WILMER, CUTLER & PICKERING

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SEC PROPOSES ENHANCED MD&A DISCLOSURE ABOUT FINANCIAL STATEMENT ESTIMATES AND ACCOUNTING POLICIES

The Securities and Exchange Commission (the "SEC" or the "Commission") issued on May 10, 2002, proposed rules that would require issuers to disclose substantial new information about estimates used in preparing their financial statements and about issuers' adoption of new accounting policies.[1] The proposal follows the Commission's "cautionary advice" in December of last year, in which the SEC "alert[ed] companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation."[2] The rules proposed May 10 would expand and formalize this advice by mandating extensive, detailed, and carefully crafted disclosure by issuers in management's discussion and analysis of financial condition and results of operations ("MD&A") in annual and quarterly reports, registration statements and other disclosures.

I. Background

The SEC believes there is a general need to improve the quality and transparency of corporate disclosure, and specifically a need to provide "higher-quality, more insightful financial information."[3] The Commission's Cautionary Advice Release was designed to promote enhanced disclosure regarding accounting policies in annual reports for 2001. Specifically, the Cautionary Advice Release "encourag[ed] public companies to include in their MD&A this year full explanations, in plain English, of their 'critical accounting policies,' the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions."[4]

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1 *Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies*, Release Nos. 33-8098, 34-45907 (May 10, 2002), *available at* http://www.sec.gov/rules/proposed/33-8098.htm (hereinafter *Critical Accounting Policies Release*).

2 *Cautionary Advice Regarding Disclosure about Critical Accounting Policies*, Release Nos. 33-8040, 34-45149 (Dec. 12, 2001), *available at* http://www.sec.gov/rules/other/33-8040.htm (hereinafter *Cautionary Advice Release*).

3 *See Critical Accounting Policies Release* § I.

4 *See Cautionary Advice Release*.

The SEC noted in both the Cautionary Advice Release and the Critical Accounting Policies Release that accounting standards currently require disclosure about accounting principles and methods and the risks and uncertainties inherent in estimates used in preparing financial statements.[5] However, the SEC is proposing additional disclosure requirements in MD&A because it is concerned that "a technically accurate application of generally accepted accounting principles" would fail to accurately portray the current and future financial condition of a company unless it were accompanied by additional disclosure regarding the potential impact of the lack of certainty surrounding particular accounting measurements.[6]

In proposing the new rules, the SEC staff expressed some concern about the disclosure provided in response to the Cautionary Advice Release. The staff observed that many companies simply recited the description of accounting policies contained in note 1 to their financial statements and did not draw attention to, or explain the impact of, the accounting policies and estimates on financial results.[7] The proposal accordingly includes detailed specific requirements relating to the proposed new disclosure. The SEC summarized its objectives for the new rules as follows:

- To increase investors' understanding of, and appreciation for, a company's use of estimates in its financial statements;
- To concentrate investors' attention on those difficult estimates that require the exercise of significant judgment on the part of management;
- To help investors understand the influence of these estimates on the presentation of a company's financial condition, changes in financial condition, or results of operations;
- To aid investors' appreciation of the sensitivity of these estimates; and
- To inform investors of a company's significant new accounting policies and their impact.[8]

In sum, the SEC believes these proposals will "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 GAAP."[9]

II. Description of the Proposal

As described in more detail below, the proposed new disclosure would require a new "Application of Critical Accounting Policies" section of MD&A. Disclosure would be required separately for:

- Accounting estimates made by a company in applying its critical accounting policies; and
- A company's initial adoption of critical accounting policies.[10]

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5 *See Critical Accounting Policies Release* § II.B; *Cautionary Advice Release*. The SEC referred specifically to Accounting Principles Board Opinion No. 22, "Disclosure of Accounting Policies" (Apr. 1972); AICPA Statement of Position No. 94-6, "Disclosure of Certain Significant Risks and Uncertainties" (Dec. 1994); Accounting Principles Board Opinion No. 20, *Accounting Changes* (July 1971); and Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (June 1953), Chapter 2, "Form of Statements," Section A, "Comparative Financial Statements," paragraph 3, and paragraph 2.

6 *Cautionary Advice Release*.

7 SEC, Open Meeting (Apr. 30, 2002).

8 *See Critical Accounting Policies Release* § III.A.

9 *Id*.

10 *See id*. § I. The SEC is also considering requiring disclosure of a company's change from one accounting policy to another and disclosure about using acceptable alternatives—particularly those predominantly used by other companies in the same industry—to the accounting policies used by the company. *See id*. § III.B.

