

## Client Advisory

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# SEC Proposes MD&A Rules Requiring Far-Reaching Disclosure of Critical Accounting Policies

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As an initial step toward making the financial disclosures of reporting companies more transparent, the Securities and Exchange Commission (SEC) has proposed new disclosure requirements that would require companies to discuss their application of critical accounting policies in the “Management’s Discussion and Analysis” (MD&A) sections of registration statements and periodic reports. The proposals, which are significantly more far reaching than other recent disclosure proposals, are intended to help investors obtain higher-quality, more insightful financial information by better understanding important accounting estimates that reflect significant subjectivity and uncertainty of management.

The proposed disclosure would take place in a new “Application of Critical Accounting Policies” section of the MD&A and would encompass disclosure in two areas: 1) accounting estimates resulting from the application of critical accounting policies, and 2) the initial adoption of accounting policies that have a material impact on a company’s financial presentation. The proposed disclosure requirements would apply to all companies except small business issuers that have not had revenues from operations during the last two fiscal years, and the disclosure would cover the most recent fiscal year and any subsequent interim period for which financial statements are required to be presented.

### **Disclosure about Critical Accounting Estimates**

Under the first of the two proposals, the SEC would require a company to provide a detailed description of any accounting estimates that result from the application of critical accounting policies. A reporting company must consider two questions to determine whether an accounting estimate would qualify as a “critical accounting estimate” under the proposal:

1. Did the accounting estimate require us to make assumptions about matters that were highly uncertain at the time the accounting estimate was made?

A matter would involve a high degree of uncertainty if it is dependent on events remote in time that may or may not occur, or if it is not capable of being readily calculated from generally accepted methodologies or derived with some degree of precision from available data. Accordingly, a matter that is highly uncertain would require management to use significant judgment in making assumptions about

that matter. The application of management's judgment in those circumstances typically results in management developing a range within which it believes the accounting estimate should fall.

2. Would different estimates that we reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, have a material impact on the presentation of our financial condition, changes in financial condition or results of operations?

Two types of accounting estimates are included here. First, accounting estimates for which a company in the current period could reasonably have recorded in the financial statements an amount sufficiently different such that it would have had a material impact on the company's financial presentation must be considered. Second, the company must decide if any accounting estimate is reasonably likely to change from period to period to the extent that the change would have a material impact on the company's financial presentation. Thus, whether management's judgment has an impact primarily in the current period or on an ongoing basis (or both), the estimate would qualify.

If the answers to both questions are "yes," the accounting estimate would be deemed a critical accounting estimate and disclosure would be required. For each critical accounting estimate, the company would have to disclose the following information in the MD&A section of filed registration statements:

- A description of the accounting estimate and the methodology underlying the estimate;
- The assumptions underlying the accounting estimate that relate to matters highly uncertain at the time the estimate was made and any other material assumptions;
- Any known trends or uncertainties that are reasonably likely to occur and materially affect the methodology or assumptions;
- Why different estimates that would have had a material impact on the company's financial presentation could have been used;
- 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 estimate to the company's financial condition and, if material, the line items in the financial statements affected by the estimate;
- A quantitative discussion of changes in overall financial performance and, if material, specific line items, if the company were to assume either of the following changes: (1) the inclusion of any reasonably possible ("more than remote but less than likely") near-term ("within one year") changes in the most material assumption(s) underlying the accounting estimate (with generally the effects of both a positive and a negative change to be disclosed) or (2) the changing of the accounting estimate to the upper end and the lower end of the range of reasonable possibilities determined by the company in the course of formulating the recorded estimate, with a discussion of any material impact on the company's liquidity that would result from any of the changes in either of these cases being effected;
- 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;

- 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; and
- If the company operates in more than one segment, an identification of the segments of the company's business the accounting estimate affects.

The proposal would also require in every quarterly report on Form 10-Q by a U.S. company the following additional disclosures:

- Disclosure of any new critical accounting estimate; and
- For any critical accounting estimate previously disclosed, any material change to the prior disclosure necessary to make that disclosure not materially misleading.

The SEC states that it believes the number of critical accounting estimates will vary by company, but it expects very few companies to have none at all and the vast majority to have somewhere in the range of three to five such estimates. The SEC cautions against the use of a long list of accounting estimates since such a list might obscure the critical ones.

For a more detailed discussion of the required disclosures, as well as examples of possible MD&A disclosures under the proposal, please see the proposed rule at the SEC's web site provided below.

### **Disclosure of Initial Adoption of Accounting Policies**

Under the second of the two proposals, the SEC would require a company to describe in detail the adoption of an accounting policy if it will have a material impact on the company's financial condition, changes in financial condition or results of operation. For example, a company may for the first time enter into transactions involving derivative instruments, such as interest rate swaps, or may begin selling a new type of product that has delivery terms and conditions that are different from those associated with the products the company has previously been selling. Such information is typically required to be disclosed in the first note to the financial statements, but the SEC proposes that the MD&A should be the vehicle to describe the policy in plain English and to quantify the impact of the policy. The proposed disclosure would be required in filed annual reports, annual reports to stockholders, registration statements and proxy statements. The disclosure would consist of:

- The events or transactions that gave rise to the initial adoption;
- The accounting principle that has been adopted and the method of applying that principle;
- The qualitative impact on the financial condition and results of operations;
- If the company had a choice between acceptable accounting principles, an explanation of why it made the choice it did including a discussion of the alternatives, including, where material, qualitative disclosure of the impact on the financial presentation that the alternatives would have had; and
- An explanation of why the policy was adopted if there is no accounting literature existing on the issue.

## Conclusion

The SEC proposals, though largely concerned with accounting minutiae, are much more far reaching than other recent disclosure proposals, going to the heart of what has historically been the exclusive jurisdiction of a company's auditors. For the first time, the SEC is looking to require descriptions of the decision-making underlying the financial statements, rather than just the financial statements themselves. By requiring that the disclosure be placed in the MD&A rather than in the financials, the SEC is encouraging the participation of underwriters, audit committees and lawyers – as well as auditors – in the preparation of both MD&A and financial statement disclosures. The comment period for the proposed disclosure requirements will expire on July 19, 2002.

You can access the Proposed Rule at <http://www.sec.gov/rules/proposed/33-8098.htm>

## We Can Help

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