

# Client Alert

A report  
for clients  
and friends  
of the firm      May 2002

## Summary

On April 30, 2002, the Securities and Exchange Commission authorized issuance of proposals to require disclosure by domestic and foreign private issuers about "critical accounting estimates and judgments" (f/k/a "critical accounting policies") in their Management's Discussion and Analysis of Financial Position and Results of Operations required by Item 303 of Regulation S-K, Item 303 of Regulation S-B and Item 5 of Form 20-F (the "MD&A") in various registration statements and reports under the Federal securities laws. See Securities Act of 1933 Rel. No. 33-8098 (May 10, 2002). (The "Proposing Release")

This action was presaged by an "interpretative" release (the "Interpretive Release"), Financial Reporting Release No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (December 12, 2001), which advised, alerted, cautioned and encouraged companies to include in their MD&As "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.

## The SEC's Proposals

The Proposals are intended to codify, elaborate on and provide additional guidance on the advice in the Interpretive Release.

The Proposing Release also includes proposals to require disclosure about the initial adoption of an accounting policy.

Moreover, SEC officials have indicated that these proposals are only a first step in additional rulemaking regarding the MD&A.

The comment period on these proposals will expire on or about July 15, 2002, and these proposals could be adopted and take effect by the end of 2002.

It should be noted that the SEC's proposals concerning critical accounting policies are supported, in part, in Sections 6(c)(2)(A) and (B) and (3) of H.R. 3763 ("CARTA" or the "Oxley Bill").

## The Interpretive Release

While the proposals are pending and, if adopted, until the effective date of the new requirements, the provisions of the Interpretive Release govern disclosure about "critical accounting policies." For additional guidance, *see also*, "Critical Accounting and Critical Disclosures," speech by Robert K. Herdman, Chief Accountant, SEC, at Financial Executives International - San Diego Chapter, Annual SEC Update, San Diego, California, January 24, 2002.

While the Interpretive Release purports to be advisory, in practice the SEC staff has administered this advice as it would the requirements of a rule. (Note: Rule 1-01(a) of Regulation S-X, the SEC's accounting regulation, provides that the Regulation and the Financial Reporting Releases "Set[s] forth the form and content of and requirements for financial statements required to be filed as part of " disclosure documents filed with the SEC.)

SEC officials have indicated dissatisfaction with some of the disclosure provided in response to the Interpretive Release. Others have noted that some of these disclosures have:

- Merely repeated significant accounting policies found in the footnotes to the company's financial statements;
- Have copied significant accounting policies of others in the company's industry; or
- Have not been in understandable English.

Perhaps, the proposed requirements, which offer more guidance, and experience will result in more acceptable disclosure.

## The Proposing Release

The Proposing Release provides more guidance than the Interpretive Release.

## What Are Critical Accounting Estimates?

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

- The accounting 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 reasonable 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.

### **What Would Be Required to Be Disclosed?**

To inform investors of each critical accounting estimate, and to place it in the context of the company's financial condition, changes in financial condition and results of operations, the proposals would require the following information in a separate section of the MD&A:

- A discussion that identifies and describes the estimate, the methodology used, certain assumptions and reasonably likely changes;
- 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 line items in the financial statements and overall financial performance if the company were to assume that the accounting estimate were changed, either by using reasonably possible near-term (within one year) changes in certain assumption(s) underlying the accounting estimate or by using the reasonably possible range of the accounting estimate;
- Disclosure of the impact, if material, on the company's liquidity and capital resources if such changes were to occur;
- A quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years (but only two years during a one year transition period), the reasons for the changes, and the effect on line items in the financial statements and overall financial performance;
- 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;
- 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 estimate on a segment basis, mirror-

ing 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.

### **Foreign Companies**

These requirements would be doubly complex for foreign companies, since they would have to disclose their critical accounting policies and estimates under applicable foreign GAAP and, upon reconciliation to U.S. GAAP, what those policies and estimates would have been under U.S. GAAP. (These proposals do not apply to Canadian companies filing under the SEC's Multi-jurisdictional Disclosure system.)

### **Updating**

The proposals would require that companies, in registration statements containing interim financial statements and in their quarterly reports on Form 10-Q or Form 10-QSB, update this disclosure to show material changes. Foreign private issuers would not be subject to this updating requirement, unless they are required to update their MD&As in Securities Act registration statements.

