

## SEC Proposal On Disclosure of Critical Accounting Policies

ON APRIL 30, 2002 the Securities and Exchange Commission voted unanimously to propose new rules that would require companies to discuss the accounting policies that have a material impact on their financial statements. The proposals address disclosure in two areas: the initial adoption of accounting policies and the critical accounting estimates made in the application of those accounting policies. They follow up a January 2002 SEC release recommending that issuers make many of the same disclosures.

Companies now would be required to address these issues in a new section of the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") included in their SEC reports entitled "Application of Critical Accounting Policies."

### Initial Adoption of Accounting Policies

If a company adopted an accounting policy within the past year and the adoption of the policy had a material impact on the company's financial condition, changes in financial condition or results of operations, then the company would be required to disclose in the new section of the MD&A:

- 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 that the other 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.

### Critical Accounting Estimates in the Application of Accounting Policies

Under the SEC proposal, the company also would have to disclose each "critical accounting estimate" used in the financial statements, meaning one where:

- 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 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 the company's financial condition, changes in financial condition or results of operations.

To place each critical accounting estimate in the context of the company's financial condition, changes in financial condition or results of operations, the proposals require the inclusion, and quarterly updating, of the following information in the MD&A:

- A discussion that identifies and describes the estimate, the methodology used, certain assumptions and reasonably likely changes;

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- 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 changes in certain assumptions 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 SEC's position is that the proposed disclosure requirements would further the main objectives of the MD&A: providing context in which financial statements should be analyzed; providing information regarding the potential variability of a company's earnings and cash flows, thereby enabling investors to determine whether past performance is indicative of future performance; and allowing investors to see a company through the eyes of management.

The comment period on these proposed disclosure requirements ends July 19, 2002. While it is possible that there may be some tinkering in response to comments, we expect that the rule will be adopted substantially as proposed fairly quickly after the end of the comment period.

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