

DETERMINED TO BE AN
ADMINISTRATIVE MARKING
E.O. 12065, Section 8-102
By *JMV* NARS, Date *5/2/2013*

Recommendation
Approved by
Commission

Tara Sussan
Program Information Specialist

Circ. 4/26 for 4/30

APR 2002

as modified
ACTION MEMORANDUM

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TO: The Commission

FROM: Division of Corporation Finance
Office of the Chief Accountant *[Signature]*

SUBJECT: Disclosure in Management's Discussion and Analysis ("MD&A") about Critical Accounting Estimates

RECOMMENDATION: That the Commission issue a release, substantially in the form of the attached draft, proposing amendments to Item 303 of Regulation S-K, Item 303 of Regulation S-B and Item 5 of Form 20-F under the Securities Exchange Act of 1934 to require disclosure relating to a company's critical accounting estimates.

ACTION REQUESTED BY: April 30, 2002

SUNSHINE ACT STATUS: Open Meeting

COST BENEFIT ANALYSIS: The draft proposing release includes a cost-benefit analysis. The Division has consulted with the Office of Economic Analysis and Office of General Counsel concerning this analysis.

REGULATORY FLEXIBILITY ACT STATUS: The draft proposing release includes an Initial Regulatory Flexibility Analysis. The Division has consulted with the Office of Economic Analysis and Office of General Counsel concerning this analysis.

PAPERWORK REDUCTION ACT STATUS: The draft proposing release includes a Paperwork Reduction Act analysis. The Division consulted with the Office of General Counsel regarding this analysis and intends to submit Paperwork Reduction Act filings to the Office of Management and Budget for the draft proposing release.

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**“MAJOR RULE”
STATUS:**

Based on our preliminary cost estimates, the proposals may represent “major rules” for purposes of Congressional review and the Small Business Regulatory Enforcement Fairness Act. The draft proposing release solicits comment on whether the proposed amendments are “major rules.”

**NOVEL, IMPORTANT
OR COMPLEX ISSUES:**

The release proposes new MD&A disclosure with respect to critical accounting estimates to give investors a better understanding of companies’ financial condition, changes in financial condition and results of operations. As discussed further in “Scope of the Proposals” below, the release does not address all areas in which companies may exercise discretion with respect to their accounting, including situations in which companies have choices between acceptable accounting policies under GAAP.

**OTHER OFFICES
OR DIVISIONS
CONSULTED:**

Office of General Counsel (David Fredrickson, Monette Dawson)

Office of Economic Analysis (Jonathan Sokobin, Vivek Mande)

Copies provided to:

Division of Enforcement (Stephen Cutler, Linda Thomsen, Charles Neimeier, Laurie Stegman, Samantha Ross)

Division of Investment Management (Paul Royce, Cynthia Fornelli, Susan Nash, Paul Cellupica)

Division of Market Regulation (Annette Nazareth, Robert Colby, Larry Bergmann)

Office of Compliance Inspections and Examinations (Lori Richards, Karen Burgess)

**PERSONS TO
CONTACT:**

Anita Klein, Senior Counsel to the Director, Division of Corporation Finance (x2839)

Andrew Thorpe, Special Counsel, Office of Rulemaking, Division of Corporation Finance (x2924)

Jackson Day, Deputy Chief Accountant, Office of the Chief Accountant (x4419)

Jenifer Minke-Girard, Associate Chief Accountant, Office of the Chief Accountant (x4413)

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I. Introduction

The Division of Corporation Finance and the Office of the Chief Accountant recommend that the Commission publish the attached draft release to propose amendments to Item 303 of Regulation S-K, Item 303 of Regulation S-B and Item 5 of Form 20-F. The proposals would require new disclosure in "Management's Discussion and Analysis" regarding a company's critical accounting estimates. As defined in the proposals, an accounting estimate recognized in a company's financial statements is a "critical accounting estimate" if: (i) the accounting estimate requires a company to make assumptions about matters that are highly uncertain at the time the estimate is made; and (ii) different estimates that a company reasonably could have used, 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 a company's financial condition, changes in financial condition or results of operations.

