TO OUR FRIENDS AND CLIENTS

May 15, 2002

SEC Proposes New MD&A Disclosure Requirements For Critical Accounting Estimates

The SEC has proposed for comment new disclosure requirements in the Management’s Discussion and Analysis portion of registration statements and periodic reports relating to the application of critical accounting policies and estimates. The proposals, which are significantly more far reaching than other recent proposals regarding disclosure, would require disclosure of a detailed mathematical sensitivity analysis of critical assumptions underlying the estimates. They would also require disclosure of the extent to which the audit committee has discussed the critical accounting estimates and related MD&A disclosure with management. The additional financial disclosure would not be covered by the audit report and in effect would place incremental review and due diligence obligations on the audit committee, management, and underwriters. The new requirements apply to both U.S. companies and foreign private issuers.

The proposals continue an effort by the SEC to upgrade the quality of financial disclosure with an emphasis on disclosing the fiscal sensitivities inherent in a company’s business. The new proposals build on cautionary advice issued in December 2001 in which the SEC encouraged public companies to include in their MD&A full explanations of their critical accounting policies. Many public companies responded to this advice by including in the MD&A in their annual reports a section entitled “Critical Accounting Policies” which reviewed management’s critical accounting policies in a narrative but not numerical or analytical form. Frequently the disclosure has consisted of little more than a recitation of accounting policies copied from a footnote to the financial statements.

The SEC’s new proposals—and the three examples included in the SEC’s proposing release—make it clear that the SEC is looking not just for a narrative recitation of policies but for a company-specific, mathematical sensitivity analysis of the assumptions made by management in preparing the financial statements. The proposal states that the SEC expects a typical company will have “somewhere in the range of three to five” critical accounting policies, although some companies could have none. The SEC release also includes a statement, buried in the back of the release, that “we anticipate that the average company’s application of critical accounting policies disclosure would consist of about six pages of additional text when the company is required to prepare the proposed disclosure in its entirety” (emphasis added).

The Devil is in the Desired Detail

The proposing release provides three detailed examples of hypothetical companies and the expected MD&A disclosure of critical accounting estimates. One example involves a manufacturer of electrical equipment which provides customers a multiyear warranty.
The company increases its cost of goods sold each year based on an internal estimate of the future cost of the warranty services it will need to provide to customers. Under the new proposal, simply identifying warranty expense as a critical accounting policy—something many companies have done in response to the SEC’s December 2001 guidance—would not be sufficient. Instead, the SEC now expects this company to disclose in the MD&A the following type of information:

**SEC Suggested MD&A Disclosure By a Manufacturer of Electrical Equipment**

<table>
<thead>
<tr>
<th>Topic</th>
<th>SEC Suggested Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description of the estimate</td>
<td>The company’s cost of sales is significantly impacted by management’s estimate of future warranty cost.</td>
</tr>
<tr>
<td>Key assumptions underlying the estimate</td>
<td>The cost of copper has been 35-40% of the total cost of warranty repairs over the past three years. Because over 1/3 of the cost of the warranty service consists of the cost of copper, the company’s estimate of the future cost of copper is material to its estimate of its future warranty cost and thus to its cost of sales and operating income.</td>
</tr>
<tr>
<td>Impact of estimate on a line item in the financial statements</td>
<td>In 2001 the company decreased its estimate of the cost of copper over the next 10 years by 15% due to copper oversupply. The 2001 decrease in the copper cost estimate resulted in a decrease in the company’s 2001 cost of sales of $15 million and an increase in 2001 operating income of $15 million.</td>
</tr>
<tr>
<td>Impact of a decrease in a material assumption</td>
<td>A 30% decrease in the company’s internal estimate of future copper costs would have decreased warranty cost by 6% and cost of sales by 4% and increased operating income by 9% in 2001.</td>
</tr>
<tr>
<td>Impact of an increase in a material assumption</td>
<td>A 50% increase in the company’s internal estimate of future copper costs would have increased warranty cost by 7% and cost of sales by 7% and reduced operating income by 23% in 2001.</td>
</tr>
<tr>
<td>Changes made to the estimate in the past three years</td>
<td>In 2001 the company decreased its estimate of the cost of copper over the next 10 years by 15% due to copper oversupply. In 2000 the company did not change its estimate of the future cost of copper. In 1999, because copper prices increased 28% generally, we increased our estimated cost of copper over the next 10 years by 15%.</td>
</tr>
<tr>
<td>Impact on liquidity</td>
<td>A significant increase in copper prices would result in a significant increase in warranty expense, a decrease in net income, and an increase in the company’s leverage ratio, which could limit the company’s ability to borrow under its revolving credit facility.</td>
</tr>
<tr>
<td>Audit committee review of the estimate and related disclosure</td>
<td>Management has discussed this critical accounting estimate with the audit committee and the audit committee has reviewed this disclosure in the MD&amp;A.</td>
</tr>
<tr>
<td>Impact on segments</td>
<td>The estimate for warranty obligations is a critical accounting estimate for all of the company’s segments.</td>
</tr>
</tbody>
</table>