A. *Critical Accounting Estimates*

The proposed rule first requires disclosure regarding estimates used in preparing financial statements. The proposed rule does not require disclosure about every estimate, but defines the limited number of estimates that must be discussed as "critical accounting estimates." A critical accounting estimate is one that meets each of the following criteria:

- The estimate must require assumptions about matters that are highly uncertain; and
- The different estimates that a company reasonably could have used, 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.[11]

The SEC believes that nearly every issuer will have some critical accounting estimates.[12] On the other hand, the SEC is clearly seeking to limit issuers to discussion of the most important estimates. The proposal observed that "[i]nvestors . . . will not benefit from a lengthy discussion of a multitude of accounting estimates in which the truly critical ones are obscured."[13] The proposal predicts that the vast majority of companies would have "somewhere in the range of from three to five critical accounting estimates."[14]

For each critical accounting estimate, an issuer would be required to make the following disclosures:

- *Description of the Estimate* – An identification and description of the estimate and any alternatives, the methodology used in arriving at the estimate, highly uncertain and other material assumptions underlying the estimate, and reasonably likely changes to the estimate;
- *Explanation of Significance* – A description of the estimate's significance to the company's financial condition and results, as well as an identification of specific line items affected by the estimate (where material);
- *Discussion of Sensitivity* – A quantitative discussion of how changes in the estimate, due to either near-term changes in important assumptions underlying the estimate or the use of values at the upper and lower end of the estimate's reasonably possible range, would affect the company's financial condition (including liquidity and capital resources) and results, as well as particular line items (where material); [15]
- *Discussion of Historic Changes* – A discussion, both quantitative and qualitative, of significant changes to the estimate in the prior three years, the reasons for the changes, and the effects of the changes on line items in the financial statements and financial performance;
- *Discussions with Audit Committee* – A statement regarding whether the company's management has (and if not, why it has not) discussed the estimate with the audit committee of the company's board of directors; and

[11] *See Critical Accounting Policies Release* § X – Proposed Item 303 of Regulation S-K at Item 303(c)(2)(ii) (to be codified at 17 CFR 229.303(c)(2)(ii)) (hereinafter "Proposed Rule").

[12] The proposal did note that "a very few companies" may have no critical accounting estimates. *See Critical Accounting Policies Release* § III.C.1.

[13] *Id.*

[14] The proposal noted that the number might be at the high end of the range, or slightly higher, if there were estimates that were critical to specific segments. *See id*.

[15] The Commission is considering requiring companies to use whichever choice would have the greatest impact on their finances. *See id.* § III.C.4.a.

- *Segments* – An identification of the segments affected by the estimate, as well as 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.[16]

This disclosure would be required in MD&A in annual reports, registration statements, and, where required because of the matters considered, in proxy statements.[17] MD&A in quarterly reports would also contain similar disclosure regarding newly identified critical accounting estimates, as well as disclosure regarding "any material change … necessary to make [previous] disclosure not materially misleading."[18] The disclosure regarding discussions of critical accounting estimates among management and the audit committee is intended to encourage such discussions to the extent they do not already take place.[19] In addition, the Commission has requested comment on whether a company's independent auditors should be required to examine MD&A disclosure regarding estimates.[20]

Other than requiring a separate discussion of each critical accounting estimate (and each initial adoption of an accounting policy), the proposals do not expressly prescribe the form of the disclosure.[21] Nevertheless, the detail required by the proposal will require that all the disclosures discuss certain elements, and the disclosure is likely to be relatively lengthy in order to achieve disclosure that is "clear, concise and understandable to the average investor" and not mere boilerplate or overly technical.[22]

The SEC provided three examples of disclosure relating to critical accounting estimates in the rule proposal. The examples, which provide important insight into the nature and form of disclosure that the SEC is seeking, covered:

- The liability accrued for warranty returns on products, where the estimate of liability depends critically on volatile raw material costs;
- The amount of revenue recognized on software products subject to a liberal return policy, where a deduction is made based on an estimate of future product returns; and
- Impairment of long-lived assets where the impairment is based on estimated future cash flows from the assets.[23]

The sample disclosure provided by the SEC is one or two pages long for each of the three estimates discussed and demonstrates that the SEC will expect specific and individualized analysis of the application of accounting policies to the issuer and its business.

B. Initial Adoption of Accounting Policies

The second aspect of the new disclosure required by the proposed rule relates to the initial adoption of accounting policies that materially impact a company's

16 *See* Proposed Rule at Item 303(c)(3).

17 *See id.* at Item 303(c)(1).

18 *Id.* at Item 303(c)(5).