II. Discussion

A. Background

In December 2001, the Commission issued cautionary advice regarding disclosure about critical accounting policies.¹ In that release, the Commission recognized the need for greater transparency of financial disclosure, as well as greater investor awareness of the sensitivity of financial statements to the methods and assumptions underlying the preparation of estimates. The Commission asked companies to begin addressing that need.

In response to the Commission's December cautionary advice, a number of companies have provided additional MD&A disclosure in their most recent filings with the Commission. Because the annual reports filing season has recently ended, we have not had the opportunity to make overall judgments about companies' responses. We have thus far observed a wide range in the quality of the disclosure we have seen. We have read approximately 50 of these disclosures. Although limited in number, it was evident that the vast majority of those disclosures failed to fulfill completely the Commission's objective of providing greater transparency as to which few accounting estimates involve highly uncertain assumptions and allow a range of outcomes, either at the time the estimate is made or from period to period.

Many of the voluntary disclosures we read were simply general explanations of the significant accounting policies similar to that already found in notes to the financial statements. The voluntary disclosures we saw rarely provided insight specifically into the connection between the critical accounting estimates and the company's financial statements. Without this type of disclosure, investors would not have the context within which a company's financial statements could be analyzed. Many of the voluntary

¹ See Securities Act Release No. 8040, FR-60 (Dec. 12, 2001) [66 FR 65013].

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disclosures we read also failed to provide a true sense of the sensitivity of financial results and financial condition to the assumptions and methodologies underlying a company's accounting estimates.

The voluntary disclosure we read supports the Commission taking the step of proposing rules as contemplated in the December cautionary advice. The proposals would complement the current disclosure requirements and the Commission cautionary advice.

B. Objectives of Proposals

The objectives of the proposals are:

- to reinforce investors' understanding of the existence of, and necessity for, estimation in a company's financial statements;
- to focus investors on the important estimates that are particularly difficult for management to determine and where management therefore exercises significant judgment;
- to give investors an understanding of the impact those estimates have on the presentation of a company's financial condition, changes in financial condition or results of operations; and
- to give investors an appreciation for how sensitive those estimates are.

To achieve these objectives, we have designed proposals for disclosure of critical accounting estimates in MD&A. Such a discussion is uniquely suited to MD&A because it would further the broader goals of MD&A -- showing investors the company's financial condition "through management's eyes," providing important additional information in narrative form that enhances understanding of a company's financial statements, and providing information about the quality of, and risks to, a company's earnings. The attached release is another step towards greater transparency and quality in companies' financial disclosures. The proposed rules should elicit meaningful disclosures about critical accounting estimates in annual reports, registration statements and proxy and information statements, with quarterly updates of that disclosure. We would like to take this step on an expeditious basis.

C. Scope of the Proposals

The proposals were designed to address a subset of accounting estimates about which there is a clear need for improved disclosure. We do not intend for the proposals to address all current areas in which companies have discretion with respect to their accounting. Some areas of accounting discretion that the proposed rules would not cover are: judgment in the initial selection of accounting principles and changes by a company from one accounting policy to another, both of which are acceptable under GAAP. The proposals leave disclosure about those other areas of accounting discretion to existing MD&A requirements, materiality standards and existing financial statement disclosure requirements. Because we may revisit some of those issues at a later date, however, the

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release solicits comment on expanding our objectives to consider disclosure regarding other areas of accounting discretion.

D. Proposed Amendments

1. Proposed items of disclosure

Under the proposals, a company would make certain disclosure for each critical accounting estimate. First, the company would identify each critical accounting estimate, discuss the nature of the material assumptions and the methodology underlying it, and disclose any known trends, demands, commitments, events or uncertainties that may materially affect those assumptions and that methodology.² If the company operates in more than one segment, it would have to identify the segments of the company's business materially affected by the critical accounting estimate. If the discussion of a critical accounting estimate on a company-wide basis would be materially misleading, a company also would have to discuss the estimate on a segment basis.

The proposals would require a quantitative discussion of the sensitivity of a company's critical accounting estimates. A company would have two alternative methods for discussing this. First, a company could discuss the effect on its financial statements if it assumed that reasonably possible near-term changes in its most material assumption(s) occurred. Alternatively, a company could choose the upper and lower ends of the range of the estimate (which it probably calculated in the course of preparing its financial statements) and discuss the impact assuming it used those values for its estimate. The proposals also contemplate a quantitative and qualitative discussion of management's history of materially changing its estimates in the past three years. Quantitative disclosure was not specifically discussed in the Commission's December cautionary advice, but without it, based on examples we have seen, narrative discussion addressing sensitivity and past experience would be imprecise, vague and not particularly useful to investors.