This example, and two others provided in the SEC proposal, would require a level of detailed disclosure far beyond the current disclosures made by public companies. We are not aware of any company that has provided this type of detailed disclosure.
Critical Accounting Estimates Disclosure

As proposed, every MD&A in any annual report, registration statement or proxy or information statement would include a separately-captioned section regarding critical accounting policies and estimates. An "accounting estimate" means an approximation made by management of a financial statement element, item or account in the financial statements. Examples of accounting estimates include:

- property and casualty insurance loss reserves,
- contract obligations that will be fulfilled over several years,
- future returns of products sold,
- the amount of cash flow expected to be generated by a group of assets,
- estimates of pension and warranty expenses and
- estimates of the net realizable value of accounts receivable and inventory.

An accounting estimate is "critical" and would require disclosure if (1) it requires the company to make assumptions about matters that are highly uncertain at the time of the estimate and (2) different estimates that the company reasonably could have used, or changes in the 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 or results of operations.

The MD&A disclosure for each critical accounting estimate would include the following:

- Basic disclosures about the critical accounting estimates, including:
  - A description of the accounting estimate and the methodology underlying the estimate.
  - The assumptions underlying the accounting estimate that relate to matters highly uncertain at the time the estimate was made and any other material assumptions.
  - Any known trends or uncertainties that are reasonably likely to occur and materially affect the methodology or assumptions.
  - Why different estimates that would have had a material impact on the company’s financial presentation could have been used.
  - If applicable, why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation.
  - An explanation of the significance of the estimate to the company’s financial condition and, if material, the line items in the financial statements affected by the estimate.
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- A quantitative discussion of changes in overall financial performance, and, if material, specific line items, assuming that either (1) reasonably possible ("more than remote but less than likely") near-term ("within one year") changes occur in the most material assumption(s) underlying the accounting estimate (generally both a positive change and a negative change), or (2) the accounting estimate was changed to the upper end and the lower end of the range of reasonable possibilities determined by the company in the course of formulating its recorded estimate and, in either case, a discussion of the impact, if material, on the company's liquidity if any of the changes being assumed were in effect.

- 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.

- Whether the company's senior management has discussed the development and selection of the critical accounting estimates and the MD&A disclosure with the audit committee and, if not, the reasons for not doing so.

- If the company operates in more than one segment, the segments that the accounting estimate affects.

The proposal would also require in every quarterly report on Form 10-Q by a U.S. company the following additional disclosures:

- Disclosure regarding any new critical accounting estimate.

- For any critical accounting estimate previously disclosed, any material change to that prior disclosure necessary to make that disclosure not materially misleading.

Accordingly, if the company reviews its assumptions on a quarterly basis, significant disclosure could be required each quarter, particularly for assumptions based on commodity prices or other items that regularly fluctuate.

Proposals Call For More Forward-Looking Information

The SEC release acknowledged that the proposals will require greater disclosure of forward-looking information. The proposal would delete from the MD&A rules a statement that forward-looking information is not required and add an instruction that "your response to this section requires you to make certain forward-looking statements." Because the release calls for the disclosure of new types of information, some of which is forward-looking, it raises the possibility of incremental liability for public companies and the officers and directors who sign periodic reports. The increased focus on forward-looking information should lead companies to put greater emphasis on including sufficient "forward-looking statement" warnings (and related risk disclosure) in press releases and periodic reports so that the company can benefit from the statutory and rule-based safe harbors for forward-looking statements.
Disclosure of Initial Adoption of an Accounting Policy

The SEC proposal would also require disclosure regarding the initial adoption of an accounting policy that has a material impact on a company’s financial condition or results of operations. The initial adoption of an accounting policy may occur when events or transactions affecting the company occur for the first time, or were previously immaterial in their effect but become material, or events or transactions occur that are clearly different in substance from previous ones. The new disclosure requirement would not apply to the adoption by a company of new policies resulting from the adoption of new accounting literature by the FASB, AICPA, SEC or other recognized standard setter (which is already subject to existing disclosure requirements).