19 *See Critical Accounting Policies Release* § III.C.5.

20 *See id*. § III.E.

21 *See id.* § III.4.

22 *Id.* § I.

23 *See id*. § III.D.

finances or results. Such a policy is typically adopted when a material event or transaction occurs for the first time or when an event or transaction that was previously immaterial becomes material.[24] The proposals would require the following disclosure for each initial adoption of an accounting policy:

- *Description of Reason* – The events or transactions that led to the initial adoption of the policy;
- *Description of Principle and Its Application* – The accounting principle adopted and the method of application;
- *Discussion of Impact* – A qualitative discussion of the policy's impact on the company's financial condition, changes in financial condition and results of operations;
- *Discussion of Alternatives* – If the company chose between acceptable principles, an explanation of the alternatives (including, where material, a qualitative discussion of the impact that the alternatives would have had on the company's financial presentation) and why the company chose the alternative it did; and
- *Explanation of Underlying Principles* – If no accounting literature exists governing the accounting for the events or transactions giving rise to the initial adoption, an explanation of the decision regarding which accounting principle and which method of application to use.[25]

Disclosure regarding new accounting principles is required in the annual report that first reflects the new policy.[26]

In addition to the proposed rules as described above, the Commission has requested comment on whether to require disclosure of the effect of accounting policies adopted in connection with unusual transactions[27] and the use of policies other than those predominantly used by other companies in the same industry.[28]

III. Potential Implications for Reporting Companies

The proposing release clearly signals the Commission's intent to promote substantial changes in the way MD&A is presented. The proposed rule outlines specific disclosure requirements to a far greater extent than either existing disclosure requirements or prior guidance from the Commission on MD&A.[29] The release contains a number of statements indicating that it is seeking to change what it sees as inadequate MD&A presentation. For example, the release notes that the Commission "[has] discouraged and continue[s] to discourage companies from providing . . . rote calculations of percentage changes in figures in the financial statements combined with boilerplate recitations of a

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24 *See id*. § III.G. The proposed rule specifically notes that the disclosure is not required when a new accounting policy is adopted by an issuer solely because of the "adoption of new accounting literature issued by a recognized accounting standard setter." Proposed Rule at Item 303(c)(4).

25 *See Critical Accounting Policies Release* § III.G.

26 Disclosure is also required in registration statements and proxy statements, where applicable. *See* Proposed Rule at Item 303(c)(1). Disclosure of the adoption of accounting policies does not appear to be required in quarterly reports on Form 10-Q. *See id.* at Item 303(c)(5).

27 *See Critical Accounting Policies Release* § III.G.

28 *See id.* § III.B.

29 *See, e.g.*, Securities Act Release No. 6711 (Apr. 17, 1987) [52 FR 13715], and Securities Act Release No. 6835 (May 18, 1989) [54 FR 22427]. The one prior release that required similarly detailed MD&A disclosure was the Staff Legal Bulletin relating to disclosure of risks of liability arising from expected disruption surrounding Y2K. *See* Staff Legal Bulletin No. 5 (CF/LM) (Jan. 12, 1998), *available at* http://www.sec.gov/interps/legal/slbcf5.htm.

surfeit of inadequately differentiated material and immaterial factors related to such changes."[30]

The Commission also announced in the proposal that it is actively considering the following:

- Requiring a summary that would identify the most important factors of a company's finances and results;
- Requiring all of MD&A to focus more generally on any matter that is material and less on detailed business results;
- Requiring a description of the risks and effects of a company's structured finance transactions;
- Requiring a description of a company's related party transactions and a discussion of any non-arm's-length terms;
- Requiring a discussion of the trends on which management focuses; and
- Changing the MD&A rules to specify that forward-looking statements are a required part of MD&A.[31]

The proposals actually made in the Critical Accounting Policies Release will alone require substantial additional disclosure by all issuers, and this disclosure will require careful crafting and attention to individualized circumstances. The additional proposals that the SEC is considering would require further additional disclosure. Moreover, if the Commission adopts the proposed rules regarding accelerated filing of periodic reports, then the additional detailed disclosure will need to be prepared in a compressed time period.[32]

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Comments on the Critical Accounting Policies Release must be submitted to the SEC by July 19, 2002. The release is available online at http://www.sec.gov/rules/proposed/33-8098.htm. If you need a hard copy of the release or have any questions, please do not hesitate to contact:

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30 *See Critical Accounting Policies Release* § II.A.

31 *See id*.

32 *See Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports*, Release No. 33-8089 (Apr. 12, 2002), *available at* http://www.sec.gov/rules/proposed/33-8089.htm.

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