

SEC PROPOSES DISCLOSURE REQUIREMENT IN MANAGEMENT'S DISCUSSION AND ANALYSIS ABOUT THE APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

On May 10, 2002, the Securities and Exchange Commission (the "SEC") proposed a disclosure requirement for companies to include a separately captioned section regarding the application of critical accounting policies in the "Management's Discussion and Analysis" ("MD&A") section contained in annual reports, registration statements and proxy and information statements.¹ The proposed disclosure is designed to provide additional key information to enhance an investor's understanding of a company's financial condition, changes in financial condition and results of operations, and to provide information about the quality of, and potential variability of, a company's earnings. Furthermore, the proposed requirement would encompass both disclosure about 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 a company.

1. Critical Accounting Estimates

The proposals define an accounting estimate recognized in the financial statements as a "critical accounting estimate" if:

- (a) the accounting estimate requires the company to make assumptions about matters that are highly uncertain at the time the accounting estimate is made; and
- (b) different estimates that the company reasonably could have 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.

2. Information to be Required in the MD&A Section

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

- (a) A discussion that identifies and describes the estimate, the methodology used, certain assumptions and reasonably likely changes;

¹ The proposals also include a requirement that companies update this part of the required disclosure to show material changes in their quarterly reports.

- (b) 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;
- (c) 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;
- (d) 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;
- (e) A statement of whether or not 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;
- (f) If the company operates in more than one segment, an identification of the segments of the company's business the accounting estimate affects; and
- (g) A discussion of the estimate on a segment basis, mirroring the one required on a company-wide basis, to the extent that a failure to present that information would result in an omission that renders the disclosure materially misleading.

3. Initial Adoption of Accounting Policies

The proposals envision the addition of disclosure in annual reports, registration statements and proxy information statements 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. Companies would be required to disclose:

- (a) The events or transactions that gave rise to the initial adoption;
- (b) The accounting principle that has been adopted and the method of applying that principle;
- (c) The impact on the company's financial condition, changes in financial condition and results of operations (discussed on a qualitative basis);
- (d) If the company is permitted 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

- (e) If no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption, an explanation of its decision regarding which accounting principle to use and which method of applying that principle to use.

The SEC is currently soliciting public comment relating to the aforementioned matters.

If you wish to obtain additional information regarding the SEC's proposed requirements, please contact the corporate partner with whom you regularly work.

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