The proposals would require disclosure of whether or not management discussed with the audit committee of the board of directors the development, selection and disclosure of critical accounting estimates. The disclosure would give investors better information about audit committee oversight and could promote greater interaction between audit committee members and senior management with regard to the critical accounting estimates.

We also state in the proposed rules that companies must present their disclosures in a clear, concise manner that is understandable to the average investor. One shortcoming of the voluntary disclosures we read was that they were not written in language that an average investor would understand. Concepts were often written in

² The proposed MD&A discussion would cover the financial statements for a company's most recent fiscal year and any subsequent period for which interim period financial statements are required to be included.

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accounting terms or in such a technical or vague fashion that the implications would not be clear to investors. The proposed rule would advise companies to draft with a view towards investor understanding and also assist SEC staff members reviewing the critical accounting estimates disclosure in MD&A.

Finally, in an unusual step that should improve understanding of the proposal and provide guidance, we set forth three examples of hypothetical disclosure under the proposed rules. Especially in light of the variable quality of the voluntary disclosure provided to date, we believe the examples will assist affected parties to understand the Commission's intentions.

2. Request for comment regarding auditor examination of new disclosure

We also discuss in the draft release the possibility that the Commission could require companies to subject the proposed MD&A disclosure to an auditor examination akin to that contemplated in SSAE No. 10.³ We stop short of proposing that additional step because we are not certain that it would help ensure the accuracy and reliability of the proposed disclosure. (Also, if the Commission were to take that step, new standards or some amendments to the standards may be required because SSAE No. 10 does not currently envision an auditor examination or review of just a portion of the MD&A.) An auditor examination of the proposed section of MD&A, or all of MD&A, would impose a cost on companies that may not be outweighed by improvements in the MD&A disclosure. We would, however, like to hear the reactions to the idea by the parties that would be affected.

3. Companies covered by the proposals

The new disclosure requirements would be applicable to all companies with one exception. Small business issuers that did not have revenues from operations during the last two fiscal years would not have to provide the new disclosure. Those small business issuers currently are not required to prepare an MD&A discussion; instead they must disclose their business plan for the next 12 months.

For foreign private issuers, the critical accounting estimates disclosure would focus on the primary financial statements in the foreign private issuer's filing, whether those are prepared in accordance with a foreign country GAAP, under accounting standards promulgated by the International Accounting Standards Board and the International Accounting Standards Committee, or in accordance with U.S. GAAP. If the primary financial statements are presented using non-U.S. GAAP, the company also would have to consider the reconciliation to U.S. GAAP. The reconciliation may result in the identification of additional critical accounting estimates that would be subject to the proposed disclosure.

³ Codifications of Statements on Standards for Attestation Engagements, AT §701, Management's Discussion and Analysis ("SSAE No. 10").

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4. Quarterly updates

The proposals would require that U.S. companies update the critical accounting estimate disclosure in the MD&A section of their Forms 10-Q or 10-QSB. The quarterly report would contain all of the proposed disclosure for any new critical accounting estimate, but otherwise would discuss any material change from the company's most recent critical accounting estimate disclosure (except that a company would not have to update its disclosure of past changes in the estimates on a quarterly basis). Foreign private issuers do not report on a quarterly basis and therefore would not be subject to a quarterly updating obligation.

5. Forward-looking statements

Some of the proposed MD&A disclosure, but not all of it, would require a company to make forward-looking statements. Breaking with the traditional disclaimer in the MD&A requirements that they do not require forward-looking statements, we propose to state instead in the MD&A rules that MD&A now requires that type of statement. We also would note in the proposed rules that companies making disclosure under them should be aware of, and draft their disclosure in light of, the several statutory and Commission rule safe harbors for forward-looking statements. In the release, and in the rule, we would provide a list of examples of forward-looking statements that would be made in response to the proposed mandates.

III. Conclusion

The Division of Corporation Finance and the Office of the Chief Accountant recommend that the Commission authorize the issuance of the attached release.

Exhibit A: Draft Proposing Release