclosure of a public company's critical accounting policies in a new and separate section of the Management's Discussion and Analysis ("MD&A") presentation contained in SEC filed annual and quarterly reports, annual reports to shareholders, registration statements, and proxy and information statements.¹ The new requirements would encompass two specific areas:

- accounting estimates a company makes in applying its accounting policies; and
- the initial adoption by a company of an accounting policy that has a material impact on its financial presentation.

B. Disclosure about Critical Accounting Estimates

Under the proposal, an accounting estimate involved in applying the company's accounting policies would be considered a "critical accounting estimate" if:

- the accounting estimate required the company to make assumptions about matters that were highly uncertain at the time the accounting estimate was made; and
- different estimates that reasonably could have been used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition, or results of operations.

In order to inform investors of each critical accounting estimate and to place it in the context of the company's financial presentation, the SEC would require the following information in the MD&A section:

¹ See Securities and Exchange Commission Release Nos. 33-8098; 34-45907; International Series Release No. 1258; File No. S7-16-02. A copy of the Release is available on the SEC website at: <http://www.sec.gov/rules/proposed/33-8098.htm>.

- a discussion that identifies and describes:
 - the critical accounting estimate;
 - the methodology used in determining the critical accounting estimate;
 - any underlying assumption that is about highly uncertain matters and any other underlying assumption that is material;
 - any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or the assumptions described;
 - if applicable, why different estimates that would have had a material impact on the company's financial presentation could have been used in the current period; and
 - if applicable, why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation;
- an explanation of the significance of the accounting estimate to the company's financial condition, changes in financial condition and results of operations and, where material, an identification of the line items in the company's financial statements affected by the accounting estimate;
- a quantitative discussion of changes in overall financial performance and, to the extent material, line items in the financial statements if the company were to assume that the accounting estimate were changed, either by using reasonably possible near-term changes in the most material assumption(s) underlying the accounting estimate or by using the reasonably possible range of the accounting estimate;
- a quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years, the reasons for the changes and the effect on line items in the financial statements and overall financial performance;
- ***a statement of whether the company's senior management has discussed the development and selection of the accounting estimate, and the MD&A disclosure regarding it, with the audit committee of the company's board of directors;***
(emphasis added)

- if the company operates in more than one segment, an identification of the segments of the company's business the accounting estimate affects; and
- a discussion of the accounting estimate on a segment basis, to the extent that a failure to present that information would result in an omission that renders the disclosure materially misleading.

While the SEC is not currently proposing an outside limit on the number of accounting estimates that a report must discuss under these proposals, the SEC has noted that it would expect very few companies to have none at all, and the vast majority of companies to have somewhere in the range of three to five critical accounting estimates.

The SEC has stated that it expects companies to evaluate their accounting estimates and the underlying assumptions and methodologies on a quarterly basis, and would require companies to provide an update to the MD&A information in their quarterly report on Form 10-Q for any material changes from the critical accounting estimates discussed in the company's last filed annual or quarterly report under the Securities Exchange Act, as well as any new critical accounting estimates.

C. Disclosure about Initially Adopted Accounting Policies

When a company has initially adopted an accounting policy that has a material impact on its financial presentation, the proposed rule would require additional disclosure in the MD&A included in a company's SEC filed annual reports, annual reports to shareholders, registration statements, and proxy and information statements that would include a description of:

- the events or transactions that gave rise to the initial adoption of an accounting policy;
- the accounting principle that has been adopted and the method of applying that principle; and
- the impact (discussed qualitatively) resulting from the initial adoption of the accounting policy on the company's financial condition, changes in financial condition and results of operations.

If, upon initial adoption of an accounting policy, a company is permitted to choose between acceptable accounting principles, the company would also be required to

explain in the MD&A that it had made a choice among such acceptable alternatives, identify the alternatives, and describe why it made the choice that it did. In addition, where material, the company would have to provide a qualitative discussion of the impact that the alternatives would have had on the company's financial condition, changes in financial condition and results of operations.

D. Considering other Additional MD&A Disclosures

The SEC has indicated that there may be more to come with respect to new MD&A disclosures, including a requirement for a summary of the MD&A section that would, in relatively short form, identify what management considers the most important factors in determining its financial results and condition.

Also under consideration by the SEC are other topics as to which it believes MD&A disclosure is particularly important, including:

- enhanced disclosure about liquidity risk, market price risks and effects of “off-balance sheet” transaction structures and obligations;
- material transactions involving related persons or entities, with a clear discussion of terms that differ from those that would be negotiated with independent parties; and
- trends that a company's management follows in making decisions about how to guide the company's business.

Comments Sought

The staff of the SEC invites interested persons to submit written comments on the proposed amendments and any other matters that might have an impact on the proposed amendments. Comments should be received on or before July 19, 2002. Comments may be submitted electronically at the following electronic mail address: rule-comments@sec.gov. All comment letters relating to Release No. 33-8098 should refer to File No. S7-16-02; this file number should be included in the subject line if electronic mail is used.

For Additional Information

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