The proposal would require disclosure of the following:

- The events or transactions that gave rise to the adoption.
- The accounting principle adopted and the method of applying the principle.
- The qualitative impact on the financial condition and results of operations.
- If upon initial adoption the company is permitted a choice between acceptable accounting principles (e.g., LIFO vs FIFO), an explanation that it made such a choice, what the alternatives were, and why it made the choice it did.
- If no accounting literature exists that governs the accounting for the event giving rise to the adoption, an explanation of the company’s decision regarding which accounting principle to use and which method of applying that principle to use.

Foreign Private Issuers

The proposed rules would apply to both foreign private issuers and U.S. companies. However, the rules would be more onerous for foreign private issuers because, if their primary financial statements are presented in non-U.S. GAAP, they would need to consider critical accounting estimates in connection with both the primary financial statements as well as the reconciliation to U.S. GAAP. As a result, foreign private issuers may have to describe their critical accounting estimates under both non-U.S. GAAP as well as U.S. GAAP. Foreign governments, and Canadian issuers filing reports and registration statements pursuant to Canadian disclosure requirements under the Multijurisdictional Disclosure System with Canada, would be unaffected by the proposals.

Future MD&A Rulemaking

The SEC proposing release states that the SEC is considering other proposals with respect to the MD&A.

- The SEC is considering an explicit requirement for a summary of the MD&A that would identify what management considers the most important factors in determining its financial results and condition,
including the principal trends on which management focuses and the principal risks to the business.

- The SEC is also considering the sufficiency of disclosure regarding structured finance transactions and special purpose entities, the risks of off-balance sheet transactions, and transactions with related parties. The SEC most recently issued guidance on these topics in January 2002.

- The SEC is considering improvements to MD&A disclosures relating to trend information and the trends that a company’s management follows and evaluates in making decisions to guide the business.

Finally, the release states that the SEC is considering how to adjust the relative attention devoted in MD&A toward a more general discussion of material matters and away from a detailed description of already available or immaterial information. In what may be a suggestion of proposals to come, the release particularly attacked “rote calculations of percentage changes in figures in the financial statements combined with boilerplate recitations of a surfeit of inadequately differentiated material and immaterial factors related to such changes.”

Solicitation of Comments

The SEC proposing release specifically solicits comments on virtually every aspect of the proposals regarding critical accounting estimates, including the following areas:

- Should the definition of “critical accounting estimate” be broadened? Should it include a minimum percentage impact on results of operations?

- Should there be a maximum number of accounting estimates discussed (e.g., seven)?

- Are the proposal’s sensitivity analysis requirements appropriate for all companies? Should the rules instead set a specified percentage increase and decrease to assume (e.g., 10%)?

- Does the rule adequately address disclosure of past material changes in estimates? Should the three-year period be five years? Should there be a standardized chart illustrating the dollar value of the change from year to year?

- Is it useful to investors to know whether the accounting estimate has been discussed with the audit committee? Should this disclosure be part of the “audit committee report” included in the proxy statement?

- Is there need for further guidance with respect to the application of the safe harbors for “forward looking information”?

The SEC also solicited comment on whether auditors should be required to “examine” or “review” the accounting estimates disclosure in the MD&A. Current accounting guidelines allow companies to engage an auditor to examine and render an opinion that the disclosure in the MD&A satisfies applicable SEC requirements. However, in the
absence of a rule requiring such examinations, auditor “audits” of MD&A disclosure have historically been very rare.

Conclusion

The SEC proposals, though couched in the technical language of accounting minutiae, are much more far reaching than other recent proposals regarding disclosure. The new proposals go to the heart of what has historically been the exclusive jurisdiction of the internal and outside auditors. For the first time, the SEC is looking to require companies to describe the decisionmaking underlying the financial statements rather than just the financial statements themselves. As a result, companies will face a greater need to be able to justify their material assumptions to the investors and analysts that follow their company. Many investors probably do not realize the extent to which estimates and judgment play a role in preparing the final numbers for a specific company. Moreover, by requiring that the disclosure be placed in the MD&A rather than the financials, the SEC is tacitly encouraging more involvement by a broader group of financial gatekeepers—underwriters, auditors, audit committees and lawyers—in the preparation of MD&A disclosures. Finally, the SEC may also be acknowledging what many of us suspect—that many investors are more likely to read the MD&A than the financial statements themselves. Comments on these proposals are due at the SEC within approximately 60 days.

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