### **Open Questions**

The Proposing Release raises a number of open questions, including:

- Whether selection of a particular accounting policy provided a "higher return" than another acceptable policy;
- Whether a company should be required to disclose information about the accounting policies of its competitors, based on information supplied by its outside auditors (this raises ethical and, perhaps, legal confidentiality issues); and
- Whether there should be disclosure in SEC filings about audit committee practices in reviewing the required disclosure.

### **The Critical Importance of Safe Harbors**

Given the proposals' heavy reliance on estimates and other forward looking information, reliance on the statutory safe harbors for forward looking information provided by Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and on the SEC's safe harbors for forward looking statements provided by Securities Act Rule 175 and Exchange Act Rule 3b-6 and on the judicially recognized "bespeaks caution" doctrine will be of even more importance.

### **SEC Review Practices**

The Chairman of the SEC has stated that there would need to be a period of intense review by the SEC staff to ensure compliance with these requirements. The staff has indicated that it

was not satisfied with much of the disclosure that was elicited by the Interpretive Release and it intends to do a selected and targeted review of compliance with the new regulations over a wide range of companies.

**Note:** Section 9 of CARTA would require the SEC to conduct regular and systematic reviews of Exchange Act reports and to develop a “risk rating system” for purposes of these reviews which would consider, among other factors:

- Emerging companies with disparities in earning ratios;
- Issuers with the largest market capitalization;
- Issuers whose operations significantly impact any material sector of the economy;
- Systemic factors such as the effect on niche markets or important subsectors of the economy;
- Issuers that experience significant volatility in their stock prices as compared to other issuers; and
- Any other factor the SEC may consider relevant.

The SEC, however, would be prohibited from disclosing the criteria it uses for its risk rating system (f/k/a “selective review criteria”).

The SEC already has announced that it is developing its own risk assessment system.

### Initial Adoption of Accounting Policies

The proposals would require 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:

- 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 impact on the company's financial condition, changes in financial condition and results of operations (discussed on a qualitative basis);
- 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

- 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.

Recent adoption of a new accounting standard by a standard setter would not trigger these requirements. Thus, the proposed requirements would be in addition to the requirements of an existing Staff Accounting Bulletin, SAB No. 74 (December 30, 1987), SABs Topic 11.M, “Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period”. That SAB would continue to apply regardless of whether the proposals are adopted.

These proposals would apply to both domestic and foreign companies.

\* \* \*

These are complex proposals, particularly those requiring quantification and estimation of different results. However, the chances are they will be adopted in some form by late this year. Hopefully, the SEC will not second guess good faith judgments made in efforts to comply with these requirements. The risk is, however, that, if the SEC does not act in this area, Congress may either by enacting CARTA or some even more onerous legislation.

In addition, the SEC has promised that there is more to come with respect to the MD&A.

NEW YORK LOS ANGELES  
WASHINGTON BOCA RATON  
NEWARK PARIS

#### Client Alert

**Proskauer's Corporate Law Department includes over 140 attorneys with significant and diverse corporate law experience. The following individual serves as a contact person and would welcome any questions you might have.**

**Richard H. Rowe**  
202.416.6820 - rrowe@proskauer.com

**James M. Waddington**  
33.1.53.05.60.11 - jwaddington@proskauer.com

**You may also contact any other member of the Corporate Law Department in:**

New York	212.969.3000
Washington	202.416.6800
Boca Raton	561.241.7400
Los Angeles	310.557.2900
Paris	331.53.05.60.00

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1585 Broadway  
New York, NY 10036-8299  
212.969.3000

2049 Century Park East  
32nd Floor  
Los Angeles, CA 90067-3206  
310.557.2900

2255 Glades Road  
Suite 340 West  
Boca Raton, FL 33431-7383  
561.241.7400

1233 Twentieth Street NW  
Suite 800  
Washington, DC 20036-2396  
202.416.6800

One Newark Center  
18<sup>th</sup> Floor  
Newark, NJ 07102-5211  
973.274.3200

68, rue du Faubourg Saint-  
Honoré  
75008 Paris, France  
331.53.05.60.00

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