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Advisory

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SECURITIES LAW

Critical Accounting Policies

On May 10, 2002, the Securities and Exchange Commission (SEC) issued proposed new disclosure requirements relating to the application of issuers' critical accounting policies, to be included in the Management's Discussion and Analysis (MD&A) section of annual reports, registration statements, and proxy and information statements.[1] This proposal represents another component of the SEC's ongoing response to the financial collapse of Enron and the concerns surrounding public companies' disclosure of issues affecting their financial health.

The proposed disclosure would take the form of a separately captioned section in issuers' MD&A, entitled "Application of Critical Accounting Policies," and would include:

- disclosure of the critical accounting estimates that are made by a company in applying its accounting policies, and
- disclosure concerning the initial adoption of an accounting policy by the company that has a material impact on its financial presentation.

This proposal elaborates on and requires disclosure that the SEC had encouraged issuers to make voluntarily in their MD&A sections regarding their critical accounting policies.[2]

Objectives of New Proposals

The SEC stated that its objectives in requiring disclosure on critical accounting estimates are:

- to enhance investors' understanding of the existence of, and necessity for, estimation in a company's financial statements;
- to focus investors on the important estimates that are particularly difficult for management
  to determine and where management therefore exercises significant judgment;

[1] *Proposed Rule: Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies,* Release Nos. 33-8098; 34-45907.

[2] *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, Release Nos. 33-8040; 34-45149; FR-60.

- to give investors an understanding of the impact those estimates have on the presentation of a company's financial condition, changes in financial condition or results of operations;
- to give investors an appreciation for how sensitive those estimates are; and
- to give investors an understanding of new material accounting policies as they arise and affect a company's financial results.

The SEC's aim is to increase the transparency of the application of those accounting policies where management is the most prone to use judgment, generally because objective data and methodologies do not exist for the estimates or management is given initial policy choices under generally accepted accounting principles (GAAP).

Critical Accounting Estimates

If a company makes a critical accounting estimate in applying its accounting policies, disclosure would be required. The proposal defines an estimate as a "critical accounting estimate" if:

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

If adopted in their current form, the proposed rules would require the following information regarding critical accounting estimates to be included in MD&A:

- a discussion that **identifies and describes** the estimate, the methodology used in arriving at the estimate, assumptions made and reasonably likely changes to the estimate;
- 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 that are affected by the accounting estimate;
- a **quantitative discussion of changes in line items in the financial statements and overall financial performance** if the company assumed changes in the accounting estimate, either by using reasonably possible near-term changes in the most material assumptions underlying the estimate or by using the reasonably possible range of the estimate;
- a quantitative and qualitative discussion of **any material changes made to the accounting estimate in the past three years (or two years for small business issuers)**, the reasons for the changes, and the effect on line items in the company's 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;
- if the company operates in more than one segment, **an identification of the segments of the company's business that the accounting estimate affects;** and
- a discussion of the estimate on a segment basis, mirroring the one required on a company-wide basis, if a failure to present the information would make the disclosure materially misleading.

The proposals also would require companies to update this disclosure to show any material changes in their Quarterly Reports on Forms 10-Q.

Initial Adoption of Accounting Policies

The proposals would also require disclosure in MD&A regarding a company's initial adoption of an accounting policy if the accounting policy was adopted in the past year and had a material impact on the company's financial condition, changes in financial condition or results of operations. However, disclosure would not be required if the adoption resulted solely from new accounting literature issued by a recognized accounting standard setter (such as the Financial Accounting Standards Board). Companies would be required to disclose:

- the **events or transactions that gave rise to the initial adoption of the policy;**
- the **new accounting principle that has been adopted** and the method of applying that principle;
- the **impact on the company's financial condition, changes in financial condition and results of operations** (on a qualitative basis);
- if the company is permitted to make a choice between acceptable principles, **an explanation that it had made such a choice, what the alternatives were, and why it made the choice it did** (including, where material, qualitative disclosure of the impact on the company's financial presentation that the alternatives would have had); and
- if no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption, **an explanation of the company's decision regarding which accounting principle to use and which method of applying that principle to use.**

Periods Covered

The proposed rules would require disclosure on critical accounting policies for the most recent fiscal year and any subsequent interim period for which financial statements are required to be presented in the filing.

Auditor Examination of MD&A Disclosure

The SEC requested comment in the release on whether it should require companies' independent auditors to conduct a formal examination (which is a heightened standard from an auditor's "review" of MD&A) of the disclosure that would be prepared by companies under the proposed critical accounting policy requirements. Currently, formal auditor examinations of MD&A disclosure are typically only undertaken in connection with initial public offerings or after a significant acquisition or corporate restructuring.

Future MD&A Rulemaking

The SEC noted in the proposed rules that it intends to continue its focus on improving MD&A disclosure. In particular, the SEC is considering proposals that would enhance what the SEC sees as the three primary objectives of MD&A:

- to provide a narrative explanation of companies' financial statements that enables investors to see the company through the eyes of management;
- to improve overall financial disclosure and provide the context within which financial statements should be analyzed; and
- to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

In furtherance of those objectives, the SEC is considering:

- requiring a summary of MD&A that would identify what management considers to be the most important factors determining an issuer's financial results and condition, including trends and risks involved;
- focusing MD&A towards a more general discussion of material matters affecting a company and away from a detailed description of business results; and
- requiring more explicit detail of transactions involving special purpose entities, structured finance transactions, and related parties.

Foreign Private Issuers

The proposed rules regarding critical accounting policies would also apply to foreign private issuers. If a foreign private issuer's financial statements were presented in accordance with non-United States GAAP, the new MD&A disclosure would have to be provided in connection with both the non-U.S. GAAP financial statements and the required reconciliation to U.S. GAAP.

Small Business Issuers

The proposed rules would not apply to small business issuers that have not had revenues from operations during the last two fiscal years. However, other small business issuers would be required to comply with the rules.

Time Frame for Comments

Comments on the proposed requirements are due by July 19, 2002.

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Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions regarding these proposed rules.