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MAY 2002

SEC PROPOSES REQUIREMENTS FOR DISCLOSURE OF CRITICAL ACCOUNTING POLICIES IN MD&A

As part of its increased scrutiny of the periodic disclosure regime, the SEC has proposed new disclosure rules concerning (a) accounting estimates that underlie critical accounting policies and (b) the initial adoption of accounting policies that have a material impact on financial statements. This action follows the SEC's December 2001 release cautioning management of public companies, auditors, audit committees and company advisors that greater effort needs to be made to alert investors to the sensitivity of financial statements to the methods, assumptions and estimates underlying their preparation.

The proposed rules would require that public companies include a new section entitled "Application of Critical Accounting Policies" in their Management' s Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in 10-K/20-F annual reports, annual reports to shareholders, registration statements and, to the extent Items 11, 12 or 14 of Schedule 14A require MD&A, proxy statements and information statements. The disclosure would cover the most recently completed fiscal year and any required interim periods. Certain updates would be required to be included by US filers in their quarterly reports.

The proposed rules are subject to a 60-day comment period.

The Proposals

Critical Accounting Estimates

Management will need to identify critical accounting estimates and then make a series of disclosures concerning them. An accounting estimate is an "approximation made by management of a financial statement element, item or account in the financial statements." Examples of accounting estimates include: net realizable value of accounts receivable, net realizable value of inventory, insurance loss reserves (for property and casualty companies), future returns of products sold, expected cash flows from identified assets and costs of warranty-related claims.

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What is a critical accounting estimate?

An accounting estimate would be deemed critical if:

- it requires management to make assumptions about matters that are highly uncertain at the time; *and*

- different estimates that management 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 financial condition, changes in financial condition or results of operations.

A matter involves a high degree of uncertainty if it is dependent on events remote in time that may or may not occur, or it is not capable of being readily calculated from generally accepted methodologies or derived with precision from available data. Management is likely to develop a range within which it believes the accounting estimate should fall.

How many estimates are likely to be critical*?*

The SEC believes that few accounting estimates will be critical. The SEC further believes that very few companies will have no such estimates, and that the vast majority will have between three and five such estimates. The proposed disclosure is not supposed to be presented as a single discussion of the aggregate consequences of multiple critical accounting policies. Rather, each critical accounting estimate would be discussed separately.

What disclosure would be required?

The MD&A would need to describe:

- the critical accounting estimate;
- the methodology used in determining the critical accounting estimate;
- any underlying assumptions that reflect highly uncertain matters at the time the estimate was made or that are material;
- any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or assumptions described;
- if applicable, why different estimates that would have had a material impact on the company could have been used; and
- if applicable, why the accounting estimate is reasonably likely to change from period to period.

For each critical accounting estimate, management would describe its significance to financial condition, changes in financial condition and results of operations and, where material, its effect on specific line items.

The MD&A would also need to include two sets of quantitative discussions:

- the first, to demonstrate sensitivity of overall financial performance and, to the extent material, line items to changes to the estimate. Management could choose to assume a change in the most material assumption(s) underlying the critical accounting estimate, and discuss those changes, or it could assume a change in the critical accounting estimate itself. In doing so,

  - management could select an alternative material assumption as long as the alternative represents a change that is "reasonably possible" (i.e., more than remote but less than likely) in the "near term" (i.e., up to one year). It would need to alter the single most important assumption twice – once positively and once negatively. If it cannot select the single most material assumption, or believes selecting one would be misleading, it can use the ends-of-the-range approach (below) or clearly disclose the separate effect of each changed assumption; or

  - management could use the upper and lower ends of the range of reasonably possible estimates which it likely determined in formulating the critical accounting estimate, and first substitute the upper, then the lower, end for the recorded estimate and discuss the impact.

- the second, together with a qualitative discussion, to address any material changes in the past three years (or, during the first year following effectiveness, the past two years) to critical accounting estimates. This discussion would address each such change, the reasons for the change and the effect on overall financial performance and, to the extent material, any line items. If there were no material changes during the covered period, or if the company did not make that estimate during the covered period, disclosure to that effect would be sufficient. The disclosure would address material changes to the estimates as well as material changes to assumptions that did not necessarily result in a change to the estimate (e.g., changes to assumptions that have an offsetting impact). This discussion would be in addition to traditional MD&A disclosure of changes in relationships between costs and revenues resulting from a known event; matters that will impact future operations that did not have any prior impact and matters that impacted past results that are not expected to have any impact in the future.

What role should the audit committee play in respect of these estimates?

Management would be encouraged to discuss the critical accounting estimates with the audit committee. Encouragement would come in the form of required disclosure in the MD&A as to *whether* management had had such discussions (not the substance of such discussions, however) and, if not, the reasons why not. This disclosure, unlike the audit committee report, would not be limited to proxy statements for the election of directors.

What if the company has reportable business segments?

If a company operates in more than one segment (as defined in SFAS 131) and a critical accounting estimate affects fewer than all segments, it would be required to identify segment(s)

and, to the extent material (i.e., where discussion on a company-wide basis only would result in omissions that render the disclosure misleading), to include a separate discussion of the estimates for each such segment necessary to avoid an incomplete or misleading presentation.

What would a company be required to do on a quarterly basis?

