K&L ALERT

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New SEC Rules—The Deluge Continues

Based upon our discussions with SEC staff members and other staff presentations, in last month's Commentary we predicted that the next reporting release from the SEC would likely deal with disclosure requirements concerning the application of critical accounting policies. It was no surprise, then, when on April 30, 2002 the Commissioners voted 3–0 to require companies to disclose in a separately captioned section of the "Management's Discussion and Analysis" ("MD&A") section of annual reports, registration statements and proxy and information statements information regarding critical accounting estimates that are made by a company in applying its accounting policies, and information regarding the initial adoption of an accounting policy. We believe that the first of these two disclosure proposals is likely to be highly controversial and the subject of significant commentary, while the second is likely to be viewed as requiring reasonably narrow and manageable disclosure.

CRITICAL ACCOUNTING ESTIMATES

As we noted in our April Commentary, the SEC has since December of last year been urging companies to disclose in their annual reports additional information regarding the impact of critical accounting policies on a company's financial statements. In commenting on the SEC's action, Chairman Harvey Pitt and Corporation Finance Director Alan Beller noted that despite companies' efforts to comply with the SEC's voluntary initiative, the disclosure during the recent annual report season was disappointing. Our sense is that companies were far more successful in identifying material accounting policies than in providing investors with a meaningful insight into how these policies, including the estimates used in their application, actually affect their financial statements either historically or prospectively. As a result, the SEC chose to require disclosure and to be very specific regarding what it believes to be "critical accounting estimates."

Under the proposal, a "critical accounting estimate" is deemed to be:

- An accounting estimate that 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 in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, that would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations.

In order to enable average investors to better understand that the basis of a company's financial statement presentation can vary and to better appreciate the significance and volatility of changes that may occur in a company's financial statements depending upon the use of different estimates and assumptions in applying various accounting policies, the SEC's proposal would require disclosure of the following information in a separate MD&A section regarding critical accounting estimates:

- 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 was changed, either by using reasonably possible near-term changes in certain assumption(s) underlying the accounting estimate or by using the reasonably possible range of the accounting estimate;

- 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;

- 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, 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.

The proposal also would require companies to update this part of the required disclosure to show material changes in their quarterly reports.

The SEC's proposal seems to require a company to disclose information regarding each item in its financial statements that is based upon management's estimates or assumptions. And, if a different estimate or assumption could otherwise reasonably be used by management, the different estimate or assumption and the resulting material change in the company's financial statements. This proposal would put companies in a very difficult disclosure position. Companies will be in jeopardy if they do not make disclosure in any instance where there is ambiguity or uncertainty as to whether the estimate involves matters that are "highly uncertain" or whether the use of a different estimate could materially change financial statement presentation. The result is that a company now will feel pressure to publicly disclose the basis upon which it has arrived at all of its material estimates and assumptions, a process unlikely to be easily described.

The SEC recognizes the difficulty that companies will face in attempting to comply. Chairman Pitt acknowledged that the SEC should provide as much guidance as possible in advance of the compliance date for the proposal, and Corporation Finance Director Beller has said that the actual release for the proposal, which we are still awaiting, should contain some examples that will assist companies in complying with the new requirement.

INITIAL ADOPTION OF ACCOUNTING POLICIES

The SEC's new disclosure proposal also will require MD&A disclosure 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 alternative would have has); 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 decision regarding which accounting principle to use and which method of applying that principle to use.

It is significant and helpful that, unlike the proposal for "critical accounting estimates," this part of the new MD&A regime focuses only on qualitative (and not quantitative) disclosure. Accordingly, we believe that, although not without ambiguity, the required disclosure regarding the impact of the adoption of new accounting policies is a much narrower disclosure field and likely to involve fewer internally sensitive issues and discussions with the auditors and fewer predictive difficulties.

A LOOK AHEAD

We now await the actual text of the SEC new disclosure proposal and the examples. We expect this proposal will be subject to a vigorous comment process, which the SEC generally encourages and values. We encourage companies who have strong views on the proposal after it is officially released to join the comment process either directly or through us.

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