In 10-Qs, management would be required to provide an update to the MD&A information related to critical accounting estimates contained in the most recent 10-K or intervening 10-Q. Newly identified critical accounting estimates (or critical accounting estimates that were not discussed as such in a previous 10-K or intervening 10-Q) would be disclosed in the same way as in a 10-K. Any material changes that would render critical accounting estimate disclosure in the latest report materially out of date or otherwise materially misleading, and the effects of such changes, would be disclosed.

Quarterly updates of quantitative and qualitative discussions of past material changes in critical accounting estimates in 10-Ks, annual reports, registration statements, and proxy and information statements would not be required.

Registrants may assume for purposes of quarterly disclosure that investors have read or had access to discussions of critical accounting policies in the most recently filed 10-K or intervening 10-Qs.

Adoption of New Accounting Policies

What disclosure would be required if management adopts new accounting policies?

Generally, disclosure of new accounting policies will be contained in notes to the financial statements. To improve disclosure of the impact of the adoption of such policies, the SEC has proposed additional MD&A disclosure of the material impact, if any, of the initial adoption of accounting policies. Disclosure would cover:

- the events or transactions giving rise to the adoption;
- the accounting principle and the method of application;
- the impact, from a qualitative standpoint, of adoption;
- where management had a choice among acceptable accounting principles, a description of the alternatives (and where material, a qualitative discussion of the impact that the alternatives would have had) and a discussion of why the selected principle was chosen; and
- if there is no accounting literature governing accounting for the events or transaction giving rise to the adoption, an explanation of management's decision as to which principle to use and the method of applying that principle.

Would this requirement apply to all new accounting policies?

The new disclosure rules would not apply to any policy adopted solely as a result of the adoption of new accounting literature by a recognized accounting standard setter. Initial adoption of accounting policies might occur where events or transactions affect the company for

the first time, or were previously immaterial in their effect but become material, or where events or transactions occur that are clearly different in substance and impact from prior ones.

Disclosure would not be required if the adoption of the policy did not have a material impact on financial condition, changes in financial condition or results of operations.

Coverage of the New Proposals

What would a foreign private issuer be required to disclose?

The foregoing rules would apply, with certain limited exceptions, to annual reports and registration statements filed by foreign private issuers. Where the primary financial statements are presented in accordance with a GAAP other than US GAAP, management would have to consider critical accounting estimates in connection with both the primary financial statements and the US GAAP reconciliation. Foreign private issuers providing disclosure under Item 17 of Form 20-F are not required to provide segment disclosure and, therefore, would not be required to provide discussion of critical accounting estimates by identified segments.

Foreign governments and Canadian issuers filing reports and registration statements under the U.S. - Canadian MJDS would not be affected by the proposals. Presumably, based on the Staff's approach to foreign filers that voluntarily subject themselves to the domestic reporting regime (i.e., that file using 10-Ks and 10-Qs), such foreign issuers would be subject to the rules applicable to US reporting companies. Foreign private issuers that voluntarily submit quarterly information on a Form 6-K would not be required to comply with the proposed quarterly updating rules, though they would be encouraged to do so. Such updating would be required, however, to the extent any such issuer is filing a registration statement that includes, under the age of financial statement rules, interim financial statements.

Liability Concerns

Must management frame its disclosure as forward-looking statements?

The proposed rules would delete the statements in the MD&A rules to the effect that registrants are not required to make forward-looking statements. Some of the proposed disclosures (e.g., assumptions involving projections of business trends or reasonably possible near-term changes in material assumptions) would be forward-looking. Registrants would need to consider the terms, conditions and scope of the statutory safe harbors that provide protection for forward-looking statements. Note that the safe harbor in any event does not cover forward-looking statements in notes to the financial statements.

What disclaimers would be appropriate?

The SEC made clear that the proposed disclosure would have to be presented in clear and understandable language. Boilerplate disclosures would not satisfy the proposed requirements. The SEC also noted that disclosures consisting principally of blanket disclaimers of legal liability for the application of new accounting policies or the development of critical accounting estimates in light of the attendant uncertainties would defeat the purpose of the proposals. Simple disclaimers of legal liability would not be permitted.

Possible Additional Proposals

The SEC announced, or in a few cases reiterated, that is considering, but has not officially proposed:

- requiring an MD&A summary that identifies what management considers the most important factors in determining its financial condition and results, including key drivers, key trends and key risks;
- guidance to elicit more general discussion of material matters and less focus on the detailed description of changes in line items;
- improved disclosure of structured finance and related-party transactions;
- requiring information about the trends that management follows and evaluates in making decisions about the future of the business; and
- requiring that a company's auditors examine critical accounting estimates along the lines contemplated by the infrequently used *Codification of Statements on Standards for Attestation Engagements, Management's Discussion and Analysis*, section 701.

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Although it may be difficult at this point to fully identify the exact parameters of MD&A disclosure in the future, it is safe to say that the existing model, with its emphasis on a fairly rigid set of comparisons of changes in line items, will change. The new approach will require less focus on quantitative changes and far more focus on qualitative factors. One can expect that the information contained in the overview section of MD&As included in registration statements (but less often in ongoing periodic reports) will have greater prominence. Management and their legal advisors will need to spend more time preparing disclosure that meets the three-pronged objective of MD&A disclosure – namely to provide: the explanations necessary to enable investors to see financial results and financial condition through the eyes of management; the context within which financial results and financial condition can be analyzed and understood; and information about earnings and cash flow to permit an assessment of the likelihood that past performance will be indicative of future performance.

Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (including any of those listed below). This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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